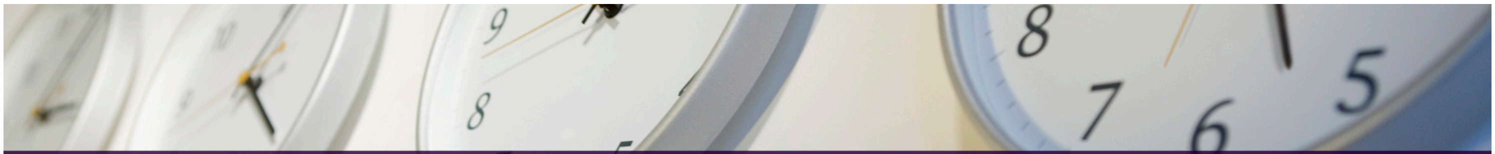

Credit Outlook

30 September 2021

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China's actions on Evergrande are likely to avoid financial, social instability, but not preclude economic costs

Originally published on 27 September 2021

China's (A1 stable) authorities will seek to avoid social and financial instability from the resolution of China Evergrande Group (Evergrande, Ca negative), although significant costs will be borne across the economy. Important motivations are avoiding widespread negative repercussions for Evergrande's homebuyers, suppliers and contractors, constrained access to funding by property companies and Chinese issuers more broadly, damage to certain banks' asset quality, and disruption to the real-estate market, a key driver of economic growth.

Government will aim to avoid instability but may not prevent losses with credit-negative impact for wide-ranging entities The authorities have tools to avoid financial instability and control a variety of balance sheets to engage in burden sharing of losses. They will prioritize retail creditors and customers, which could involve not fully adhering to creditor hierarchies. Direct government bailout by cash injection is unlikely, as is substantial acquisition of equity interest from state-owned enterprises without significant discounts.

Evergrande credit distress to have limited direct impact on sovereign, but prolonged slowdown in property sector would hurt RLG revenue Evergrande's troubles are likely to trim economic growth, given the property sector's large contribution to GDP, and the possibility that real estate may not recover as strongly as in previous cycles. But the authorities do have fiscal and monetary headroom to respond. Prolonged slowdown in the property market would weigh on land sales which are a material source of revenue for many regional and local governments, curbing infrastructure financing, and undermining growth.

Some financial institutions will suffer losses from exposure to Evergrande The direct impact of Evergrande's distress on some small regional banks and trust companies could be material. China's big four state-owned asset management companies also have moderate exposure. For large banks and rated Chinese insurers, direct exposure is not significant.

Spillovers through bond market, bank loans put credit pressure on other property developers, non-financial companies Our outlook on China's property sector is negative, given tight funding conditions and a likely slowdown in national sales in the next 6-12 months.[1] Investor concerns about the impact of tight regulatory conditions on funding and Evergrande's distress have weakened funding access to developers, and intensified credit polarization. Financing conditions for weaker developers will remain tight for some time.

Impact on China's RMBS is limited given stringent mortgage policies and the highly diversified securitized pools of most Chinese residential mortgage transactions.

Click here for the full report.

Endnotes

1 See Property - China: Outlook turns negative on tightened funding access, September 2021

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China's crackdown on virtual currencies is credit positive for financial institutions

Originally published on 29 September 2021

On 24 September, the People's Bank of China (PBOC) released new rules to ban virtual currency activities in China (A1 stable). Cryptocurrencies that are not issued by monetary authorities – such as Bitcoin, Ether and Tether – will not be considered legal tender. The new rules are credit positive because they will support financial stability, strengthen government authorities' control on the financial system and assist China's policy of reducing its carbon footprint.

The PBOC's new rules prohibit offering exchange, trading, order matching, pricing, token issuance and derivatives for virtual currencies. The rules also prohibit overseas virtual currency exchanges from offering services to domestic residents through the internet. The PBOC will work with other government authorities to implement the rules, with provincial governments given the responsibility to contain virtual currency activities regionally.

Chinese financial institutions do not hold cryptoassets. Although private virtual currencies could promote technological development in money and payment, they are causing rising concern regarding China's financial stability. Private virtual currencies transcend national borders and could lead to leakages in China's capital control regime. Furthermore, private virtual currencies' high volatility and speculative risk create chances of significant losses for their investors that could spill over into the financial sector and damage social stability.

The clampdown is also in line with the Chinese government's policy priority to control carbon emissions and reduce energy consumption. Some cryptocurrencies require enormous amounts of energy because of computations needed for mining, resulting in substantial carbon emissions. China has a target of peak carbon emissions by 2030 before achieving carbon neutrality by 2060.

On the same day as the PBOC's release of new rules, the National Development and Reform Commission of China published a notice that prohibits new virtual currency mining projects and requests an orderly exit of existing projects.

