When The Cycle Turns: Do Not Push The Panic Button On Emerging Market Sovereigns

October 9, 2018

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Key Takeaways

- Recent increases in global interest rates, followed by market turmoil, have raised concerns about potential liquidity problems spreading across emerging market sovereigns.
- We do not think that credit problems will spread to the emerging market asset class as a whole.
- A large number of emerging market countries have undertaken reforms over past decades to strengthen their creditworthiness, improving their economic structure and reducing their vulnerability to a potential drop in global liquidity. We expect our sovereign ratings on those countries to be relatively stable over periods of stress.
- An exclusive focus on external imbalances and debt burdens may provide a misleading picture of future credit developments in this asset class.

Higher U.S. interest rates signal the end of an era of cheap money and herald a growing risk of negative credit developments in emerging markets (EM). The expansive monetary policies of advanced economy central banks in response to the global financial crisis in 2008 boosted EM currencies, lowered local interest rates, increased the value of local assets, bolstered credit growth, and stimulated GDP growth.

Over the last year, the U.S. Federal Reserve Bank has increased the pace of normalization of its monetary policy. This has resulted in capital outflows from many EM countries, putting pressure on their currencies to depreciate, raising local interest rates, lowering local asset prices, and dampening GDP growth.

Such negative developments could hinder access to liquidity for EM sovereigns and nonsovereign borrowers, and potentially lead to lower credit ratings to the extent that it undermines their economic fundamentals. Investors have recently focused on those EM sovereigns with large external imbalances, assessing their vulnerability to a sudden loss of foreign financing due to tightening global liquidity, and have started to take defensive actions. Argentina and Turkey, two economies with large current account deficits and a reliance on external capital inflows (largely debt), were the first ones to be seriously affected. Subsequently, investors have focused on a potential second wave of market turmoil affecting other EM sovereigns and the possibility of

liquidity problems spreading across the asset class.

We do not foresee an imminent and high risk of contagion from recent market turmoil to the EM asset class as a whole. S&P Global Ratings' average rating for EM sovereigns is within the investment-grade category (around 'BBB-'; investment-grade ratings are 'BBB-' or higher), and we have stable outlooks on most of these. We believe that the level of credit risk among EM sovereigns is quite diverse, as reflected in our differing ratings.

We focus our analysis on 22 EM countries that have substantial investor interest given their large amount of debt outstanding both in local and foreign currency (see Appendix).

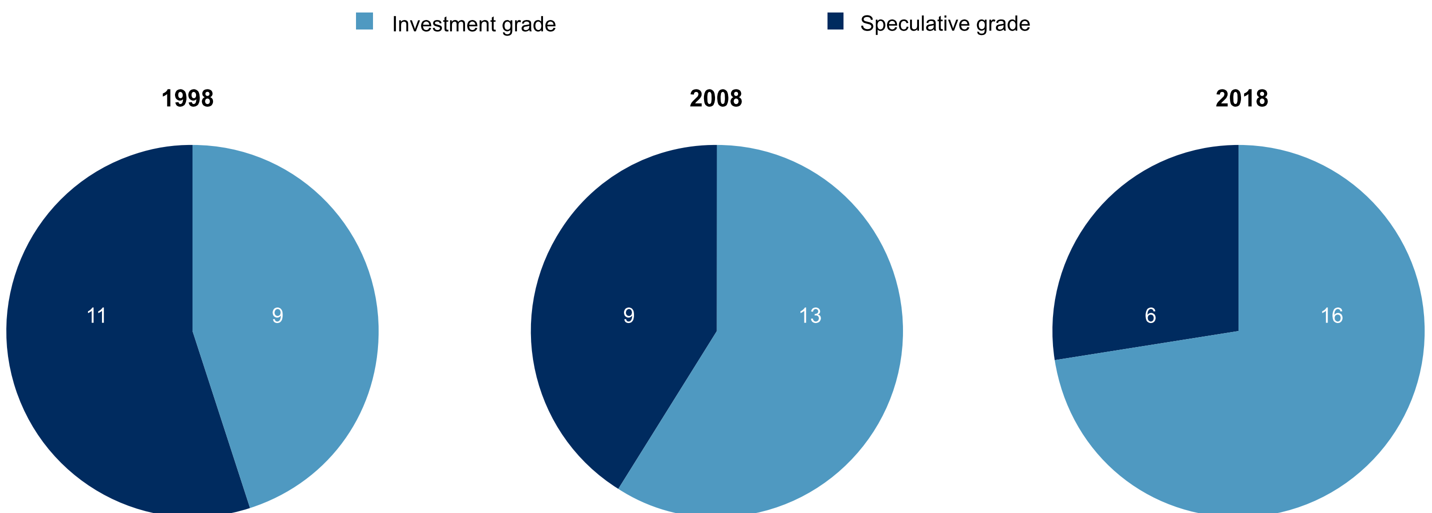
A Diverse Asset Class

There is much more to the credit cycle in EMs, and to our sovereign ratings, than trends in global interest rates. An exclusive focus on external imbalances and debt burdens may provide a misleading picture of future credit developments. Other factors, quantitative and qualitative, have helped determine the performance of EM sovereigns during the last two decades.

