European Rates Watch

H1 2023 UK sovereign credit rating watch: there is time to wait and see

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First round of 2023 credit rating reviews starts this Friday

Major credit rating agencies – Fitch, S&P and Moody's – are due to start making their first round of 2023 UK sovereign credit rating updates this Friday (Exhibit 1). We have received questions about the UK's sovereign credit ratings and the market implications if any changes were to occur (this Friday or more broadly in 2023-2024).

In this report we look at the latest UK credit rating developments in 2022, review upside and downside scenarios as outlined by the rating agencies and present our own outlook. Current guidance from the agencies implies a big focus on fiscal and macro developments in the next year or two, among other factors. In our own view, the risks to the fiscal outlook have fallen substantially since last September as the government has unwound much of the 'mini Budget' of September last year and growth has improved. But there do appear to be challenges ahead in delivering the fiscal forecast.

Based on typical timeframe in which negative outlook tends to be resolved, we think the credit rating agencies will be in no great rush in H1 2023 to make changes. A one-notch downgrade by Fitch or Moody's – if a downgrade were to happen at some point in the future – would result in the UK's ratings entering the "Upper Medium" band of Investment Grade (IG) – still very far from speculative. But for some investors following AAA-AA index (although hard to tell how many there are), the shift could be important.

Exhibit 1: UK sovereign credit rating review dates for 2023
S&P and Moody's to review UK's sovereign credit rating this Friday

Credit rating agency	1st review	2nd review
Fitch (AA-, negative)	Fri, 2 Jun	Fri, 1 Dec
S&P (AA, negative)	Fri, 21 Apr	Fri, 20 Oct
Moody's (Aa3, negative)	Fri, 21 Apr	Fri, 20 Oct

Source: Fitch, S&P, Moodys, BofA Global Research

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'Mini Budget' sparks changes in UK's credit rating outlook

The UK Chancellor Kwasi Kwarteng's poorly received 'mini Budget' of 23 September 2022 led to turmoil in the markets. Shortly after, the three major credit rating agencies revised the UK's sovereign credit rating outlook to negative on rising fiscal risks:

- On 30 September 2022, S&P Global Ratings revised the outlook on its unsolicited 'AA' long-term foreign and local-currency ratings on the UK to negative from stable.
- On 5 October 2022, Fitch Ratings revised the UK's outlook on long-term foreign-currency issuer default rating (IDR) to negative from stable and affirmed the IDR at 'AA-'.

Refer to important disclosures on page 4 to 5.
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Timestamp: 18 April 2023 05:39AM EDT

- On 21 October 2022, Moody's Investors Service changed the outlook on the UK ratings to negative from stable and affirmed the domestic and foreign-currency long-term issuer and domestic-currency senior unsecured rating at Aa3.

Our credit rating scoring method outlined in Exhibit 2 illustrates the UK's downward credit rating trajectory since 2010, as shown in Exhibit 3 (we score from triple-A rating at 10 to triple-B rating at 1 and assign ±1 for a rating upgrade/downgrade; ±0.5 for a credit-watch insertion/removal; ±0.25 for a change in outlook).

Exhibit 2: UK sovereign credit rating matrix and rating scores
Red shading indicates negative outlook

	Fitch	S&P	Moody's	Score
Investment grade	AAA	AAA	Aaa	10
	AA+	AA+	Aa1	9
	AA	**AA**	Aa2	8
	AA-	AA-	**Aa3**	7
	A+	A+	A1	6
	A	A	A2	5
	A-	A-	A3	4
	BBB+	BBB+	Baa1	3
	BBB	BBB	Baa2	2
	BBB-	BBB-	Baa3	1
Outlook		Negative		-0.25
		Stable		0.00
		Positive		0.25
		Negative watch		-0.50

Source: Fitch, S&P, Moodys, BofA Global Research

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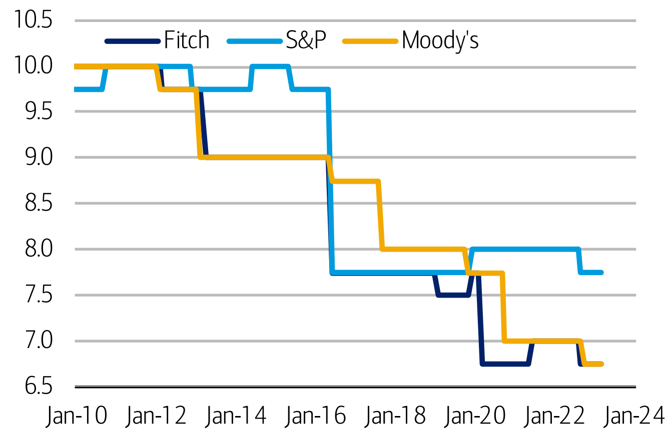
Exhibit 3: UK sovereign credit rating evolution since 2010
Current average score is 7.1 using Fitch, S&P and Moody's



Source: Fitch, S&P, Moodys, BofA Global Research. We assign ±1 for rating upgrade/downgrade; ±0.5 for a credit-watch insertion/removal; ±0.25 for a change in outlook.

