

# The Credit Outlook

## Fragility and Interconnectedness Special Report

The Credit Outlook provides an overview of Fitch Ratings' outlook across all rated sectors and regions, identifying the main macro factors that will drive credit trends over the next 12-24 months. It is published semi-annually.

**Macro Themes Dominate:** The credit environment continues to be dominated by macro themes and issues confronting sovereign credit – from austerity to bailout packages to debt ceilings. The benefits and pitfalls of strategies to improve growth and trim deficits are not yielding sustained results in key developed markets.

**Euro-Zone Debt Crisis:** A crisis of confidence in the policy response to the euro-zone sovereign debt crisis has greatly increased the risk to sovereign and financial sector stability across the region. While the catalyst was once again a crisis in Greece, the lack of a coherent and unified policy response at the European level and the focus on 'private sector involvement' has sparked contagion across the region, including to Italy, its third largest economy.

**US Debt:** The US is risking its own governance and sovereign debt crisis through the brinkmanship over lifting its statutory government debt ceiling. However, Fitch Ratings considers the possibility of a US default remote.

**Market Volatility:** Confidence is key to recovery and to the proper functioning of markets. Conflicting data and statements of central bankers and policy makers, the magnitude and breadth of the issues, as well as the interconnectedness of these challenges weigh heavily on regaining confidence.

A disorderly Greek default would be likely to result in severe market volatility, pressures on sovereign as well as bank funding and liquidity, and a broader repricing of euro-area sovereign credit. The risk of contagion to other distressed and vulnerable euro-area sovereigns and their banking systems is material.

Resolution of the Greek crisis is therefore a necessary, though not a sufficient condition for preventing a broader systemic threat to the euro area. Likewise, default by the US – the world's largest borrower and issuer of the pre-eminent reserve currency – would threaten US and global financial stability.

### Related Research

[Appendix: Select Related Research](#)

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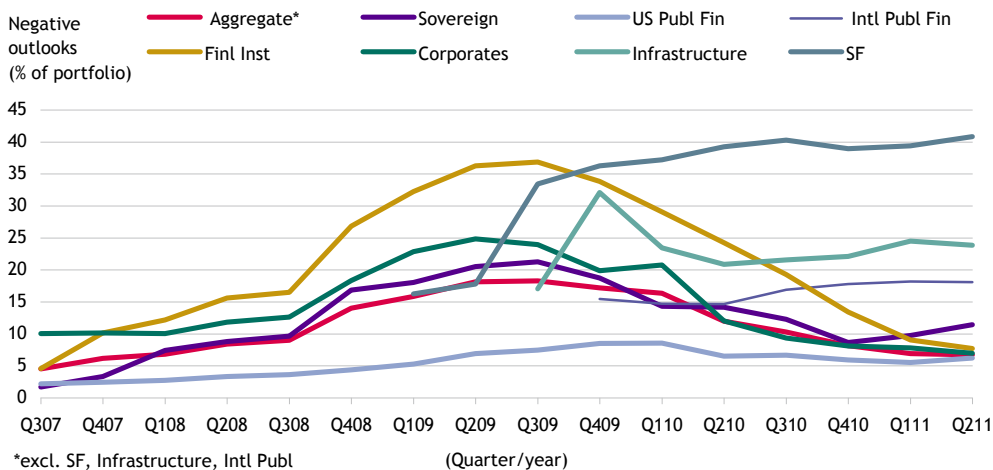
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Figure 1

### Rating Outlooks - Largely Stabilising but with Notable Exceptions



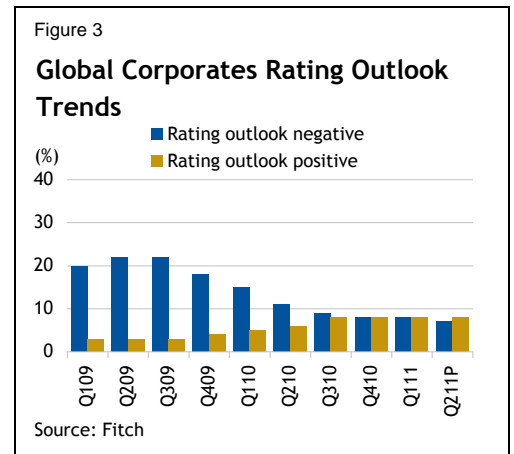
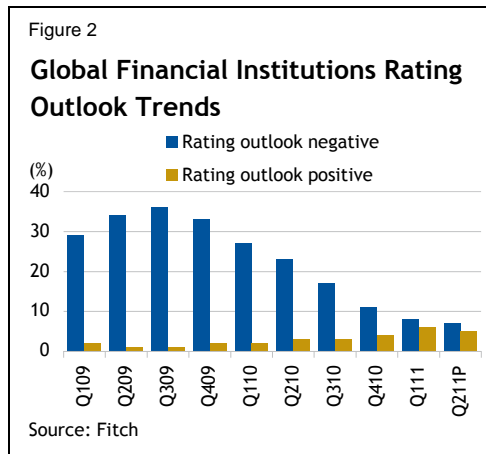
**Growth and Funding**

**Soft Patch in Growth:** Recent weakness in growth is largely attributed to the natural and nuclear disasters in Japan in March. While Fitch has recently downgraded its growth forecast for 2011 for certain major economies, including the US, Japan and the UK, this temporary softening should be rectified in the second half of the year. The downward revisions were largely offset by an upward revision of the forecast for the euro area, where Germany remains the main growth engine.

**Areas of Strength:** Emerging market dynamism is still the main driver of the global recovery, although growth is decelerating as monetary policy tightening takes hold in the context of rising inflation. Industrials have improved profitability through cost cuts, with some companies also enjoying top-line growth. Large banks' earnings shows improvement as some economic stimulus has resulted in asset quality stabilisation, reducing provisioning.

**Funding:** The capital markets are more important than ever. Euro-zone periphery sovereigns are very exposed to market volatility and confidence. Many banks remain reliant on debt that is either government guaranteed, secured or short-term. While investors' search for yield has been positive for the high-yield and emerging-market sectors since 2010, recent funds flow data indicates a more cautious attitude to risk.

**Outlooks Overview**



- Rating outlook stability achieved in most sectors
- Trend-breakers: euro-zone periphery sovereigns and public finance as well as US RMBS

Rating outlooks have continued to stabilise, with just under 7% of ratings now on Negative Outlook - on a par with the level in Q108. This is a significant reduction from the peak of 18% in Q309. While this partly reflects a recovery of credit-profile strength, in many sectors ratings have stabilised at a lower level than pre-crisis.