A large number of EM countries have undertaken reforms to strengthen their creditworthiness, reducing their vulnerability to a potential drop in global liquidity, and a steadily increasing share of EM sovereigns are now rated investment-grade (see chart 1). These rating trends indicate that many governments have implemented difficult structural reforms and other policies that have improved the effectiveness of monetary policies, created greater exchange-rate flexibility, developed domestic capital markets, and improved economic growth prospects, boosting investor confidence. Most of those sovereigns have higher ratings today than in past periods of financial turmoil.

Chart 1

Number Of Investment-Grade Versus Speculative-Grade Emerging Market Sovereigns



Source: S&P Global Ratings.

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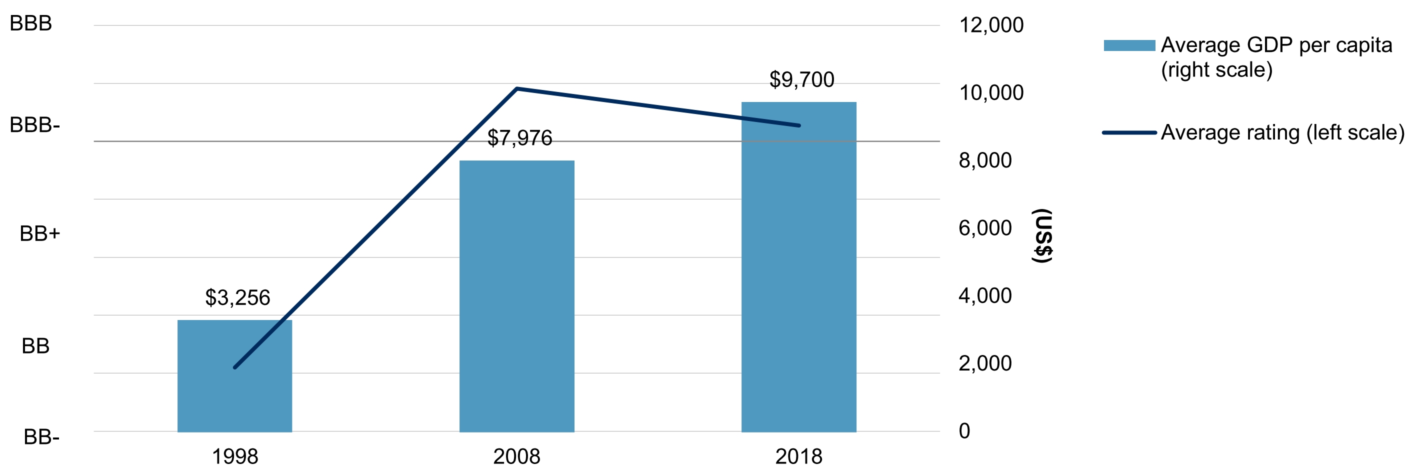
There are, of course, sovereigns that did not undertake reforms, either out of policy choice or because they lacked the political stability and will to carry out such policies. Some sovereigns used their access to cheap external funding to pursue policies that encouraged growing debt (in both the private and public sectors), boosting consumption, rather than investing in projects that would generate future cash flows. Such EM sovereigns are likely to be toward the lower end of our ratings spectrum, highlighting their vulnerability to the current changing market dynamics.

The Importance Of Economic Growth And Structure

Rapid and sustainable economic growth is a key element in our rating analysis. Growing prosperity allows governments to collect more revenues, attend to social pressures, and undertake more effective debt management. Many EM sovereigns have pursued policies to strengthen the productive structure of their economies and diversify the sources of growth, thereby reducing their external vulnerability to the current risk of tightening global liquidity. We reflect these strengths in our sovereign credit ratings (see chart 2).