The measures to ban the use of private virtual currencies outright may exclude China and its financial institutions from potential innovations in global digital currencies and payment systems that could bring economic benefits. However, the risk is mitigated by the development of central bank digital currencies, which can be designed based on digital technology and supervised in a more orderly manner. The PBOC's new rules target private virtual currencies and will not affect central bank digital currencies, such as the e-CNY issued by the PBOC.

Chinese investors in virtual currencies could also suffer significant losses if they are unable to liquidate their existing positions because the PBOC's new rules prohibit financial institutions, payment service providers and internet companies from serving virtual currency activities.

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Scientific Games' sale of sports betting business supports deleveraging, a credit positive

Originally published on 28 September 2021

On 28 September, Scientific Games Corporation, parent company and guarantor of Scientific Games International Inc. (collectively Sci Games, B3 stable), announced that it had reached a definitive agreement to sell OpenBet, its sports betting business, to global sports and entertainment company Endeavor Group Holdings, Inc. for $1.2 billion. The announcement is credit positive for Sci Games because the company is divesting its sports betting and lottery businesses and strengthening its balance sheet. Doing so will allow Sci Games to significantly de-lever with the sale proceeds, significantly de-lever with proceeds, and enable continued investment for growth in the company's land-based and digital markets.

The transaction has no immediate effect on the company's ratings at this time, including the B3 corporate family rating and stable outlook, because it marks the first definitive agreement reached with regards to Sci Games' strategy. We estimate that gross debt-to-EBITDA will remain above the 6.0x potential upgrade factor based on the sale of the sports betting business alone. The company is still evaluating strategic alternatives to execute the divestiture of the lottery business, including an initial public offering, a combination with a special purpose acquisition company or a sale or strategic combination with another business.

Nonetheless, the announced agreement to sell the sports betting business is a milestone toward achieving the company's goal to significantly de-lever. The sale price for OpenBet is $1.2 billion, of which $1 billion will be paid in cash and $200 million in Endeavor's Class A common stock. The parties expect the transaction to close in the second quarter of 2022, subject to regulatory consents and approvals, and customary closing conditions.

Sci Games' decision to divest the lottery and sports betting businesses would leave the company with Gaming, iGaming, and SciPay businesses, enabling it to focus on its land-based and digital markets, which have a large total addressable market and opportunity for growth. We expect the company to focus on content franchises utilizing a cross-platform gaming approach, leveraging content creation investments and enabling player trends.

Scientific Games is a developer of technology-based products and services and associated content for worldwide gaming, lottery, social and digital gaming markets. Scientific Games Corporation is the publicly traded parent company of Scientific Games International, Inc., the direct borrower of over $8 billion of rated debt. Consolidated revenue for the latest 12-month period that ended 30 June 2021 was $3.07 billion.

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Fuel panic buying in the UK will not move the needle for country's forecourt operators

Originally published on 29 September 2021

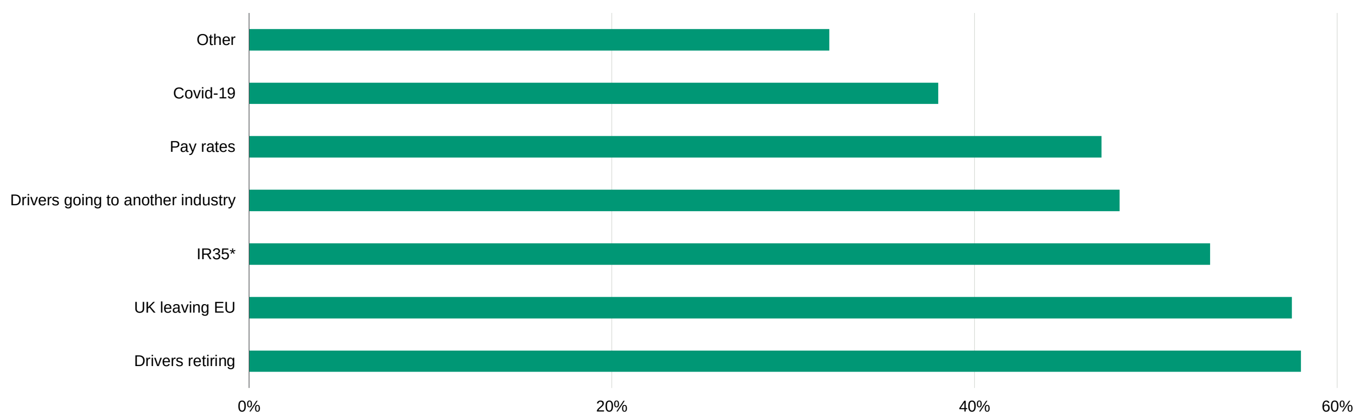
On 28 September, the UK government announced measures to tackle the lack of heavy goods vehicle (HGV) drivers, which has resulted in petrol stations running out of fuel because of panic buying in the past few days.