The outlook for ratings is more negative in some important areas, notably euro-zone peripheral countries. The problems in these countries have a knock-on effect for their respective local and regional governments, which are getting squeezed between reduced state funding and lower tax collection and other revenue. In the US, the rating outlook is negative for a small number of revenue supported public finance sectors. However, this shift comes from a backdrop of overall very strong credit profiles – Fitch rates 98% of US PF issuers at investment grade, making it the most highly rated sector ahead of insurance (96%).

A negative bias to Outlooks remains in US RMBS, with house prices still on a declining trend and the loan foreclosure process having become more complex. In Europe, Negative Outlooks within the Infrastructure sector are concentrated in the whole business sector where credits are adversely affected by changes in demand, particularly in the pub segment.

**Outlook Trend**

- There are divergent trends in sovereign credit quality between fast-growing emerging economies and developed market

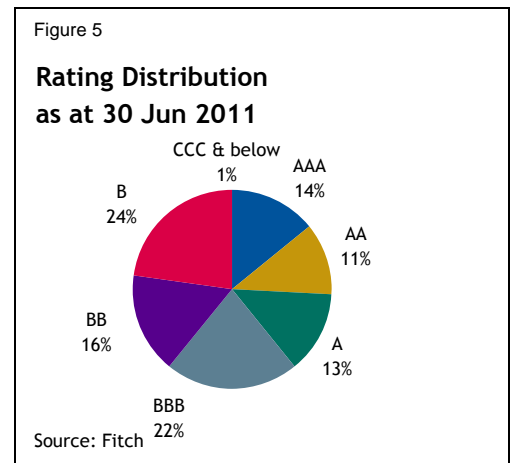
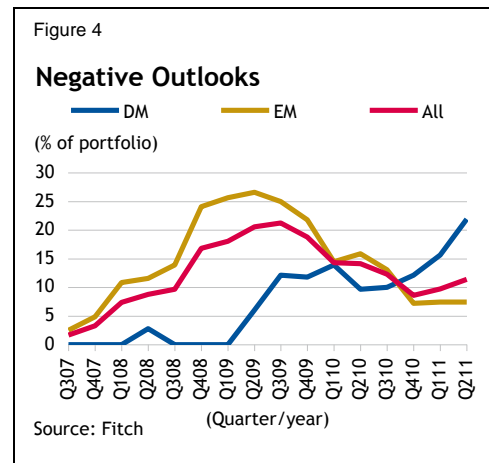
**Key Risks**

- The euro zone sovereign debt crisis is approaching tipping point
- The US will avoid default but fails to establish fiscal credibility
- Inflation undermines macro-financial stability in emerging markets

**Sovereign**

The fragility of the global economic recovery has been highlighted by weak Q111 GDP numbers in several major economies, slowing global manufacturing indicators and concerns about the effect of monetary policy tightening on key emerging markets (EM). However, with much of the slowdown attributable to temporary factors — the impact of higher oil prices and the Japanese natural disasters of March 2011 — Fitch maintains that the global economic recovery is on track, albeit at an uneven pace from quarter to quarter, and from country to country. Nonetheless, by historical standards, recovery in the major advanced economies, notably the US, will remain lacklustre, unemployment will stay elevated and central banks will remain reluctant to raise policy interest rates despite inflationary pressures arising from rising commodity prices.

Fitch expects world growth to moderate to 3.1% in 2011, having reached 3.8% in 2010, and to rise to 3.4% in 2012 and 2013. Major advanced economies (MAE) are expected to register growth of 1.9% in 2011, rising to 2.3% for 2012 and 2013.



**Developed Markets**

The US, Japan and the UK face a formidable challenge to reduce large budget deficits and stabilise high and rising public debt ratios, in an environment of high private-sector debt and weak growth. Even countries with strong “monetary sovereignty” face a persistent budget constraint, and a failure to stabilise public finances would put downward pressure on ratings over the medium term.

Japan's sovereign Foreign- and Local-Currency IDRs of 'AA' and 'AA-' were placed on Negative Outlook in May reflecting concerns over the failure to articulate a credible medium-term fiscal consolidation strategy that would stabilise public debt, which in gross terms reached 201% of GDP, the highest of any rated sovereign government.

*Europe*

The euro-area sovereign debt crisis and fears of a Greek default remain the predominant sovereign credit theme and risk for the global economic and credit outlook. A disorderly Greek default would be likely to result in severe market volatility, pressures on sovereign and bank funding and a broader repricing of euro-area sovereign credit. The risk of contagion to other distressed and vulnerable euro-area sovereigns and their banking systems is significant.

Resolution of the current Greek crisis is therefore essential — although not sufficient — to prevent a systemic threat to the euro area. Following parliamentary approval of further austerity and reform measures against the backdrop of social and civil unrest, the EU and IMF approved the disbursement of a further EUR12bn that will be sufficient to fund Greece through to September. However, no agreement has been reached on an extended and fully-funded EU-IMF programme of support for Greece as policymakers have failed to agree on the nature and

extent of private sector involvement (PSI) in any new package of financial support for Greece. An exchange or “voluntary rollover” in order to secure PSI would probably be viewed by Fitch as a sovereign default event.

The focus of European policymakers on PSI rather than developing a credible solution to the Greek crisis and a coherent and unified response to the broader sovereign and bank crisis has prompted a loss of market confidence in the region, with contagion spilling over to Italy, the third largest economy in the euro zone. In order to prevent a systemic threat to the financial stability in the euro zone as a whole, a more focused and effective policy response is necessary. This is likely to involve greater resources and flexibility for the European Financial Stability Facility (EFSF) and secondary market purchase of sovereign debt, as well as clarity on the role of private sector creditors and dealing with the Greek crisis.

#### *North America*

In Fitch's opinion, agreement on the debt ceiling will ultimately be reached and the US government will make full and timely payments on its debt. Nonetheless, failure to act in a timely manner could imperil the country's 'AAA' status and in the event that the debt ceiling is not raised by 2 August (the date that the US Treasury exhausts its borrowing authority), Fitch will place the US sovereign rating on Rating Watch Negative. Default by the world's largest borrower and issuer of the pre-eminent reserve currency would threaten US and global financial stability, especially in the context of the euro-area debt crisis.