Chart 2

Average Rating And Average GDP Per Capita



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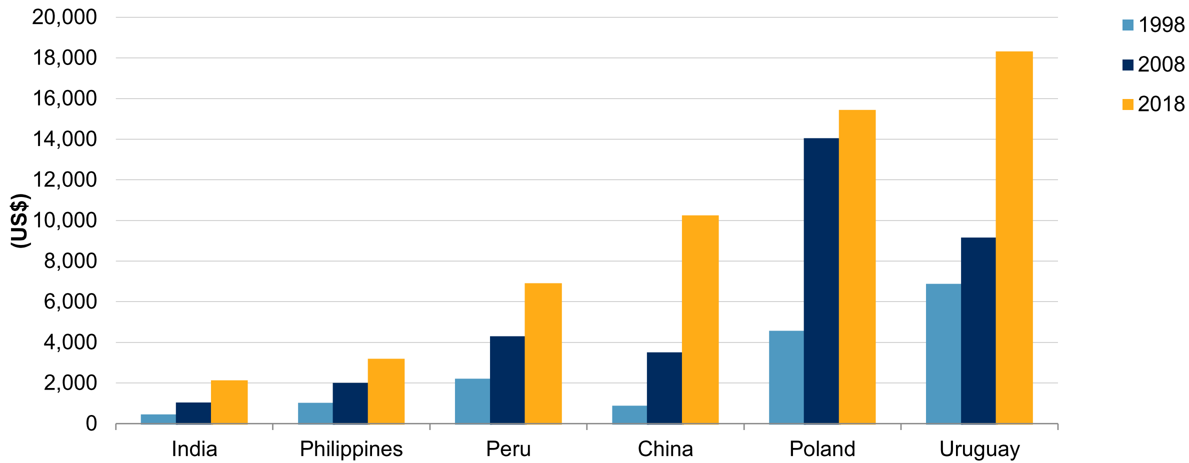
Many EM sovereigns, especially larger countries like China, India, Mexico, and Poland, have strengthened and diversified their economies in recent years through both domestic and foreign investment. They typically relied, in large part, on inflows of foreign direct investment (FDI) rather than volatile short-term debt and portfolio inflows. The ability to attract long-term productive direct investments contributed to GDP growth and helped to contain the risk of capital flight due to higher global interest rates.

China enjoyed average GDP growth of 9.3% during 2000-2017, thanks to high domestic investment and considerable FDI, much of it going to export-oriented production. While the country's overall debt levels have increased faster than nominal GDP growth since the onset of the global financial crisis, nearly all of the funding has come from domestic sources, leaving China in a comfortable net external creditor position. We project per capita GDP in China to be more than 11 times higher in 2018 compared with 1998 (see chart 3).

Chart 3



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Many years of fast GDP growth have strengthened the economic resilience (and supported the creditworthiness) of other EM sovereigns, such as India. We project that India's per capita income, albeit still relatively low, will be more than four times higher in 2018 than its level two decades ago. Per capita GDP has more than doubled in the Philippines during the same period on the back of vibrant growth in the service sector.

In Europe, Poland enjoyed average GDP growth of 3.6% between 2000 and 2017--more than tripling per capita GDP. Over that same period, exports of goods and services to GDP doubled in their share of the economy from 27% to 54% of GDP. This structural improvement helped the country to avoid recession even during the financial crisis of 2008. Its EU membership, proximity to prosperous Germany, competitive labor market, and strong export performance have played a key role in supporting its credit story, underpinning our positive outlook on our sovereign rating, despite institutional challenges that have raised tensions between Poland and its EU partners.

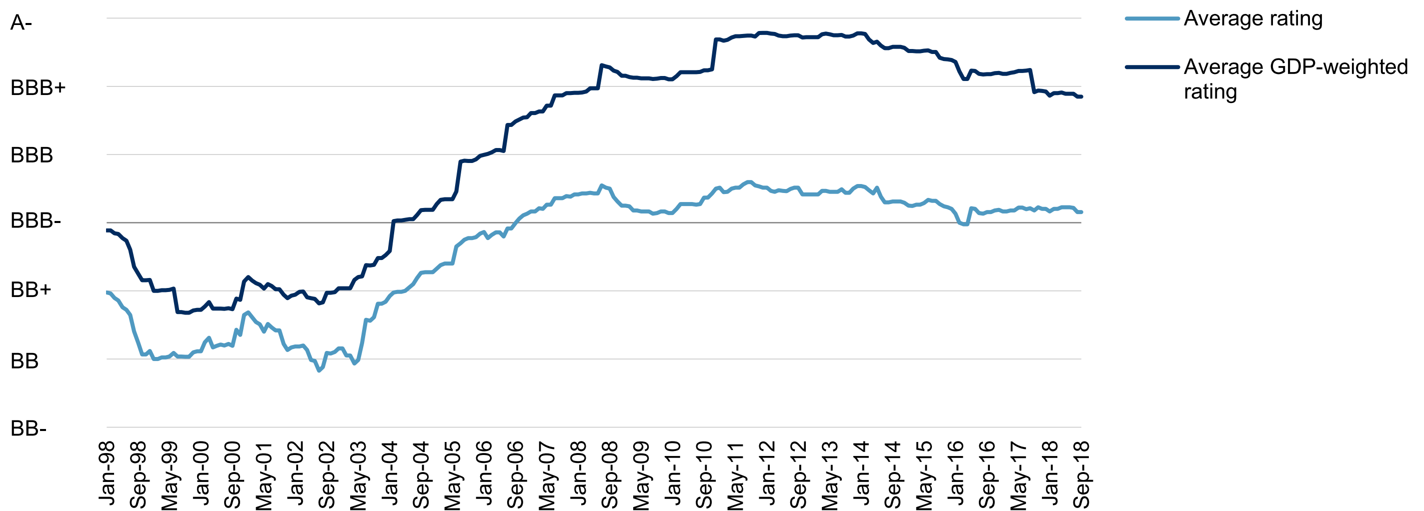
In Latin America, Peru's per capita income increased by nearly 61% during 2008-2018. Pro-growth policies have boosted the credit standing and resilience of Uruguay, a small, open economy that is more vulnerable to negative external shocks than larger economies. Uruguay defaulted on its sovereign debt in 2003 and regained an investment-grade rating nine years later in 2012. This recovery in our rating reflected, in large part, creation of new economic sectors (such as pulp and paper, business process outsourcing, and information technology) in the past 15 years. In addition, Uruguay effectively "decoupled" its economic trajectory from that of Argentina and Brazil, its two large neighbors, through a series of policy reforms starting in 2003. As a result, we estimate that the country's GDP is likely to have expanded about 20% over 2011-2018, compared with less than 2% in Argentina and 1% in Brazil. Greater prosperity and economic diversification, cautious macroeconomic policies, and prudent debt management support our long-term sovereign credit rating ('BBB') and stable outlook, despite its vulnerability to external shocks due to its net external debtor position.