The rush to buy fuel is a short-term positive for fuel station operators, including EG Group Limited (B3 stable) and CD&R Firefly 4 Limited (B2 negative), because their sales have jumped in the past week. However it is not enough to make a significant and sustainable difference to their credit quality because we expect that the disruption will be temporary and fuel demand over the next few months will not change owing to this not being a permanent shift in driving patterns. EG's UK sites account for between 5% and 6% of EG's estate by store numbers, so the company will not be affected by temporary changes in its UK business.

Oil majors BP p.l.c. (A2 stable) and Royal Dutch Shell Plc (Aa2 stable) also operate UK fuel stations, but their UK sites are just a small proportion of BP's 20,300 global locations and Shell's 46,000 global locations. BP said some of its UK sites had temporarily closed because of a lack of supply. However, only 13% of BP's total company adjusted second-quarter 2021 EBITDA came from its convenience and mobility segment.[1] The percentage of EBITDA from retail operations is even lower for Shell. A joint statement from 10 oil companies including BP and Shell on 27 September stressed there is enough fuel at the refineries.

The shortage of HGV drivers has caused problems for a range of industries in recent months. Retirements and leaving the UK were the main reasons for the driver shortage, according to a recent survey by the Road Haulage Association (see exhibit).

Hauliers' reasons for driver shortage
Percentage selecting each reason in survey, multiple answers allowed



*Recent changes have been made to off-payroll working rules, known as IR35
Source: Road Haulage Association survey

To ease the supply shortage, the UK government's new measures include putting a pool of UK Army tank drivers on standby to deliver fuel. The government is also extending specialist and dangerous goods driver licenses expiring between 27 September and 31 December until 31 January 2022 so drivers can continue to work without having to take refresher training. On 26 September, the government said it would exempt fuel companies from competition law temporarily so they could get supplies to the places most in need. The government also said it would offer temporary visas to foreign truck drivers to limit disruption in the months leading up to Christmas.

So far, UK retailers' supply chain distribution networks have been largely unaffected by the panic buying. They have still been receiving fuel deliveries for their own vehicles without disruption because this fuel is supplied through different agreements than those suppliers make with forecourt operators.

If the fuel shortage lasts longer than we currently expect some retailers will struggle with staff shortages and online delivery disruptions, which would hit sales.

Endnotes

1 This excludes lubricants business Castrol; before corporate cost and Rosneft contributions.

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Intertrust's planned share buybacks will delay deleveraging, a credit negative

Originally published on 27 September 2021

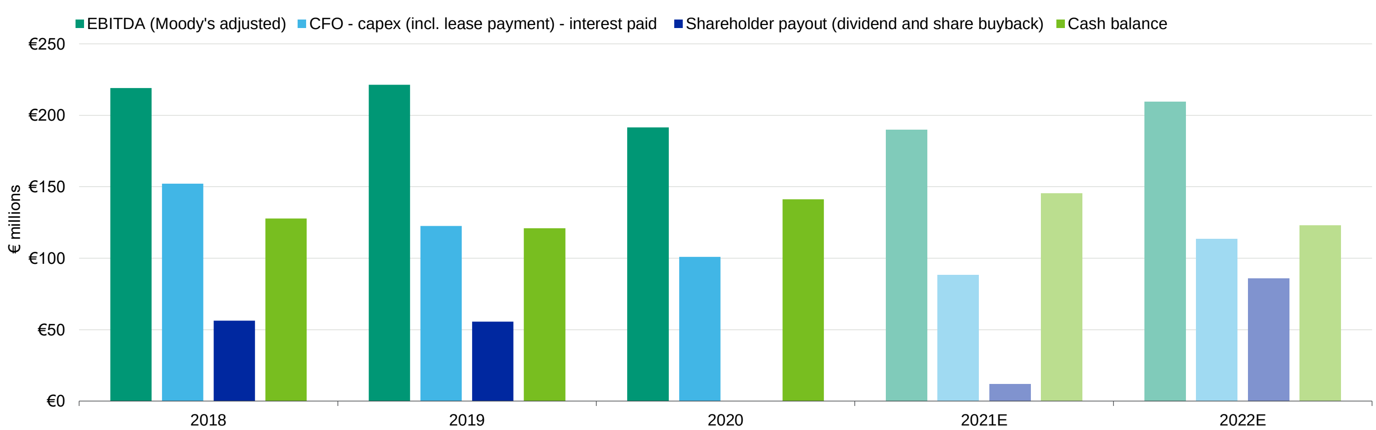
On 27 September, Intertrust N.V. (Ba2 negative) announced a share repurchase for a total consideration of €100 million. The planned share buybacks will result in weaker debt metrics than we had expected over the next 12-18 months, a credit negative. The Ba2 rating with a negative outlook is unchanged because it already reflects the ongoing challenge for Intertrust to improve its credit metrics over the next 12-18 months.

Gross leverage was at 5.4x as of 12 months that ended June 2021 on a Moody's-adjusted basis, which was above the 3-0x-4.5x range we expect for its Ba2 rating category. As a result, the rating is currently weakly positioned. The planned share buybacks will result in a delay of the company's deleveraging trajectory. We estimate that the share buyback will raise the company's net leverage by around 0.1x in 2021 and by around 0.3x in 2022.