Leaving aside the debt ceiling issue, the US faces a more fundamental challenge of how best to place its public finances on a sustainable path over the medium to long term. Fitch projects the general government to be in deficit of around 10% of GDP in 2011, the largest of any 'AAA' rated sovereign. Moreover, the agency expects the ratio of general government debt to GDP to reach 100% in 2012 — again the highest in its rating peer group. The 'AAA' status of the US is underpinned by the flexibility and dynamism of its economy, and the special financing flexibility that derives from the dollar's role as the world's predominant reserve currency. Nonetheless, even the US government faces a durable budget constraint. Failure to reduce the budget deficit and stabilise public debt would eventually erode confidence in US sovereign creditworthiness and its 'AAA' status.

#### **Emerging Markets**

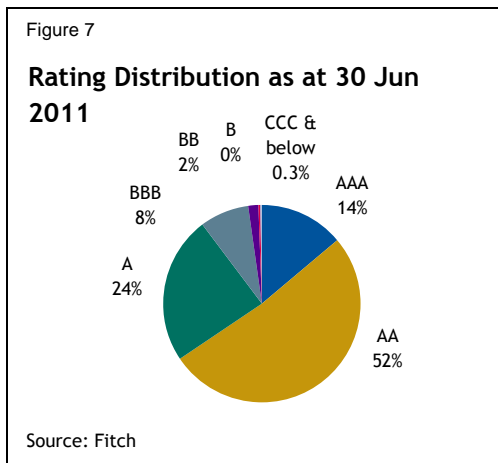
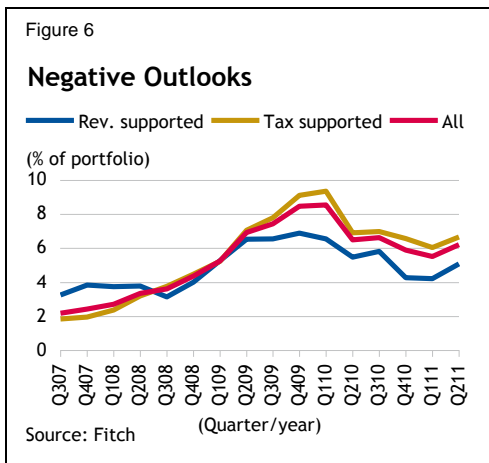
In contrast, EMs are growing strongly and, in aggregate, have moderate and declining budget deficits, relatively low government debt ratios and are continuing to accumulate large stocks of foreign reserves. Fitch forecasts EM GDP growth at 5.7% in 2011 and 2012, down from 6.8% in 2010. This provides a supportive backdrop for EM creditworthiness.

Nevertheless, sustaining robust growth requires reorientating it away from exports to sluggish MAEs and towards domestic demand, and reforms to ease supply-side bottlenecks and timely policy action to forestall overheating. Extremely loose monetary policy in MAEs has fuelled strong capital inflows in some large EMs, posing a policy challenge to prevent inflation, excessive exchange rate appreciation and potential threats to macro-financial stability. Fitch placed China's local currency rating ('AA-') on Negative Outlook in April reflecting concerns over asset quality in the banking sector against the backdrop of rising inflation pressures. Rising commodity and food prices have exacerbated fiscal and political risks across several emerging market economies and as the “Arab Spring” has underlined, potential political shocks remain an important risk factor in a number of EMs.

Public Finance – US

Outlook Trend

- Mostly stable with the exception of a small number of revenue supported sectors, where the outlook is more negative



Key Risks

- Continued real estate downturn
- Rising pension-related fixed costs
- Downshifting of state responsibilities to local governments

The US public finance outlook for H211 is characterised by limited economic recovery. Nearly all states have adopted balanced budgets for fiscal 2012, offsetting the loss of federal fiscal relief primarily with significant spending cuts, including cuts to local aid, alongside a recovery in sales and income tax revenue. Local and state governments (LSGs) across the country continue to face varying degrees of fiscal and economic pressure as the prospects for recovery differ widely across the sector. In light of this pressure, Fitch anticipates downgrades to continue to outpace upgrades, although ratings stability will continue to dominate the sector.

Local governments reliant upon property taxes will be negatively affected by continued declines in real estate values and/or assessed valuations, as well as declining or delayed state funding and/or the shifting of responsibilities from states to local governments. School districts and counties will be most affected by state actions and the former will also suffer the loss of direct federal stimulus money. With falling revenues, reserve levels may continue to decline. This may lead to increased seasonal borrowing for cash flow, although Fitch believes most local governments will continue to retain at least a moderate level of reserves.

For fiscal 2012, local governments are taking a more realistic approach to budgeting. Cost-cutting efforts focus on labour costs, as they make up the bulk of overall spending. Labour contracts with low or zero wage increases have become increasingly common, and in some cases wages are being reduced. Potential adjustments to pension benefits and employee participation levels have become a greater focus of labour-related actions. Nevertheless, pension costs will continue to be a heavy, and sometimes increasing burden in municipal budgets. Healthcare plan design changes and the introduction, or extension of employee cost sharing are also being implemented. Layoff activity is also likely to continue, with the emphasis shifting away from furloughs to more permanent measures.

Despite current elevated levels of financial pressure, Fitch believes that, as a class of debt, municipal tax-backed credit remains strong and that while the incidence of default may increase from very low historical levels, defaults will continue to be isolated situations. In addition, LSGs have captive tax bases and significant control over taxing and spending, and bond security for general obligation and dedicated tax bonds is sound. Furthermore, due to market norms of 20- to 30-year principal amortisation, credit exposure to large bullet maturities and consequent refinancing risk is limited. Debt levels for these issuers are relatively low, with annual debt service representing a relatively small part of budgets, generally less than 10% and in many cases much less.

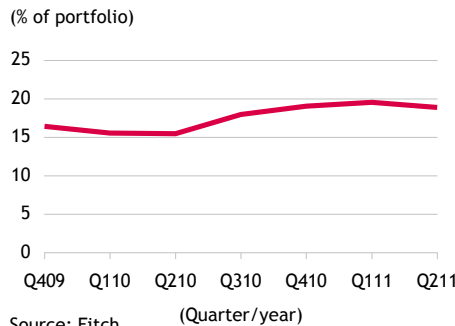
Public Finance – International

Outlook Trend

- Developed markets: negative
- Emerging Markets: stable to positive

Figure 8

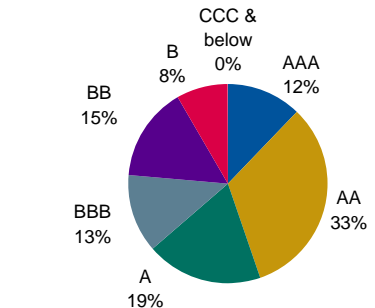
Negative Outlooks



Source: Fitch

Figure 9

Rating Distribution as at 30 Jun 2011



Source: Fitch

Key Risks

- Slower-than-expected fiscal recovery
- Inability to cut back operating expenditure sufficiently
- Continued difficulties in accessing long-term financing

Developed Markets

**EMEA:** As anticipated, negative rating action has dominated the first six months of 2011 and is expected to continue to do so for the rest of the year. The majority of negative rating actions continue to be related to Spanish regions, as the difficulties in significantly reining back operating expenditure and the weak fiscal recovery are still resulting in overall deficits. In addition, the need to control general government deficits has been instrumental in French subnationals maintaining strict adherence to central government imposed budget discipline. However, the requirement to fund social responsibilities in a context of increasing unemployment has contributed to an impairment of budgetary performance of French departments, German Laender and Italian subnationals.