Overall, the average credit profile of the EM asset class improved substantially in the early years of this century (prior to the advent of low global interest rates that followed the 2008 financial

crisis) and has been relatively stable in recent years. The average long-term foreign currency rating of the 22 EM sovereigns is just above 'BBB-', or 'BBB+' if the ratings are weighted by the GDP of the countries (see chart 4). This compares favorably with 1998, when the average rating of the group was 'BB+', and the weighted average just below 'BBB-'.

Going forward, many of these export-oriented economies' credit quality will be more at risk due to the increased wave of protectionism and the threat of full on "trade wars" than global interest rates dynamics.

Chart 4



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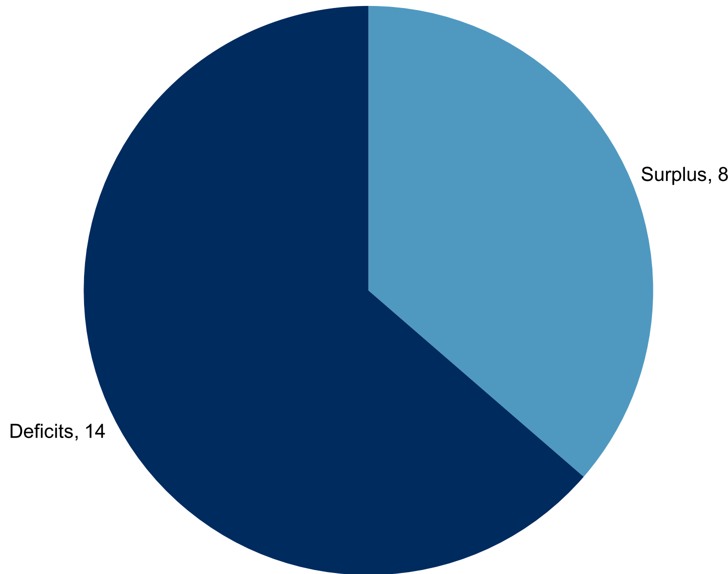
External Profile

We project that most of the 22 EM sovereigns we're focusing on will operate a current account deficit in 2018 (see chart 5). The combination of a net external debt position and a current account deficit (which implies reliance on external hard currency financing) makes sovereigns vulnerable to adverse external developments, such as rising financing costs. However, the stable outlooks on most of those sovereigns reflect our view that they have other credit strengths that give them financial and policy flexibility to manage external challenges according to their rating levels.

Chart 5

Emerging Market Countries--Current Account Balance (2018)



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For EMs with young growing populations and lower incomes, compared with their trading partners, it is hardly surprising that investment demand exceeds the domestic savings rate, resulting in current account deficits. East Asia, with its high savings rates and low welfare spending, is the major exception in this regard. Unsurprisingly, most of the larger current account deficit EM countries are therefore located in Europe, the Middle East, and Africa or Latin America.

S&P Global Ratings has stable outlooks on three out of the four speculative-grade EM sovereigns (rated 'BB+' or below) that show negative features of external vulnerability, namely Turkey, Egypt, and South Africa (see table 1).

Table 1

Speculative-Grade Emerging Market Countries With Current Account Deficits (2018)

(%)	Current account balance/GDP	Narrow net external debt/GDP	Long-term foreign currency rating/Outlook
Turkey	(5.6)	45.5	B+/Stable
Egypt	(4.0)	17.6	B/Stable
Argentina	(3.4)	29.4	B+/Watch Neg
South Africa	(2.9)	10.3	BB/Stable
Brazil	(0.9)	(1.7)	BB-/Stable

Our 'B' rating on Egypt reflects its external weaknesses and poor debt and fiscal profile. However, we upgraded Egypt in May 2018 based on strengthening GDP growth, rising foreign exchange reserves, and implementation of key economic reforms, not least the decision to liberalize the currency regime and cut politically sensitive subsidies on food and fuel. Its current account deficit, which peaked at 6.5% of GDP last year, has been narrowing during 2018 thanks to a recovery of tourism and a more competitive exchange rate since the November 2016 devaluation, while the elimination of fuel subsidies has alleviated its fiscal deficit. We expect, going forward, that ongoing economic and fiscal reforms will underpin business confidence and sustain capital inflows, especially FDI (which should largely fund the current account deficit over the next couple of years).