That said, the company's financial policy is unchanged. That policy calls for a reduction in company-adjusted net debt/EBITDA to below 3.4x by year-end 2021 from 3.8x at year-end 2020. The company's midterm net leverage target of around 3.0x is also unchanged.

We forecast Moody's-adjusted EBITDA to grow to around €210 million in 2022 from €185 million as of 12 months that ended June 2021 based on our expectation of mid-single-digit organic revenue growth and gradual profitability improvements. The growth in EBITDA, combined with low capital intensity of the business and annual dividend payout amounting to 20% of company-adjusted net income, should lead to €80-90 million of free cash flow, on a Moody's-adjusted basis and after dividends, in 2022 (see exhibit).

Solid free cash flow generation and cash holdings support Intertrust's planned €100 million share buyback



Forecast represents Moody's view, not the issuer's.
Source: Moody's Investors Service

The planned share buybacks will be funded through available cash (€137 million as of 30 June 2021) and free cash flow generation, and should not prevent the company from repaying the upcoming US dollar-denominated term loan maturity of around $108.3 million (or €93 million) in 2022 (outstanding amount as of 30 June 2021). The expected earnings growth and coupled with debt repayments should lead to Moody's-adjusted debt/EBITDA below 4.5x by year-end 2022.

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CNOOC Limited's planned share issuance is credit positive

Originally published on 28 September 2021

On 26 September, CNOOC Limited (A1 stable), China's (A1 stable) largest producer of offshore crude oil and natural gas, announced plans to issue renminbi A-shares in the domestic market. The company plans to issue no more than 2.6 billion shares, equating to around 5.82% its share capital as of 26 September. We estimate that CNOOC Limited could raise around RMB35 billion from the share issuance.

The planned share issuance is credit positive for CNOOC Limited because it will strengthen the company's financial position, support its capital spending and mitigate the effect of its American depositary shares (ADS) being delisted in the US market.

The share issuance as planned will lower CNOOC Limited's adjusted debt/capital to 23.3% from 24.7% at year-end 2020. CNOOC Limited is the only major Chinese national oil company that has not listed shares on the domestic A-share market.

CNOOC Limited plans to use the proceeds of the share issuance for its upstream oil and gas projects, including the Payara oil field development and Liza oil field phase II, both in Guyana, and around six offshore oil and gas projects in China. It will also use the proceeds to supplement its working capital needs.

The proceeds of the planned share issuance will account for 35%-39% of CNOOC Limited's total capital spending in 2021, which amounts to around RMB90-RMB100 billion. As such, the share issuance will reduce CNOOC Limited's need to raise debt to fund its capital spending and further strengthen its already strong liquidity.

Additionally, the share issuance will expand CNOOC Limited's access to the domestic A-share market, and mitigate the effect from New York Stock Exchange LLC's delisting the ADS of CNOOC Limited in March 2021. CNOOC Limited has filed a written request for review of the New York Stock Exchange's decision.

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Norway raises reference rate, hinting at future increases, a credit positive for banks

Originally published on 29 September 2021

On 23 September, Norges Bank, Norway's central bank, increased the reference rate to 0.25% from 0% and signalled future rate hikes. The higher rate is credit positive for Norwegian banks because it will moderate property price appreciation, reducing banks' asset risks. It will also support banks' already strong profitability and net interest margins.

The central bank's decision reflects the Norwegian economy's robust state: we expect Norway's GDP to grow 2.9% this year after contracting by 0.8% in 2020, in real terms. The rebound's pace suggests that maintaining the prior degree of monetary accommodation is no longer necessary.

Norges Bank's rate increase follows its advice to the Ministry of Finance in June to begin restoring banks' counter cyclical buffer (CCB) requirement to 1.5% by the end of June 2022 from 1% currently. Norges bank also indicated that further rate increases will occur by the end of this year and that it expects the reference rate to reach 1.7% by year-end 2024, while it expects to hike the CCB in December to 2%.

We expect the rate increases coupled with normalisation of household consumption to moderate growth in property prices, which would reduce banks' asset risks. Residential real estate prices reached all-time highs amid all-time low interest rates, lower consumption and remote working growth. Price growth peaked at 12.6% year over year in March 2021, declining to 9.5% year over year at 30 August 2021. Mortgages comprised approximately 55% of Norwegian banks' total lending in 2020.

Household debt is largely property related, with mortgages accounting for 98.8% of household debt at end 2020. Although household's debt-servicing capacity is strong, debt accounted for 233% of household disposable income in June 2021, compared with an average of around 200% for other Nordic peers.

The reference rate increase also supports banks' already strong profitability because net interest income accounts for more than 70% of total income. The higher rates alleviate pressure from interest margins, while also increasing investment returns on banks' liquidity portfolios.

After Norges Bank's rate hike, a number of Norwegian banks announced 0.25% rate increases to mortgages, almost 94% of which carry floating rates. Banks set the floating rates and can change the rate at their discretion provided they give their customers advance notice.