Still-weak consumer confidence and high levels of unemployment will particularly hit VAT and personal income tax receipts, respectively. Property-related tax revenues are also expected to be depressed both as a result of the halt in construction activity in many countries and the continued decline in house prices which has contributed to a contraction in the tax base. Although measures have been introduced to curb the rise in expenditure, these have not yet been sufficient to compensate for the revenue loss. Rating actions should begin to stabilise by late 2012 as fiscal revenues begin to pick up and central government imposed control on expenditure becomes more institutionalised.

Emerging Markets

**EMEA:** The budgetary performance of subnationals in European emerging markets, such as Russia and Turkey, have not been as badly affected, as they have traditionally enjoyed higher operating margins and accumulated considerable reserves from surpluses in previous years. In fact, Fitch has taken positive rating actions in subnationals in these countries.

**Latin America:** The deterioration in fiscal performance for Mexican and Colombian subnationals which occurred in 2010 due to revenue decline has now seen signs of recovery and Fitch expects overall budgetary performance to improve in 2011. However, the increased use of short-term debt, primarily in Mexico, has raised liquidity concerns. Severe rain in Colombia because of La Niña has placed pressure on capital spending in those regions hit by the weather. In Argentina, the provinces are very much dependent on federal transfers and their potential fiscal recovery will depend on the improvement in the national economy. Nevertheless, some issuers, such as the Province and City of Buenos Aires have succeeded in tapping the international capital markets recently.

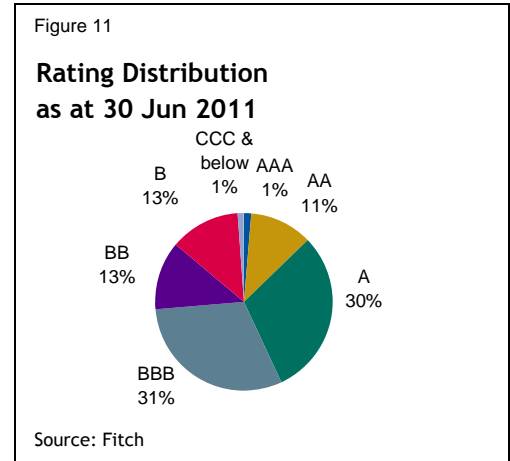
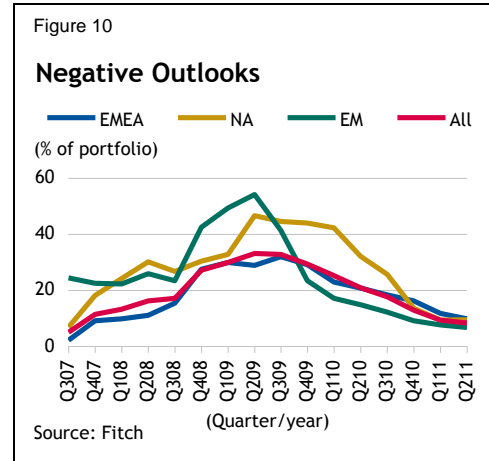
**Outlook Trend**

- Continued stabilisation in performance balanced against downside risks of economic recovery reversal and shocks from sovereigns
- Immediate negative pressure most acute in peripheral euro-zone markets
- Sovereign rating actions remain key rating driver as support continues to play a role in IDRs assigned to some major banks in Europe

**Key Risks**

- Disorderly path of resolution for sovereign budget issues in peripheral euro zone, resulting in sharply increased creditor risk aversion towards European banks
- Recent economic improvement in many major markets remains fragile, hampering loan growth and profit recovery
- Funding trends remain biased toward short-term, secured and recently invoked government programmes

**Financial Institutions**



**Developed Europe**

Developments in the peripheral euro-zone countries, especially Greece, are likely to be the main area of rating focus. With a handful of exceptions, major European commercial banks exposure to Greek sovereign risk is not by itself large enough to justify concern of widespread bank solvency problems stemming from a Greek restructuring or rollover event. Fitch's primary concern would be the risk of a disorderly contagion spiral, including a sharp increase in creditor risk aversion to European banks. Most major European banks have used the past two years to bolster capital and liquidity, leaving them with considerably improved balance sheets. Provided contagion risks can be relatively quickly contained, most major European banks should be able to absorb the immediate credit, market and liquidity risks with only minor, if any, negative rating actions. However, should contagion risks amplify and prove durable, many more European banks would be at risk of negative rating action.

**North America**

The financial performance and profile of US banks continue to improve. The uncertain prospects for the domestic economy are likely to lead to restrained loan growth and revenue generation, leaving future improvement in profitability highly reliant on lower asset quality charges. The recent emergence of commercial loan growth and competitive pressures on pricing and terms is notable given the still challenging operating environment. Ongoing implementation of financial reform legislation will remain influential, particularly in the areas of regulatory capital and liquidity. Merger and acquisition activity is expected to continue to increase as buyers gain comfort with their ability to gauge the future prospects of potential sellers. The major Canadian banks present less immediate concern relative to peers in the US and developed Europe. However, domestic economic conditions and future performance of residential real estate are turning less benign.

**Emerging Markets**

EM banks continue to fare well relative to peers in the developed world. This is particularly true for much of Asia and Latin America, where most economies continue to grow, or have returned to growth. However, stubborn inflationary pressures have resulted in tighter monetary policy in many markets. This will put pressure on asset quality, notably where growth has been the most rapid, such as in China, Brazil and India. With the exception of China, leading banks in many EMs continue to show sound financial strength, with most risks evident on their balance sheets. Banks in most of central and eastern Europe and the Commonwealth of Independent States continue to work through asset quality problems which arose during the crisis, and in some of these markets Fitch only expects non-performing loans to peak during H211.

