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DBRS Morningstar's Takeaways from Credit Outlook Canada 2024: Rising Rates, Rising Tensions, and Rising Temperatures Weigh on Global Sovereign Outlook

SOVEREIGNS

As part of its takeaways series, DBRS Morningstar is publishing several write-ups about pertinent topics discussed at Credit Outlook Canada 2024. With a focus on "How Economic, Climate, and Tech Pressures Are Affecting Credit Quality," this conference is a full day of global and Canadian market insights on what we should expect in the coming year.

In the session titled "Global Sovereign Outlook: Rising Rates, Rising Tensions, and Rising Temperatures," Thomas Torgerson, Managing Director, DBRS Morningstar, focused on what the challenging economic forecast for 2024 means for sovereigns.

In 2023, the G7 economies have performed uniformly better than expected and some—the U.S. and Japan in particular—grew beyond their estimated potential. However, the economic environment is unlikely to be supportive in the near term. Sovereigns are expected to face additional fiscal challenges as they prioritize increased defense spending, boost climate-related investment, and address the geopolitical conflicts that loom large across the globe, putting energy, food, and supply chain security at risk.

RISING RATES

A strong labor market, high built-up savings, and strong balance sheets, which were the headline stories in 2023, will carry through into 2024. At the same time, the world is facing the most aggressive tightening cycle and worst inflation picture in 40 years. We are still waiting for some of the effects of this to hit; as an example, in the U.S., though disposable incomes have been hit by inflation, the aggregate financial position of households remains strong and consumer borrowing is rising.

While inflation continues to be a concern, core inflation is coming down; in the U.S. and Canada, measured on a six-month annualized basis, it is now below 4%, while in Europe it is higher but declining sharply. In recent weeks, long-term rates have risen, pointing to expectations of higher rates for longer; but Torgerson is not yet convinced that the era of low interest rates is truly over. Nonetheless, there are question marks around the return to a low interest rate environment over the medium term, including the need for major investments in renewable energy and the impact of geopolitics on global trade and capital flows.

While we are beginning to see slowing employment growth in Europe, Canada and Japan are seeing accelerating employment growth. U.S. employment growth remains strong, roughly on pace to match 2022. Canada stands out in terms of the growth of what Torgerson calls the "wage mass." The year 2022 saw record immigration in Canada (at over one million, including non-permanent immigration) and 2023 is on pace to match or exceed that number; that massive growth in population is why the wage mass is rising. But at an individual household level, there are real income losses. "In short, Canada is likely to grow, but it won't feel like growth for most individual households," said Torgerson.

RISING TENSIONS

Rising global tensions are another reason why DBRS Morningstar expects the next 12 months to be challenging. In response to the Russian invasion of Ukraine, European governments have massively reduced their reliance on Russian oil and gas, which has been costly but manageable and for the most part popularly supported. Recent disputes between China and the EU over domestic subsidies are likely to compound the already tense relationship between China and the U.S. "China is also facing some domestic challenges, a slowing economy, a property market that is dealing with some significant excesses," said Torgerson. "If Chinese growth were to slow significantly, that will likely be negative for commodity prices." And of course, the past few days have seen a new conflict in the Middle East, and the length and breadth of the conflict remains to be seen. All of this comes at a time when there is a lack of bipartisan consensus in the U.S. over some important foreign policy topics and a highly polarized U.S. election in late 2024.

RISING TEMPERATURES

Increased risks of flooding and drought are going to be with us for some time, even if all climate change targets are met. "Sovereigns are going to have to cope with increasing weather risks even as they engage in what is going to have to be a rapid and aggressive transition to clean energy," noted Torgerson. Governments have made pledges that would double investments in renewable energy in the next decade and double that again over the next 20 years after that. There are greater risks to inaction in terms of climate change, but as governments take action, they will need to do so thoughtfully so that they don't undermine their own energy security. The core political and economic challenge from a sovereign perspective is that your energy supplies are adequate, reliable, and satisfy the needs of your population.

Despite the rising gloom, DBRS Morningstar has upgraded more sovereign credit ratings in 2023 than it has downgraded. Those upgrades are fundamentally recovery stories. There have also been upgrades on the sub-sovereign side, as national governments, with their greater capacity to borrow, are ensuring that the effects of the pandemic and the energy crisis are not disproportionately affecting regional and local governments. "Rising rates, rising tensions, rising temperatures really do weigh on our outlook," concluded Torgerson. "But there is always potential for countries to emerge stronger based on the quality of their leadership and the strength of their policies."

Written by Susan Morton

Notes:

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