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Bank Leumi's sale of its US operations to Valley National Bancorp is credit positive

Originally published on 29 September 2021

On 23 September, Bank Leumi Le-Israel B.M. (Leumi, A2 stable, baa2[1]) and New Jersey-based Valley National Bancorp (Valley) announced a definitive merger agreement whereby Valley will acquire Leumi's US subsidiary for $1.2 billion. The transaction is credit positive for Leumi, Israel's largest bank by assets.

The acquisition will alleviate operational risks from a noncore operation (particularly from any potential litigation or supervisory action) and will raise Leumi's regulatory capital ratios by around 0.5 percentage point, according to our estimates.

Valley will finance 90% of the acquisition with its shares and the remainder in cash. Leumi will become Valley's largest shareholder, holding approximately 14% of Valley's stock, but will not be a controlling shareholder. Additionally, the two banks will enter a cooperation agreement that will allow Leumi to maintain access to the US banking market through Valley.

The deal awaits regulatory approvals in Israel and the US and approval of Valley's shareholders, and also is contingent on confirmation that Leumi is not a controlling shareholder or a source of strength in Valley in accordance with US law. Eliminating any requirement for Leumi to recapitalise Valley in case of need and helping to reduce operational risks.

Leumi expects to report a onetime after-tax profit of NIS650-750 million ($200-$230 million) from the transaction upon completion, which the banks expect will be in the first-half of 2022. This premium, stemming from a price-to-book value of equity of around 1.4x, together with lower risk-weighted assets after Leumi stops consolidating its US subsidiary's operations, will improve Leumi's reported capital metrics.

Leumi's regulatory Common Equity Tier 1 (CET1) ratio was 11.98% as of June 2021, the highest among Israel's five largest banks, and this transaction will improve the ratio to a pro forma 12.5%, well above the bank's regulatory requirements and the internal capital threshold.[2] We expect Leumi to gradually distribute part of its excess capital to shareholders, returning its CET1 ratio to recent levels. However, this additional capital will also allow the bank more flexibility to expand organically and take advantage of substantial business opportunities in Israel.

In 2014, Leumi paid $400 million to resolve charges from US authorities that it assisted US clients in evading taxes, and subsequently disposed of its related Swiss and Luxemburg operations. Although operating in the US comes with higher risk of class action litigation, regulatory investigations and related large financial settlements, the US is an important market for Israeli banks because of significant business links between the two countries. Indeed, several large US technology firms have growing operations in Israel and many Israeli start-ups seek funding and business partners from the US. According to information from Valley,[3] Leumi's US subsidiary caters to approximately 500 of the about 2,900 US-based Israeli-related technology companies and 20 venture capital firms.

By retaining a stake in Valley, as well as the right to appoint two directors on Valley's board and the cooperation agreement, Leumi will continue to maintain a presence in the US market. On a pro forma basis, Valley National Bank, Valley's operating entity, will become the 29th-largest listed US bank by assets post-merger. However, as a minority shareholder, Leumi will be less able to direct the strategy and actions of its US partner, particularly if Leumi chooses to gradually divest of its stake after a four-year lockup period.

The US accounted for around 6% of Leumi's 2020 profits. We do not expect the bank's ongoing profitability to be materially affected by the sale given that Leumi will likely use the equity method to account for its stake in Valley[4] and record a share of Valley's net profit or loss.

Endnotes

1 The ratings shown in this report are Bank Leumi's deposit rating and Baseline Credit Assessment.

2 Leumi's minimum CET1 capital ratio requirement was 9.2% as of June 2021 and its internal minimum threshold was 9.5%, which incorporates risks identified in a supervisory review process and stress scenario. The regulatory minimum includes a temporary leniency by the Bank of Israel that lowered Israeli banks' capital requirements by one percentage point until the end of 2021 to support lending during the pandemic, and which lowered Leumi's minimum CET1 ratio requirement from 10.27% as of the end of 2019 and its internal minimum threshold from 10.5%.

3 Investor presentation, 23 September 2021, Valley National Bankcorp.

4 The equity method is used in accounting for an associate where the investor has significant influence but not control or joint control.

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Bank Nizwa's rights issue will increase capital buffers and support liquidity