**Outlook Trend**

- The global insurance sector has a stable ratings outlook

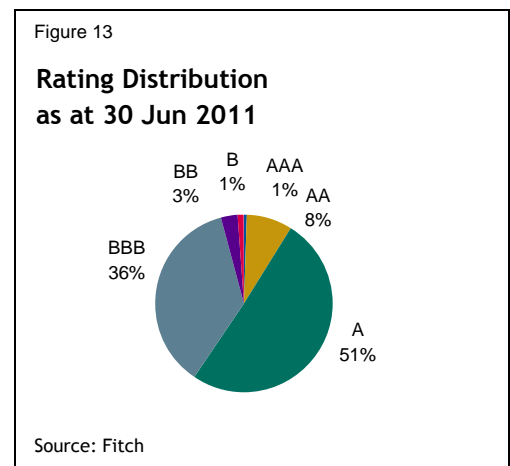
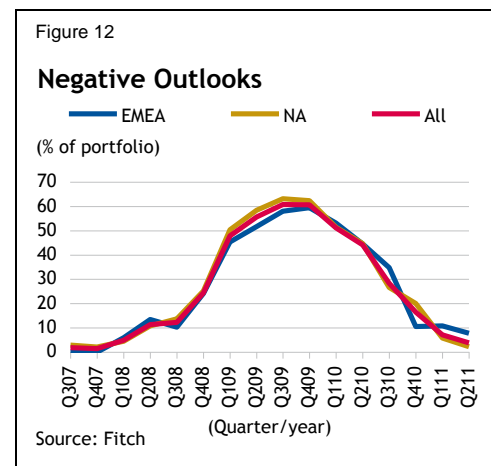
**Key Risks**

- Sovereign risk contagion
- More catastrophic losses
- Interest rate uncertainty
- Non-life pricing and reserving

**Insurance**

Outlooks on insurance ratings continue to stabilise, with only 4% of the portfolio on Negative Outlook relative to 60% during the height of the financial crisis. While Fitch is concerned about potential disorderly restructuring in the euro-zone which could cause dislocation within the broader marketplace, direct investment exposure to Greek sovereign debt is low for European insurers. Insurers are also contending with complex regulatory issues, including the impending introduction of Solvency II.

The Japanese earthquake on 11 March will probably be among the largest insured losses in history. Japanese insurers have not been downgraded, though four non-life insurers were initially placed on Negative Watch, but subsequently affirmed with Stable Outlooks on 13 June. Insurers benefited from strong reserving prior to the event, ongoing robust capital levels and the government-backed earthquake insurance system. Fitch believes that ultimate losses will match or fall below the agency's stress scenario estimate created shortly after the event.



**Life**

Asset values continue to show improvement and unrealised loss positions have strengthened modestly in 2011. Mortgage loan performance within US insurer portfolios have done better than assumed within Fitch's stress analysis used to assess asset risk in the financial crisis, and overall losses remain within projections. Interest rate risk is a key concern, especially in Europe where some markets offer guaranteed crediting rates, though a steady increase in interest rates over time may turn out favourably for life insurer earnings' quality. The US sector's large in-force variable annuity business is likely to be a near-term drag on profitability.

**Non-Life**

Current ratings assume ongoing weak underwriting fundamentals. In the US, personal lines continue to generate underwriting losses, aided by high catastrophe losses in recent quarters, and commercial lines are also weak led by poor results in workers compensation. In many European countries, the soft premium rate environment for motor insurance continues to be a drag on earnings. Issuers are seeking to address this issue through widespread premium rate increases.

**Reinsurance**

Global catastrophe losses have profoundly affected the marketplace in 2011. Losses from the Japanese and New Zealand earthquakes and Australian floods combined to increase the first quarter loss ratio to 138% from 103% the prior year. Despite these events, the reinsurance sector incurred only a 2% reduction in GAAP equity. The margin for error has shrunk significantly as risk mitigation plans have been heavily utilised and further events may lead to capital losses. In the absence of further catastrophic events, despite marketplace commentary, Fitch does not anticipate rate improvement in the near term for this sector.

**Outlook Trend**

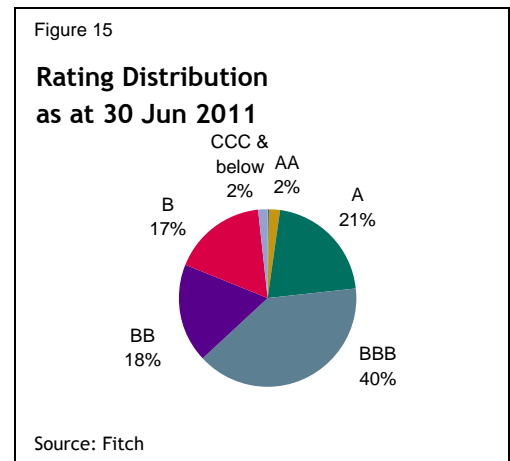
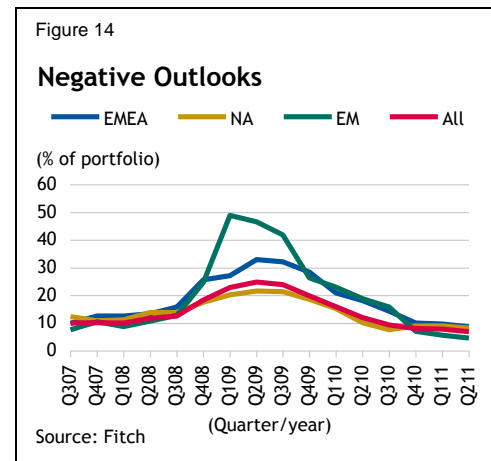
- EMEA Outlooks stabilising with H111 upward momentum slowing
- Slowing recovery favours Stable over Positive Outlooks in the US, but no increase in Negative Outlooks expected

**Key Risks**

- Political deadlock on resolving deficits in the US and Europe
- Financial market crisis impact on confidence and liquidity
- Oil price shock

**Corporates**

Corporate credit trends should remain on a flat-to-upward trajectory, with modest economic growth, improving operating profiles and good liquidity offsetting a number of still-weak macroeconomic factors. The combination of slowing growth and low interest rates is driving more shareholder-biased behaviour, especially in the US where share buybacks and dividends have increased. There is limited risk to ratings due to the generally prudent corporate approach to protecting credit profiles as well as strong corporate balance sheets. Global macro concerns remain tangible enough that most corporate issuers remain cautious in their outlooks on spending and investment. The strongest growth continues to come from EM exposure, although slowing growth in China and evidence of overheated EM economies makes this source of strength more fragile.