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Focus on fiscal and macro performance

The negative outlook assignment by the three rating agencies last September primarily reflected what they viewed as rising risks to the UK's fiscal position and its predictability over the coming years. The macroeconomic environment – growth prospects and inflation persistence – were also highlighted as important, among other factors.

According to their downside scenarios, the credit rating agencies could lower the UK's sovereign rating if fiscal performance significantly weakened compared with their base case forecasts. More uncertain policymaking amid weaker growth and high inflation were also mentioned as downside risks.

With a negative outlook indicating that a rating upgrade is unlikely, the agencies have the option to return their negative outlooks to stable. Broadly, moderating economic and fiscal risks compared to their base-case scenario would be one reason to do so.

Easing shocks since September 2022

Two of the four 'supply shocks' driving the UK economic outlook have eased since last summer. Energy prices have fallen sharply and supply chain disruptions eased. This has improved the near-term growth and fiscal outlooks, in our view. We cut our 2023 growth forecast from 0.5% last June to -0.4% before the 'mini Budget' and to -1.2% after the 'mini Budget'. Rising energy prices squeezing real incomes and higher market interest rates following the 'mini Budget' were the primary reasons for our forecast cuts. We have since raised our 2023 growth forecast to -0.3% as energy prices have fallen, supply chain disruptions eased and the government reversed the 'mini Budget', allowing market interest rates to decline.

Stronger growth has translated into an improved short-term fiscal outlook, with the fiscal watchdog the OBR (Office for Budget Responsibility) cutting government borrowing forecasts for 2022/23 and 2024/24. The risks to the fiscal outlook have, in our view, fallen substantially since last September as the government has unwound much of the 'mini Budget' and growth has improved.

But the government debt outlook remains on a considerably higher path than thought last March. This reflects the still-considerable shock to the economy from, and fiscal support to smooth through, higher energy prices. The OBR expects public sector net debt excluding the Bank of England to stabilise at around 95% of GDP in 2025-2028, around 15ppt higher than expected last March.

The UK government has adopted looser fiscal rules than in place this time last year – extending the horizon for debt to fall relative to GDP from three to five years – and the OBR forecasts the Chancellor will meet the rule with £6.5bn to spare. That is the smallest 'headroom' against fiscal rules the OBR has forecast since its start in 2010.

There appear to be challenges to delivering the fiscal forecast. First, the OBR has, in our view, optimistic potential growth estimates (see UK Watch: Budget review: optimistic 15 March 2023), suggesting upside risks to medium-term borrowing forecasts. The government spending plans underlying those forecasts also look tricky to achieve.

Still very far from speculative grade

A one-notch downgrade by the S&P would result in all three major UK credit ratings standing on the lowest 'High-grade' Investment Grade (IG) rating. One notch downgrade by Fitch or Moody's would result in the UK's sovereign credit ratings entering 'Upper Medium' IG, still very far from speculative grade.

Depending on the exact definition, some impact from exiting the AAA-AA territory is possible. For example, in the fixed-income management section of its website, Norges Bank Investment Management (NBIM) states that the company invests in high credit rating and liquid developed market bonds, allowing a small percentage of fixed-income investments to be in bonds from emerging market issuers. A high percentage of NBIM's investments are denominated in EUR, USD, GBP and JPY. Potentially, a move into 'Upper Medium' territory could become more problematic for such investors (although it's hard to tell how many there are).

More broadly, according to the ONS, overseas investors hold around 30% of Gilts. Of this 30%, less than 20% is foreign central banks. Public institutions that hold Gilts as foreign currency reserves are unlikely to reduce their Gilt allocations sharply unless a cut to speculative grade starts to look possible, in our view.

No rush to resolve negative outlook in H1 2023

Typically, an outlook period lasts 1-2 years before being resolved. From a timing perspective, the credit rating agencies are therefore in no great rush in H1 2023 to make changes and could wait until at least the second round of scheduled 2023 rating reviews to see what progress is made. Of course, deviations from the announced calendar are allowed in certain circumstances, as was the case following the government's 'mini-Budget' in 2022.

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