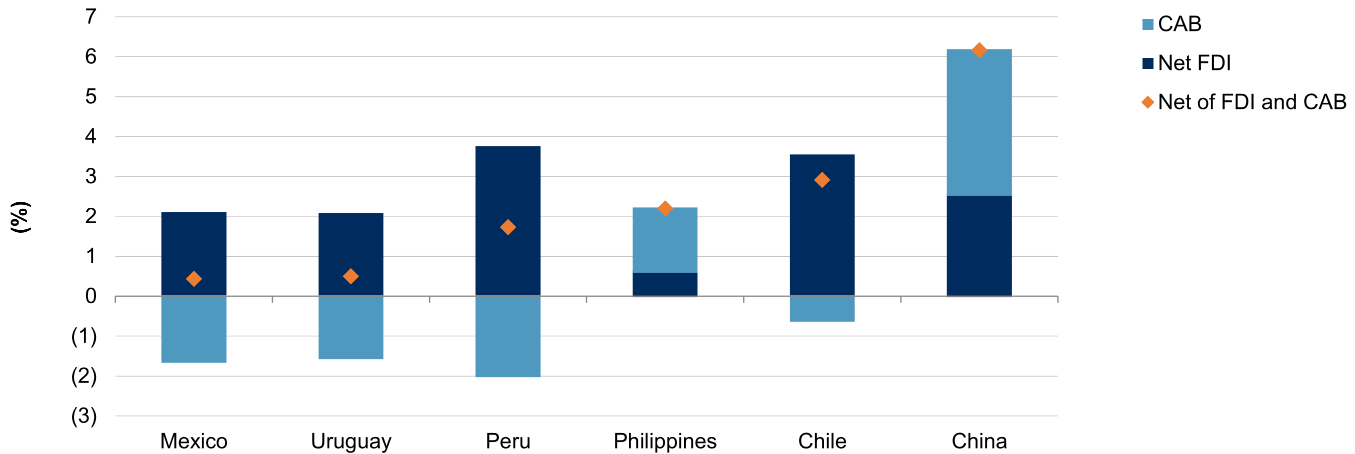
In Turkey's case, the current account deficit has averaged 5.6% of GDP since 2011, equivalent to cumulative net external financing of 45% of GDP. A nearly 40% depreciation of the Turkish lira so far this year has created major debt servicing challenges for the corporate and banking sectors, which have heavily borrowed in foreign currency. In addition, the measures taken by the government came short of market expectations to address the external vulnerability. We downgraded Turkey to 'B+' in August 2018. Our expectation to maintain the rating at this level is that the government will implement sufficient policy measures to roll over private-sector external debt (albeit with diminished external inflows), avoiding deeper stress in the banking system and an even deeper recession in 2019.

We downgraded South Africa to speculative-grade from investment-grade in April 2017 and downgraded it again to 'BB' in November 2017. However, South Africa has manageable levels of external debt, credible monetary policy, and deep domestic capital markets. The downgrades reflected disappointing economic growth, a substantial fiscal debt burden, and sizable contingent liabilities, but not external factors (indeed South Africa's net international investment position is in credit). We expect that economic growth will pick up modestly over the next year while the government pursues economic and social reforms, including steps to enhance governance in state-owned enterprises and encourage private-sector investment. South Africa's key economic challenge remains how to bring down high structural unemployment and reduce inequality while also attracting net foreign direct investment, which since 2014 has been an outflow. One concern with the current process of land reform is that it could raise questions about property rights and the rule of law, effectively deterring greenfield foreign investment.

Where low interest rates have boosted an inflow of funds into EM, FDI has constituted a substantial share of external capital flowing into many of these countries over the last few years, fully funding the current account deficit and helping to reduce the external debt burden. FDI inflows to EM countries have, on average, fully funded or exceeded their current account deficits during 2013-2017 (see chart 6). Countries that received such long-term capital inflows are less vulnerable to a potential reversal of capital flows today, compared with other sovereigns that relied more on non-FDI flows (that largely purchased domestic financial assets).

Chart 6

Average Net FDI To GDP And Average Current Account Balance To GDP
2007-2017



FDI--Foreign direct investment. CAB--Current account balance.

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A current account surplus may help to limit the negative impact of a potential tightening in external market liquidity. The combination of a current account surplus and a negative narrow net external debt position generally provides insulation against external shocks.