**EMEA**

Fitch's growth assumptions for developed markets in H211 and beyond remain subdued, with little more than inflationary growth and moderately worsening EBITDA margins, following a strong rebound in corporate performance in 2010. Combined with strong liquidity for most corporates, there is some tolerance in ratings for negative surprises. The risk of corporate downgrades as a result of further peripheral euro-zone negative sovereign rating action is limited, partly due to the absence of material transfer and convertibility risk in the single-currency zone. In an orderly default scenario, internationally diversified companies may see no impact on their ratings.

**US**

The US economy is slowing with the end of stimulus programs such as QE2, federal aid to states, and tax subsidies for housing. House prices, consumer confidence and consumer spending are still falling; unemployment is more stubborn. Any pent-up demand is currently being suppressed by perceptions of deteriorating economic conditions and increased uncertainty. Nonetheless, Fitch expects the weak recovery to continue unless exogenous shocks from financial or energy markets spill over into the real markets for goods and services by reducing demand for consumption and investment.

**High Yield**

Booming appetite for high-yield (HY) debt in the capital markets since early 2010 has helped reduce the refinancing risk in this segment globally, although recent funds flow and new issuance pipeline data indicate a cooling of investor interest. In Europe fragile markets do not provide a ready open market for deeper HY issuance. Consequently, a EUR300bn wall of refinance risk spanning 2012-2015 for around 300 'B-/CCC' leveraged credits remains an issue, also affecting their existing reluctant bank and CLO creditors. In the US modest GDP growth, improving corporate fundamentals and a lower trending default rate is expected to continue to drive strong issuance. Bond-for-loan take-outs are expected to continue to drive a majority of refinancing volume, in particular secured bond volume, in H211.

**Outlook Trend**

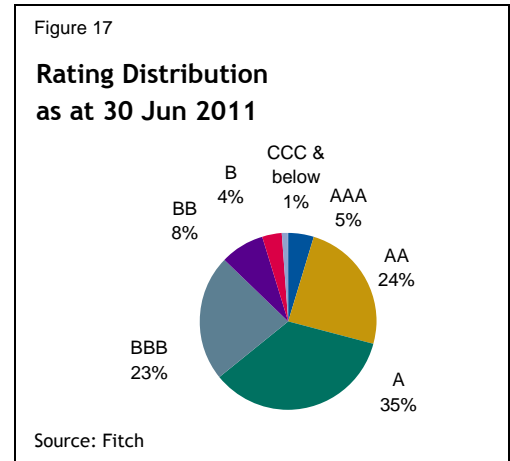
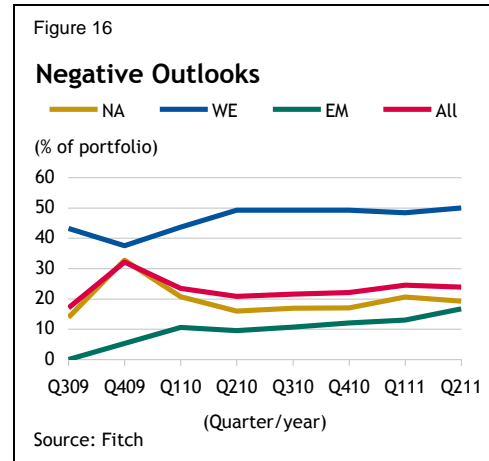
- Stable with some Negative Outlooks reflecting industry or asset specific stress

**Key Risks**

- Sustained higher fuel prices
- Weak consumer spending
- Low economic growth
- Government budget cuts

**Global Infrastructure and Project Finance**

Global infrastructure and project finance ratings are generally stable with some negative outlooks reflecting industry or asset specific stress. With the exception of merchant power facilities, energy infrastructure projects typically pass through macroeconomic risks to offtake counterparties. These remain stable with little upside in their rating profile. The outlook for transportation infrastructure globally remains mixed, with leverage issues driving the outlook, although the threat of higher fuel prices and tepid consumer discretionary spending are visible on the horizon.



**North America and Latin America**

Energy and industrial credits which rely substantially on power purchase agreements are largely insulated from input and output price changes in the energy market. Some merchant facilities, principally coal fired thermal projects, are affected by the rapid development of new natural gas resources in the US and Canada, leading to lower dispatch and price for output. This has led to downgrades and continuing Negative Outlooks.

Transportation infrastructure has been generally experiencing growth in demand globally since mid-2010. However, that demand is sensitive to increasing fuel costs and tighter consumer budgets. Outlooks remain largely Stable, with Negative Outlooks largely relating to infrastructure assets with debt structures requiring additional growth to maintain leverage ratios commensurate with the existing rating, or heightened risks to levels of government funding for infrastructure. Latin American economies remain resilient, supporting Stable Outlooks for energy and transportation assets.

**EMEA**

Negative Outlooks are concentrated in the whole business sector where credits are adversely affected by changes in demand, particularly in the pub sector. Oil and gas projects benefit from higher oil prices and are stable. Government budget concerns may impact renewable energy credits.

Outlooks have stabilised among the airports and toll roads portfolios in Europe as the ratings already capture the downside. Moreover, although economic prospects are better, they do not justify a Positive Outlook. The dominant credit themes for H211 will be common to all road types and airports: the resumption of sustained economic growth; the potential impact of higher oil prices; and the costs and benefits of higher inflation. Large and resilient toll-road networks protected from competition (mainly in Italy and France), should perform well, although without much growth. Networks exposed to more competition from toll-free national roads (eg, Spain), and those exposed to less robust economies (eg, Portugal) may continue to suffer from low growth or even slight declines. This risk is included in current ratings. Similarly, large hub airports may grow slowly, while being better protected against any residual downside risk.