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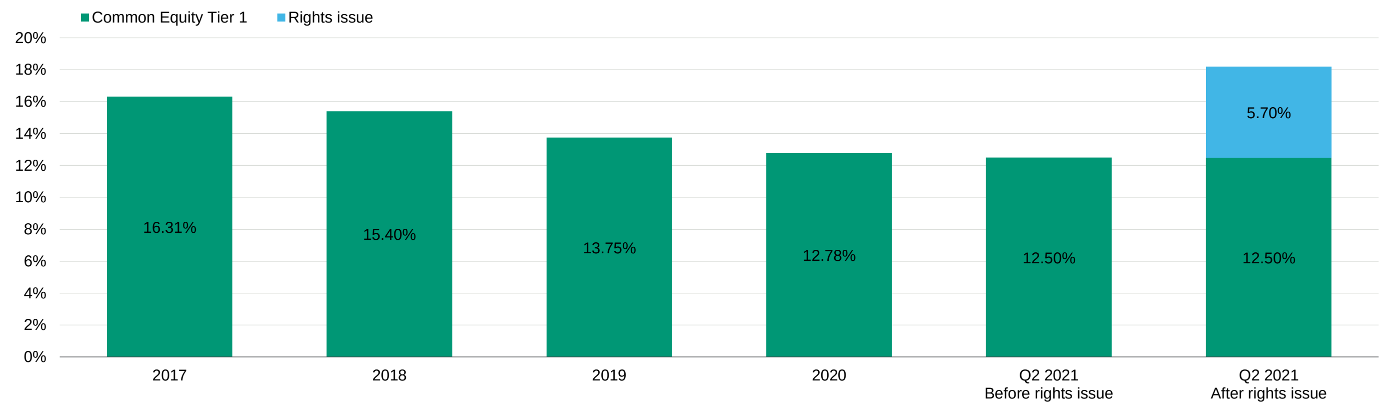
On 23 September, Bank Nizwa SAOG (Ba3 negative, b1[1]) announced that Oman's Capital Market Authority approved its OMR70 million ($180 million) rights issue. The Muscat Clearing & Depository and Muscat Stock Exchange's procedures to update and list new shares were scheduled for completion on 26 September. The credit-positive issuance will increase the bank's capital buffer by around 570 basis points (bps), supporting its liquid resources and continued growth.

We estimate the rights issue will increase Bank Nizwa's pro forma regulatory Tier 1 capital ratio to around 18.2% from 12.5% as of June 2021 (see exhibit), significantly exceeding Oman's 10.25% regulatory minimum (including a capital conservation buffer of 125 bps).[2]

Bank Nizwa's reported Tier 1 capital ratio



Source: Bank Nizwa's financial statements

The issuance will increase the bank's regulatory loss-absorption buffers after subdued economic growth and extended payment cycles weakened banks' financing (the Islamic equivalent of conventional lending) book performance. Nonetheless, Bank Nizwa's problem-financings-to-gross financings ratio was at a low 1.3% as of June 2021 and still compares favourably with the 3.6% local average at the same date. The bank's cost of risk (computed as loan-loss provisions as a percentage of gross financing) increased to 98 bps as of June 2021, from 67 bps in full-year 2020 because of building up reserves in anticipation of higher credit losses.

Given the Central Bank of Oman's phased-in implementation of the Basel III capital conservation buffer in the form of Common Equity Tier 1 capital, we expect Bank Nizwa to support its tangible common equity (TCE) ratio through capital issuances and profit retention. The bank paid a cash dividend of around 17% of its 2020 net profit, while no dividends were paid in previous years.

As of June 2021, Bank Nizwa's ratio of TCE to risk-weighted assets was 12.4%, slightly up from 12.1% at year-end 2020, but still lower than the 13.6% systemwide average (at end-June 2021). The rights issue will increase the bank's TCE to risk-weighted assets ratio, on a pro forma basis, to around 17.5%. Our TCE ratio calculation increases risk weights on local sovereign debt securities in Oman to reflect the Basel standardised framework.

As of June this year, the bank reported a Basel III Tier 1 ratio and Core Equity Tier 1 ratio of 12.5%, a total capital adequacy ratio of 13.4% and shareholder equity (excluding Tier 1 capital notes) to total assets of 12.4%.

The rights issue will also support Bank Nizwa's liquidity buffers. The bank's ratio of liquid banking assets to tangible banking assets increased to 16.6% as of June 2021 from 15.0% as of December 2020, which remains below the 23.8% systemwide average at end-June 2021. However, the bank's ratio of market funds to tangible banking assets was at 5.7% as of June 2021, well below Oman's 12.8%

systemwide average at end-June 2021. The bank's ratio of net financing to deposits improved to 101% as of June 2021 from 107% at year-end 2020. Bank Nizwa's total assets of OMR1.3 billion ($3.4 billion) as of June 2021 equates to a 3.6% share of Oman's domestic market.

Endnotes

1 The ratings shown in this report are Bank Nizwa's deposit ratings and Baseline Credit Assessment

2 The central bank reduced the capital conservation buffer minimum to 125 bps in the first quarter of 2020 from 250 bps as part of a pandemic-related stimulus package. The minimum 11.5% ratio included a 7% minimum Common Equity Tier 1 (CET1) capital, a 200 bps maximum in Additional Tier 1 capital and a 250 bps capital conservation buffer in the form of CET1 capital.