China, Russia, Saudi Arabia, and Thailand all enjoy favorable external positions (see table 2), and we rate them all investment-grade. However, we assign a much lower rating of 'B' to Nigeria, which also has a current account surplus (averaging 0.9% of GDP during 2013-2017) and relatively modest net external debt. Our rating on Nigeria reflects other credit weaknesses--for example, its average per capita GDP growth has been close to zero during 2013-2017, reflecting its weak economic profile and institutional effectiveness, alongside Nigeria's fiscal dependency on oil receipts. These negative rating factors limit the sovereign's ability to maneuver and react to adverse shocks.

Table 2

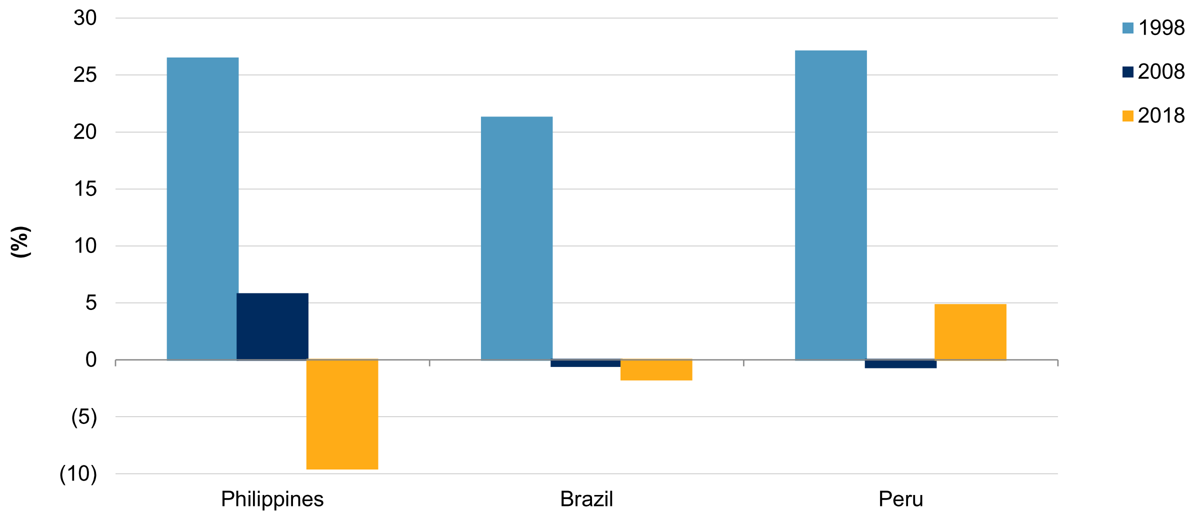
Emerging Market Countries With Current Account Surpluses (2018)

(%)	Current account balance/GDP	Narrow net external debt/GDP	Long-term foreign currency rating/Outlook
Uruguay	0.5	9.5	BBB/Stable
China	1.5	(18.5)	A+/Stable
Hungary	2.1	23.9	BBB-/Positive
Malaysia	2.7	4.2	A-/Stable
Nigeria	3.5	6.3	B/Stable
Russia	4.1	(18.5)	BBB-/Stable
Saudi Arabia	5.7	(67.7)	A-/Stable
Thailand	8.7	(21.3)	BBB+/Stable

Several EM sovereigns have improved their net external debt positions in the past 20 years, illustrating a structural change that reduces external vulnerability despite the rise in global interest rates (see chart 7). For example, we project Brazil's external assets will exceed its external liabilities by around 2% of GDP this year, a sharp improvement from 1998 when its liabilities exceed it assets by 21% of GDP. Moreover, we project that net inflows of FDI (at 2.6% of GDP) will more than twice cover the current account deficit (at 1% of GDP) in 2018.

In spite of that, our rating on Brazil has fallen in recent years (from a peak of 'BBB' in 2014) due to recession, poor fiscal performance, and rising government debt. Brazil's main ratings weaknesses are domestic, not external; the ratings fell during a period of still-low global interest rates and ample liquidity. Its future ratings trajectory, whereas it might marginally be affected by a slowdown in FDI, depends much more on the ability of its next government (following national elections in October 2018) to address structural problems in public finance and to boost GDP growth prospects than on the level of U.S. interest rates.

Chart 7



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The Philippines is likely to have external assets exceeding liabilities by nearly 10% of GDP in 2018, a remarkable improvement from 1998 when external liabilities were 26% of GDP higher than its assets. This steady improvement reflects, among other things, the strength of steady inbound remittances from Filipinos working abroad, which have improved both the current account balance and GDP growth, contributing to a rising credit rating (which went from 'BB-' in 2008 to 'BBB' today).

Peru also improved its external position in recent years. We project that its external liabilities will exceed its assets by less than 5% of GDP in 2018, down from more than 27% of GDP in 1998.