Structured Finance

Outlook Trend

- US outlook trend gradual improvement but RMBS still negative
- EMEA outlook trend overall towards stabilisation

Key Risks

- High unemployment and the risk of a double-dip recession
- Sovereign event risk in euro zone
- Rising interest rates and impact on underlying asset performance
- Impact of austerity measures
- Approaching refinancing risk in CMBS and CLOs, especially in EMEA

Figure 18

Negative Outlooks\*

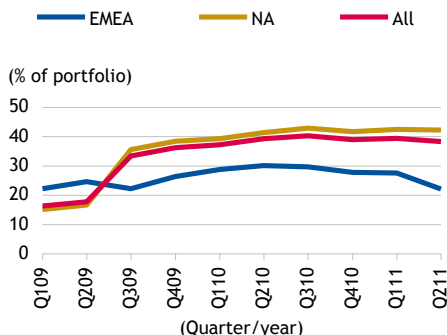
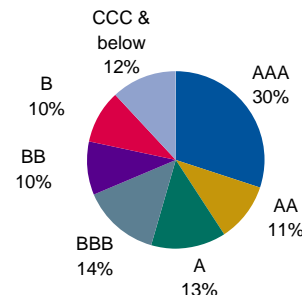


Figure 19

Rating Distribution as at 30 Jun 2011



\* The data in the chart reflects numbers of tranches giving bias to thinner subordinated tranches at the expense of thicker senior tranches. Subordinated tranches are more likely to have Negative Outlooks, while senior ones are more likely to have a Stable Outlook. Furthermore, senior tranches are usually paid down first which will increase the proportion of subordinated tranches. Ratings which have moved into distressed categories are not assigned Outlooks. This also affects the relative proportions of Outlooks  
Source: Fitch

US

Most sectors of US structured finance (SF) should see further rating stabilisation, particularly for more senior-rated classes, despite the slower rate of economic recovery in the US. Outlooks in RMBS are still generally more negative, reflecting continuing adverse asset performance trends. While stresses associated with current high unemployment levels have been factored in to current rating levels across US SF, prospects for improvements in asset performance in most sectors are limited due to the expectation of continued weak macroeconomic conditions.

With few exceptions, the outlook for ratings across Consumer ABS product types remains stable to positive. Healthy levels of credit enhancement and strong structural protections in credit card transactions are expected to absorb stresses from continuing high unemployment. The ratings outlook for Auto Loan ABS is positive, as transactions benefit from rapid deleveraging, a strong wholesale vehicle market, and more conservative underwriting of recent vintages. Private student loan transactions are an area of weakness, where asset performance and ratings remain vulnerable to negative trends, given historically weak or volatile underwriting and persistently high unemployment levels.

CMBS ratings continue to stabilise, particularly for investment-grade classes. Commercial property fundamentals are likely to maintain a gradual, albeit uneven, improvement. The sector remains burdened by a legacy of overleveraged, underperforming properties financed between 2005 and 2008, which will drive increases in CMBS loan delinquency rates through 2011, although at a slowing rate. However, increasing stability in ratings is anticipated, especially for investment-grade classes, given recent rating actions. Growth of CMBS new issuance volume in H111 has been notable but with mixed results and deteriorating underwriting standards.

RMBS rating outlooks remain generally negative, although the severity of negative rating actions is expected to continue to moderate. The outlook for asset performance is still predominantly negative, reflecting Fitch's expectations for further home price declines of 5% to 10% nationally over the next two years. In addition, Fitch's loss assumptions related to the loan foreclosure process have been increased, as foreclosure volume and procedural changes have expanded the amount of time needed to liquidate a loan. A greater degree of rating stability is expected in the Alt-A and Subprime sectors following recent rating actions. Ratings in the prime sector are expected to see some further actions during H211, but are expected to similarly

show greater rating stability thereafter. The loan performance of borrowers with large negative equity positions (33%, 50% and 53% of loans in Fitch-rated prime, subprime and Alt-A RMBS respectively as at March 2011) continues to be an ongoing concern.

Within structured credit, Outlooks are stabilising in senior classes, while subordinate classes of transactions in most sectors will remain vulnerable to continued volatility in asset performance. CLOs are a positive exception, as improving credit trends in the US HY market have led to generally strong performance, with low default levels and rapid deleveraging of transactions beyond their revolving period. These positive trends are reflected in the re-emergence of new CLO issuance.

## EMEA

The overall trend of rating stabilisation is jeopardised by sovereign event risk in the euro-zone peripherals. All outstanding SF tranches in Greece and Portugal remain on RWN, following recent sovereign-triggered downgrades. Whilst performance across several other jurisdictions and asset classes has continued to improve, anticipated Q311 interest rate increases may reverse this trend.

Macroeconomic recovery across Europe is expected to continue to support the good performance of ABS transactions, exemplified by the declining delinquency numbers in UK credit card and Spanish consumer sectors. However, the arrears declines are relatively modest and the benign outlook is sensitive to any economic setback or interest rate rises.

The RMBS sector is subject to very similar risks, especially in Spain, Italy, Portugal and Greece, where the majority of loans in the underlying pools are linked to Euribor. Interest rate rises may lead to a wave of new arrears and defaults in the course of 2012. Austerity measures may negatively affect the future performance of the underlying borrowers. This follows the stabilising arrears trend in RMBS which continued to dominate most jurisdictions in H111.

Refinancing remains the key driver of CMBS transaction performance, with loan maturities peaking in 2013,- especially for non-prime collateral, given the constraints on debt funding. The sector remains divided across Europe between prime markets, which have shown signs of recovery with renewed interest from lenders, and non-prime markets, which remain depressed. Transactions continued to perform in line with Fitch's expectations during H111 and the proportion of tranches on Negative Outlook continued to decrease.

Fitch expects continued stability in structured credit senior note ratings, driven mainly by an expected improvement in the performance of SME CDOs. This reflects the benefit of transaction deleveraging and improved recovery expectations. Refinancing risk is still a concern for leveraged loan CLOs which outweighs positive trends in performance.

## Covered Bonds

The outlook for covered bond ratings remains stable at high investment-grade levels. The advantages of dual recourse, ie, payment obligation by the lending entity as well as access to the securing collateral in case of lender insolvency, are expected to weather current economic challenges and the numerous regulatory and funding pressures faced by many issuers. There is a heightened risk of negative rating action among the 19 programmes (15% of all rated programmes) currently on Rating Watch Negative, mainly relating to issuance from Greece, Portugal and Ireland. In other countries actions may arise from downgrade action on individual issuing banks.