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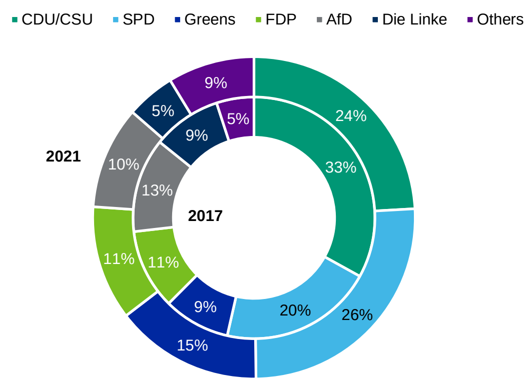
Protracted coalition negotiations are unlikely to disrupt Germany's policy environment

Originally published on 27 September 2021

On 26 September, Germany (Aaa stable) held elections for the Bundestag, which the Social Democratic Party (SPD) won marginally after making sizeable gains on 2017 partly at the expense of the Christian Democratic Union and Christian Social Union (CDU/CSU). Given that neither party has any appetite to continue governing under a "Grand Coalition" with each other, Germany is likely to see its first three-party coalition government. Although negotiations will likely take several weeks (or even months), we maintain our view that a fundamental shift in Germany's stability-oriented fiscal policy is unlikely, a credit positive.

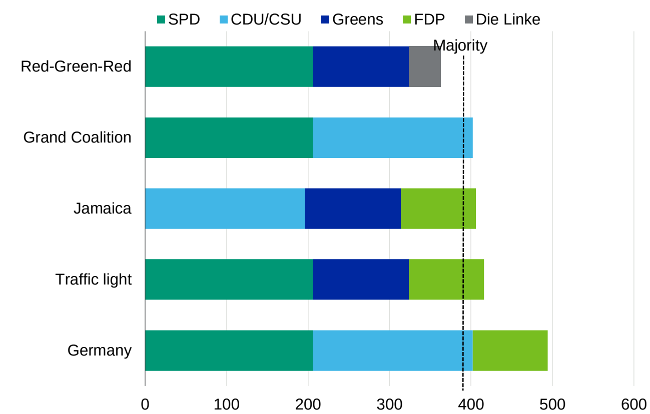
The next German government will most likely be a coalition involving the Greens and the FDP. Whether this government is led by the SPD or the CDU/CSU depends partly on who makes the bigger concessions to their junior partners. Both parties had already announced talks with each other once exit polls were made public on Sunday evening.

Exhibit 1
The SPD and the Greens made large gains, mainly at the expense of the CDU/CSU
% of second vote



Source: Bundeswahlleiter

Exhibit 2
Three-party coalition with the Greens and the FDP as most likely scenario
Seats in the Bundestag; out of 735 seats



Sources: Bundeswahlleiter

Coalition formation depends partly on which of the two big parties makes the bigger concessions to the Greens and the FDP; very low risk of snap elections. Soon after voting closed on Sunday evening, the Greens and the FDP announced to immediately start first talks. Any realistic three-party coalition will depend on the two "junior" partners finding a common ground and then agreeing on a joint basis with either the SPD or the CDU/CSU.

The SPD's larger share of the vote, its significant gains on the 2017 election and the popularity of Olaf Scholz give the party a slightly stronger mandate to form a governing coalition. Having said that, there are likely to be more policy differences within a so-called "Traffic Light" coalition, which could therefore be slightly more disruptive from a policy-continuity perspective, particularly on fiscal and housing policies.

The biggest stumbling block to a "Jamaica" coalition (named after the black, green and yellow colours of Jamaica's national flag) consisting of CDU/CSU, the Greens and the FDP is the CDU/CSU's poor electoral performance and the unpopularity of Armin Laschet. That said, there is greater policy overlap between the FDP and the CDU/CSU and the two parties have historically been closer. As a result, a "Jamaica" coalition would ensure greater policy continuity.

Even if coalition negotiations were to extend beyond Christmas (both CDU/CSU and the SPD stated that they would want to conclude before Christmas), we see a very low likelihood of snap elections being called, mainly because we believe that the Greens and the FDP are eager to join a government coalition.

The risk of radical policy shifts under either of these arrangements is low. Most parties have advocated changes to a number of taxes (personal income, corporate income), but no manifesto has provided comprehensive calculations on their fiscal impact or explained how they will be financed. We are likely to see greater fiscal continuity with the last government under a CDU/CSU-led coalition, but even with a SPD-led coalition, we do not expect any fundamental shift in Germany's fiscal trajectory following this election, especially as any changes to the debt brake require a two-thirds majority in both the Bundestag (Parliament) and Bundesrat (legislative chamber).

The European climate agenda ("Fit for 55", or FIT55) will accelerate the environmental agenda in Germany over the next few years regardless of the formed coalition. The fiscal implications of more ambitious environmental targets and increased green investment under an SPD-led coalition will depend on whether higher revenue over the longer term offsets the initial investment outlay, which is uncertain.

Overall, over the next four years, the gradual changes in the labour market, tax revenue and import shifts related to the greening of the economy are unlikely to have material credit implications for the German sovereign given the scale and diversification of its economy, the strength of its institutions and its fiscal strength.