The Importance Of Exchange-Rate Flexibility

Greater exchange-rate flexibility is a key supporting factor for creditworthiness, allowing sovereigns to manage external vulnerabilities. All 14 of the EM sovereigns running a current account deficit this year have either a floating or a free-floating exchange rate, providing a shock absorber against adverse external developments. Half of those countries went through the difficult process of moving from a fixed or semi-fixed exchange rate to their current flexible regime during the last decade or earlier.

Romania, Poland, Hungary, and Turkey shifted to flexible exchange rates at the end of the last century. So did Mexico, Colombia, Peru, and Brazil, all of which have enjoyed much greater monetary flexibility in recent years, leaving behind their legacy of high inflation.

Russia, a country vulnerable to sudden changes in its terms of trade due to its reliance on commodity exports, was able to make an economic adjustment through the exchange rate after oil prices fell in 2014. As a consequence, during 2015 alone, real wages declined by nearly 10%. A subsequent strengthening of Russia's financial profile contributed to an upgrade in early 2018. The possibility of added economic sanctions against Russia from the U.S. and other countries due to political disputes poses a bigger risk for the credit rating than the increase in global interest rates.

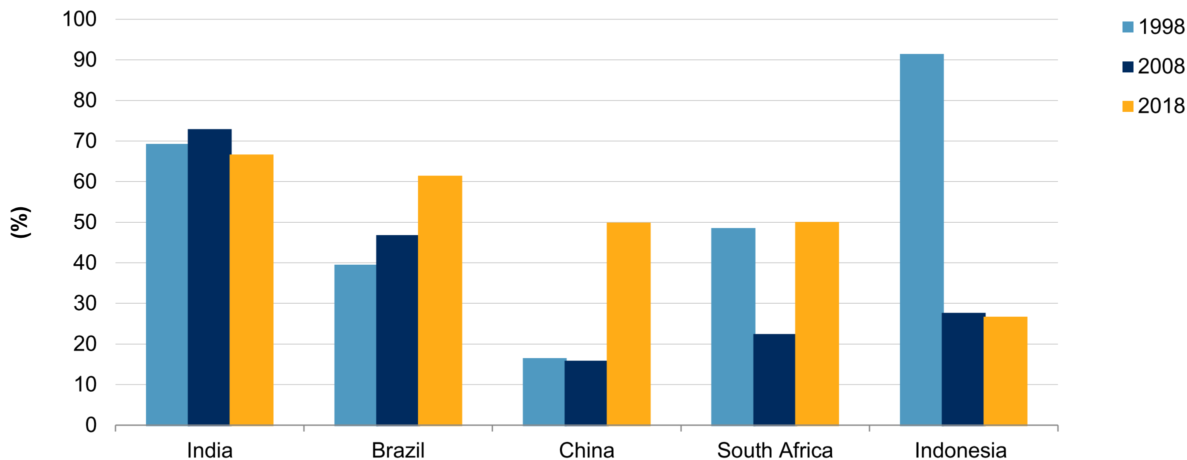
Debt Burden, Management, Composition, And Domestic Capital Markets

Flexible exchange rates can help ease the economic adjustment caused by external shocks, but sharp movements in the exchange rate can have serious negative repercussions, especially in countries with weak or ineffective monetary policy, small domestic capital markets, and reliance on external debt. A lower debt burden limits the sovereign's vulnerability to higher global interest rates. However, good debt management can also reduce the vulnerability embedded within a given level of sovereign debt by reducing the impact of adverse movements in interest rates and exchange rates. During the recent period of low and stable interest rates, several sovereigns shifted the composition of their debt to lock in favorable rates by extending maturities in fixed-rate borrowings. Many also shifted to a better mix of commercial, official, foreign, and local currency debt.

In Asia, for example, the reliance of the Indonesian, Filipino, and Thai governments on foreign currency borrowing has diminished significantly. They have also taken advantage of the low interest rates of the past decade to significantly lengthen the maturity of their debt, with Indonesia issuing 30-year bonds in recent years.

Some countries with current account deficits (such as Brazil, South Africa, Mexico, and India) have been able to limit their external vulnerability due to domestic capital markets that largely fund their fiscal deficits, reducing the risk of a sudden loss of external funding for the sovereign. In contrast, Argentina suffers from a large current account deficit, high net general government debt, and very small domestic capital markets that force the sovereign (and nonsovereign entities) to borrow abroad. A sharp depreciation of the currencies in Argentina and Turkey earlier this year sparked higher inflation and worsened the debt burden in both countries that remain vulnerable to the current market dynamics.

Chart 8



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The ability to issue debt domestically in local currency also contains external vulnerability for sovereigns with substantial net general government debt burdens, in a context of rising global interest rates. The ability of these sovereigns--such as India, Brazil, China, and South Africa--to issue debt in the local market limits the vulnerability embedded in their moderate to heavy debt burdens (see chart 8). Almost all of India's sovereign commercial debt is domestically issued in local currency, mitigating exchange-rate risk. Only around 10% of the South African government's debt is denominated in foreign currency. Most sovereign debt issued by China and Brazil is also issued locally and in local currency.