## Appendix: Select Related Research

### Sovereign

Rating Linkages to the U.S. Sovereign Rating A Sector and Transaction Analysis (July 2011)  
Global Economic Outlook (June 2011)  
Sovereign Data Comparator (June 2011)  
Thinking the Unthinkable: What if the Debt Ceiling was Not Increased and the US Defaulted? (June 2011)  
Sovereign Review and Outlook (June 2010)  
Macro Prudential Risk Monitor (June 2011)  
Fitch Outlines Rating Approach to a Sovereign Debt Exchange (June 2011)  
Potential Rating Implications of Vienna Initiative or Debt Exchange for Greece (June 2011)  
Economic Impact of Political Unrest in MENA (May 2011)  
Middle East Political Risk Erupts (March 2011)  
Eurozone Sovereign Snapshot (March 2011)

### Public Finance

Risks to Italy's Public Finances (July 2011)  
French "Etablissement Publics": Diverse Situations, Common Rating Criteria (June 2011)  
Continued Efforts Needed to Meet Spanish Autonomous Communities' Deficits Targets (June 2011)  
U.S. Public Finance Rating Actions for First-Quarter 2011 (June 2011)  
California's Budget Crisis Not Over (May 2011)  
State Influence on Local Government Credit (May 2011)  
State Funding Cuts Across the Land (Another Challenge for Municipal Budgets) (April 2011)  
2011 Outlook: U.S. Public Finance Sector Profiles (March 2011)  
Assessment of the Institutional Framework for Subnationals (March 2011)  
Spanish Provinces under the Common Regime: Sound Budgetary Situation Well Supported by Institutional Framework (February 2011)

### Financial Institutions

No Rating Impact from EBA Stress Tests; Sovereign & Funding Risks Main Concern for EU Banks (July 2011)  
Chinese Banks - Growth of Leverage Still Outpacing GDP Growth (July 2011)  
Russian Banking Sector in 2011: Back on an Even Keel (June 2011)  
European Bank Exposure to GIPs (June 2011)  
U.S. Money Fund Exposure to European Banks Remains Significant (June 2011)  
Trends in Bank Funding Profiles (June 2011)  
Japan's Major Banks: Interest-Rate Risk Likely to Remain Manageable (June 2011)  
U.S. Bank Loan Growth: Implications for the Economy and Bank Ratings (June 2011)  
EM Banking System Datawatch: Managing the Credit Built-Up (June 2011)  
CDS Spreads and Default Risk: A Leading Indicator? (May 2011)  
Global Bank Rating Trends Q111 (May 2011)  
Global Financial Institutions Snapshot (March 2011)  
Banks' Use of Covered Bond Funding on the Rise (March 2011)

### Insurance

GIPS Exposure Manageable but Broader Dislocation in Financial Markets is Primary Concern (June 2011)  
Solvency II Set to Reshape Asset Allocation and Capital Markets (June 2011)  
Life Insurers' Mortgage Portfolios - Better Than Expected (June 2011)  
Japanese Life Insurers' FYE11 Results: Credit Profiles Remain Stable (June 2011)  
Insurer Interest Rate Scenarios: Uncertainty Today, Likely Beneficial Tomorrow (June 2011)  
Japanese Non-Life Groups: Fundamentals Resilient Despite Insured Losses from the March Earthquake (June 2011)  
Hurricane Season 2011: A Desk Reference for Insurance Investors (May 2011)  
Reinsurers' First-Quarter 2011 Financial Results (May 2011)  
Japanese Earthquake Losses: Manageable for Primary and Reinsurance Companies (March 2011)

### Corporates

Steel Raw Materials Outlook - Prices to Remain High (July 2011)  
U.S. Corporate Credit: Outlook for Second Half of 2011- Sitting Out the Storm (July 2011)  
Worldwide Steel Outlook - Recovery Losing Steam in Short Run (July 2011)  
Selective Labor Inflation - A Lurking Threat? (July 2011)  
EMEA Corporate Ratings H111; Upward Momentum Slowing (June 2011)  
EMEA Corporate Outlook Summer 2011: Still Stable; Gains Slowing; Key Risks Lie in Asia, Utilities (June 2011)  
U.S. Leveraged Finance Stats Quarterly - First-Quarter 2011 (June 2011)  
Corporate Outlooks 2011 Compendium (May 2011)  
Rating Impact of Iron Ore and Metals Price Inflation (May 2011)  
Rating Impact of Agricultural Commodity Inflation (May 2011)  
Corporates in the Euro-Zone Periphery; Issuer-Level Forecasts (May 2011)  
Rating Impact of Oil and Gas Inflation (May 2011)  
Chinese Residential Real Estate: Q&A (May 2011)  
Bridging the Refinancing Cliff, Volume III (April 2011)  
Euro-Zone Sovereign Pressures and Corporates (April 2011)  
Market Implied Credit Risk: EMEA Corporate Pricing Out of Sync with Fitch Analysis (March 2011)

### Global Infrastructure and Project Finance

Rating Impact of Euro Sovereign Downgrades on Project Debt (July 2011)  
Funding Issues for Rail Networks - Public-Private Partnerships are no Panacea (May 2011)  
U.S. Surface Transportation Funding: Pitted with Potholes (May 2011)  
Paradigm Shifts: Taking the Steam Out of U.S. Coal-Fired Thermal Power (May 2011)  
Fitch Comments on EU Project Bonds Initiative (April 2011)  
Infrastructure Ratings Prove Resilient Through the Downturn (March 2011)  
Fitch Revises Outlook to Negative on Standalone GARVEE Bonds (March 2011)  
Solar Photovoltaic Feed-In Tariffs - Stability of Support Frameworks Questioned (February 2011)

### Structured Finance

Fitch RMBS Performance Metrics (June 2011)  
Fitch RMBS Loss Metrics (June 2011)  
U.S. CMBS 2010 Loan Default Study (Defaults Continued to Climb) (May 2011)  
EMEA Structured Finance Snapshot - May 2011  
U.S. Mortgage Markets: What if Rates Rise? (April 2011)  
U.S. Structured Finance Snapshot: April 2011  
Global Structured Finance Quarterly Rating Review Q111 (April 2011)  
Falling Personal Bankruptcies to Boost U.S. Consumer ABS Performance in 2011 (March 2011)  
2011 Latin American Structured Finance Review and Outlook (February 2011)

### Credit Market Research

Fitch U.S. High Yield Default Insight — June 2011 (July 2011)  
Fitch Global Corporate Finance Rating Activity - 1Q11 Update (May 2011)  
Europe Senior Fixed-Income Investor Survey Q211; High-Yield Optimism Fades (May 2011)  
The European Debt Investor Landscape; Peak Issuer Demand for Funding Faces Multiple Challenges from Investors (May 2011)  
U.S. Corporate Bond Market: A Review of First-Quarter 2011 Rating and Issuance Activity (April 2011)  
Fitch Ratings U.S. Public Finance 2010 Transition and Default Study (March 2011)  
Fitch Ratings International Public Finance 2010 Transition and Default Study (March 2011)  
Fitch Ratings Global Structured Finance 2010 Transition and Default Study (March 2011)  
Fitch Ratings Global Corporate Finance 2010 Transition and Default Study (March 2011)  
Fitch Ratings Sovereign 2010 Transition and Default Study (March 2011)  
High Yield Default and Recovery Rate Volatility in Recession and Recovery (March 2011)  
Senior Fixed Income U.S. Investor Optimism at a Three-Year High (March 2011)

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