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Fitch Ratings' 2023 Outlook: Public Finance Stable Amid Weakening Macro Environment

Fitch Ratings-New York-05 January 2023: Fitch Ratings has assigned a deteriorating asset performance outlook for 2023 to the majority of public finance (PF) sectors, reflecting a negative trend in core credit drivers for these sectors relative to 2022. Worsening macroeconomic conditions will weaken tax and other revenues, while inflation that leads to higher operating expenses, including labor costs, and higher rates affecting borrowing costs will also pressure budgets. Despite the deteriorating macro environment, most Rating Outlooks across our PF portfolio are Stable given broad budget and revenue raising flexibility, strong reserves, and/or government support.

Downside risks, including deeper and prolonged recessionary conditions with higher inflation and policy rates, a sharp and sustained housing downturn, shifts in government policies or geopolitical risks could weaken financial cushions and credit quality.

The vast majority of U.S. state and local government Rating Outlooks are Stable, reflecting broad and diverse revenue bases, control over revenues and spending, moderate long-term liabilities and sound financial cushions. State and local governments built robust reserves over the past few years, strengthening their resilience.

Fitch-rated Canadian provinces have Stable Rating Outlooks and are entering 2023 with significant fiscal momentum. Most provinces benefit from robust and diverse economies and have broad discretion to respond to changing fiscal circumstances. Debt burdens increased less than anticipated through the pandemic, and liquidity is solid.

Slowing economic growth and rising inflation are negative for EMEA government-related entities' (GRE) standalone credit profiles; however, GRE ratings are mostly driven by government support, which undergirds GREs' ability to withstand stress and meet debt-servicing obligations. About half of EMEA local and regional government (LRG) issuers are capped by or equalized with the respective sovereign international default rating (IDR). About 70% of Fitch's LRG portfolio are on Stable Outlook, and with more than a guarter on Negative Outlook.

Fitch's sector outlook for Latin American LRGs is neutral due to our expectation that trends in key rating drivers will largely remain unchanged. In the region, 71.1% of LRG IDRs are either linked or equalized to the corresponding sovereign rating.

In APAC, all Rating Outlooks across both Australian and New Zealand LRG portfolios are Stable, reflecting the resilience of LRGs to the fiscal pressures and balance sheet capacity to absorb further economic shocks. Chinese policy remains supportive of local-government financing vehicles (LGFVs) in light of their economic development role. The Rating Outlook on the majority of our China LGFV ratings is Stable, with the exception of four LGFVs with a Negative Outlook, which largely reflects the relevant LRG Rating Outlook.

Fitch's deteriorating sector outlooks for US water and sewer, public power and higher education sectors indicate our expectations that economic and business conditions will create a more

challenging operating environment in 2023 relative to 2022. Higher costs and slower economic growth are expected to contribute to softening operating performance, which could lead to a weakening in credit quality across these entities absent efforts to reduce or recover operating costs and increase rates to preserve margins. Despite these pressures, Rating Outlooks across our rated portfolio of higher education and water and sewer and public power utilities are predominantly Stable, as most credits manage operational and capital spending to preserve some budgetary flexibility and have headroom to absorb higher costs.

The U.S. not-for-profit healthcare sector's core credit drivers will remain under pressure in 2023. Inflation, especially labor costs, is compressing margins, with investment losses compounding fiscal pressures, although record levels of cash accumulated through much of 2021 provide a buffer. We anticipate that downgrades and Negative Outlooks will outpace upgrades and Positive Outlooks in 2023, although the vast majority of Rating Outlooks are currently Stable.

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