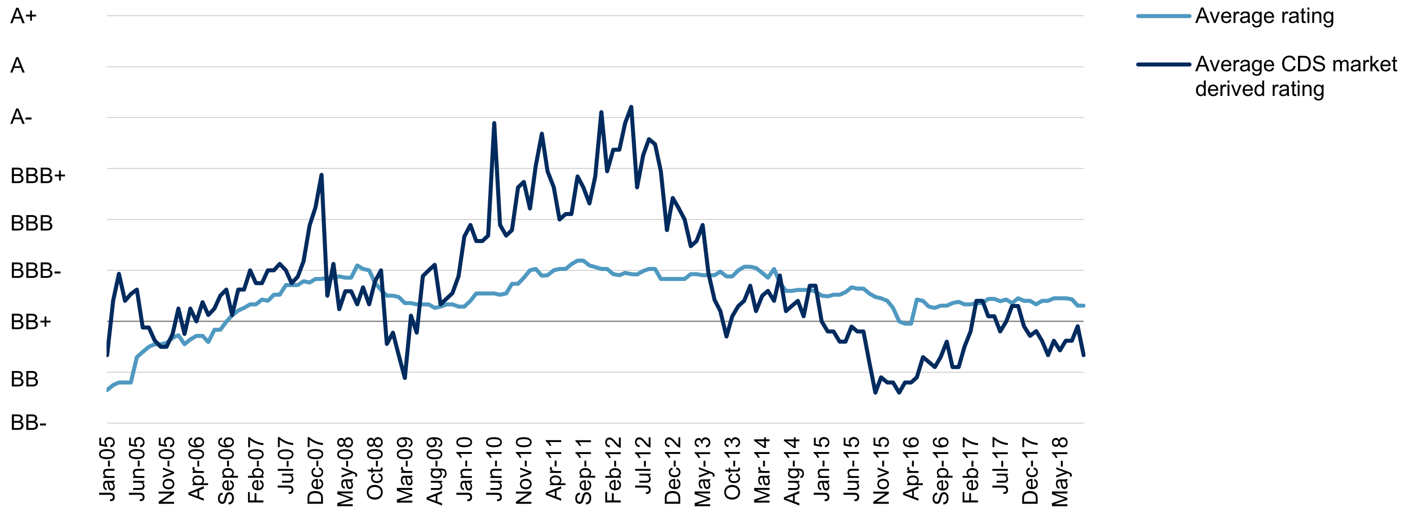
A low burden of external debt and the ability of domestic capital markets to largely fund the sovereign's debt burden allow India and South Africa, which are both likely to run a current account deficit approaching 3% of GDP this year, to better withstand the consequences of higher global interest rates and a depreciating currency. Similarly, Brazil's domestic capital markets reduce the risk of a sudden loss of liquidity despite the recent rapid growth of net general government debt.

Emerging Market Sovereigns Have Shown Increased Resilience

Our sovereign ratings show that the EM asset class has become more diverse over the last two decades, showing greater resilience against external risks such as higher global interest rates.

S&P Global Ratings evaluates various global scenarios and their potential impact on individual sovereigns. Our analysis focuses on the long-term resilience of individual sovereigns to withstand diverse shocks and respond in a timely and adequate manner. While fully incorporating current events, we aim to rate through the credit cycle and provide a reliable long-term assessment of creditworthiness (see chart 9).

Chart 9



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It is difficult to predict specific negative shocks that could affect the world economy. Higher global interest rates or recent threats to world trade are but some of many potential shocks that we factor into our credit ratings.

Sovereigns with more flexible economies that have built fiscal and financial buffers and developed a credible and predictable institutional stance have greater capacity to withstand adverse shocks, limiting potential contagion. We expect our sovereign ratings on those countries to be relatively stable over periods of stress. Those sovereigns that lack these credit qualities may soon need to make hard policy adjustments to avoid a crisis (or even default) in the event of a sudden stop in external market funding. Our sovereign ratings indicate which sovereigns are more at risk of suffering such a fate.

Appendix

Table 3

Emerging Market Sovereign Credit Ratings

	Long-Term foreign currency rating/ Outlook
China	A+/Stable
Chile	A+/Stable
Malaysia	A-/Stable
Saudi Arabia	A-/Stable
Mexico	BBB+/Stable
Peru	BBB+/Stable
Poland	BBB+/Positive
Thailand	BBB+/Stable
Philippines	BBB/Positive
Uruguay	BBB/Stable
Hungary	BBB-/Positive
Russia	BBB-/Stable
Romania	BBB-/Stable
Colombia	BBB-/Stable
India	BBB-/Stable
Indonesia	BBB-/Stable
South Africa	BB/Stable
Brazil	BB-/Stable
Argentina	B+/Watch Neg
Turkey	B+/Stable
Egypt	B/Stable
Nigeria	B/Stable

As of Oct. 9, 2018.

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