Projected rising costs related to Germany's ageing population pose a key credit challenge for the sovereign. The biggest gap exists between the proposals of the SPD and the Greens on the one hand, and CDU/CSU and FDP on the other, regarding whether to broaden the public pension system to include the self-employed and civil servants.

The SPD and the Greens are more supportive of the pay-as-you-go system, while the CDU/CSU and FDP want to strengthen corporate and private savings and introduce state-administered capital-funded systems in parallel to the existing private insurers. The left-leaning parties also aim to fix or increase the replacement rate. The parties further hold different views regarding the retirement age: the SPD is strictly against raising the retirement age beyond 67, similar to the Greens, while the CDU/CSU is less clear on that, and the FDP wants more flexibility, like in the Swedish system.

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Airlines, shipping and non-EU producers will shoulder high costs of EU carbon legislation

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» **Airlines, shipping and some non-EU producers among the most affected.** Recently proposed EU (Aaa stable) legislation will accelerate the decarbonisation of energy-intensive industries, with airlines and shipping among the most affected. The legislation, if implemented in its current form, will lead to higher operating costs and more investment required for all energy-intensive industries. Costs will also rise for some non-EU producers that export to the EU, as a result of the planned carbon border adjustment mechanism.

» **Enhanced Emissions Trading System (ETS) will lead to higher carbon costs.** The strengthened ETS, combined with the rest of the proposals, will likely accelerate the decarbonisation of manufacturers, power producers and residential buildings, as well airlines and shipping. Some sectors will seek to pass costs on to customers through higher prices for their goods and services. A new ETS for buildings and road transport faces significant political opposition.

» **Airlines and shipping face triple whammy of ETS measures, fossil fuel tax and more use of sustainable fuel.** The limited options both industries have to decarbonise will result in greater reliance on sustainable fuels to cut emissions. However, broad support from governments and relevant industries will be required to make sustainable fuels more affordable.

» **Automakers generally better-prepared for tougher emissions standards for new cars and vans.** We do not expect the proposals will have a significantly negative effect on our projections for battery electric vehicles and thereby on automakers' investments and profitability.

» **The carbon border adjustment mechanism (CBAM) will increase costs for some non-EU producers and has the potential to increase trade tensions**. If the border mechanism is expanded beyond the initial small group of products, it will significantly increase costs and reduce trade of countries exporting to the EU that lack an emissions trading system comparable with the EU's. However, lengthy negotiations are likely given the mechanism's complexity and the political challenges of implementing it.

» **Renewable energy directive will raise investments required for residential buildings, with a moderate increase for utilities**. For owner-occupied buildings, there is a significant financing gap, which may lead to a fall in the collateral value of energy-inefficient properties owned by low-income households.

Click here for the full report.

US natural gas supply will rise to meet demand, easing high prices

Originally published on 27 September 2021

- **Although demand for natural gas continues to expand in the US, supply and demand will remain in fairly close equilibrium over the medium term.** Natural gas reserves are still plentiful in the US and producers can adjust to growing demand relatively quickly, holding gas prices to a modest range for the foreseeable future apart from short-term spikes. Ample and flexible supply will keep natural gas pricing fairly close to the break-even cost of production. The US natural gas supply/demand balance depends mainly on the discipline of producers, which determines the long-term direction in prices, and not as much on demand from the power generation, industrial, and residential and commercial (R&C) sectors.
- **Power production will continue to drive growth in US natural gas consumption in the US over the next several years, just as it has for the past decade.** Greater economic activity and the increasing electrification of heating and transportation will bolster demand for power over the coming years, but conservation measures, improvements in energy efficiency, and a rise in distributed generation will limit growth in demand for electricity. Power generation will increasingly use natural gas and renewables at the expense of coal, continuing the pattern of the past decade, with a roughly balanced split between gas and renewables. Prices will be the most important factor in the power sector's demand for natural gas.
- **We expect thermal coal prices to rise in the second half of 2021 and into 2022, benefiting the Appalachian and Illinois Basin regions most.** Electricity demand from domestic power customers is picking up, while much stronger prices in the international markets will increasingly push the thermal coal industry toward exports. Domestic prices in the eastern US will be more volatile than in the west, where an export market will not develop as it has on the East Coast. Ongoing retirement of coal-fired power plants and limited investment in coal assets increase the potential for short-term price spikes when natural gas prices are high.
- **Despite some local government and state efforts to curb its use, natural gas will remain a crucial source of energy for R&C customers over the next decade.** R&C heating needs comprise roughly 30% of annual natural gas consumption. Local distribution companies—the utility companies serving most R&C customers—must have access to gas for weather-related emergencies, effectively creating a floor for their natural gas demand. Longer-term threats to natural gas use are increasing as utilities strive to reduce or eliminate greenhouse gas emissions, but renewable natural gas and hydrogen blending will require far more government subsidies and technological advances.

Click here for the full report.

Click here for a companion report, Rising exports propel US natural gas prices amid restrained supply.

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