

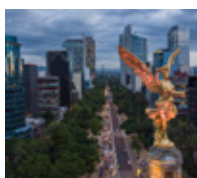
Credit Journal Sovereigns



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Welcome to **Credit Journal** – a curated compilation of Fitch Ratings’ in-depth research and commentary.

This edition takes a deep dive into the Sovereigns space, including the risks associated with rising government debt levels and related interest rate and inflation concerns. At Fitch, our expert analysts collaborate across our sovereigns, supranationals, public finance, and financial institutions teams to provide global, integrated analysis and commentary.

We hope this issue, as well as future ones, serve as reliable resources to help you make more informed investment decisions. We welcome comments for future issues, including suggestions for topical or credit-specific research.

For our latest insights, please visit **[fitchratings.com](https://www.fitchratings.com)**

Welcome

I'm pleased to share the second edition of **Fitch Ratings' Sovereigns Credit Journal**, featuring topical commentary and analysis on public finance across developed, emerging and frontier markets.

The story of the year so far has been historically low levels of sovereign rating actions, with no upgrades and only three downgrades during the first half of 2021, after a record number of negative rating actions in 2020.

Current forecasts project government debt/GDP ratios will rise in 75 of 120 rated sovereigns in 2021 and in 61 sovereigns in 2022. The five-year average in 2019 was 68, and the median global fiscal deficit was 6.9% of GDP in 2020 and we forecast it to be 5.7% in 2021 and 4.0% in 2022.

With a focus on fundamentals and long-term perspectives, our analysts are actively monitoring and providing views on global sovereign-related concerns, including external funding stresses, prolonged fiscal easing and continued concerns over inflation and interest rates as a consequence of rising government debt levels.

Our extensive coverage of sovereign debt includes ratings for 120 sovereigns across all global markets and a robust understanding of policies and macroeconomic drivers. With our team of experienced analysts covering the spectrum of sovereign issuers, supported by our economics team, we are proud to be a leading force in public finance ratings, widely accepted by issuers, investors, and other debt capital market participants.

In this issue, James McCormack, Global Head of Sovereign Ratings, touches on the risks associated with rising government debt levels, as policymakers remain focused on responding to the economic consequences of the Covid-19 pandemic and its aftermath.

As always, if there is specific research you would like to see from us, please do not hesitate to suggest it.

Enjoy your reading!



Aymeric Poizot, CFA, CAIA

Global Head of Investor Development



Global Focus



Inflation Impact on Sovereigns
Depends on Real Interest Rates

Faster World Recovery Boosting Prices,
but Runaway Inflation Unlikely

Sovereign Rating Implications of Full
Dollarisation

Strong Global Goods Demand Has Helped
EM Exports Through the Pandemic

Stranded Assets a Long-Term Risk for
Major Fossil Fuel Exporters

Inflation Impact on Sovereigns Depends on Real Interest Rates

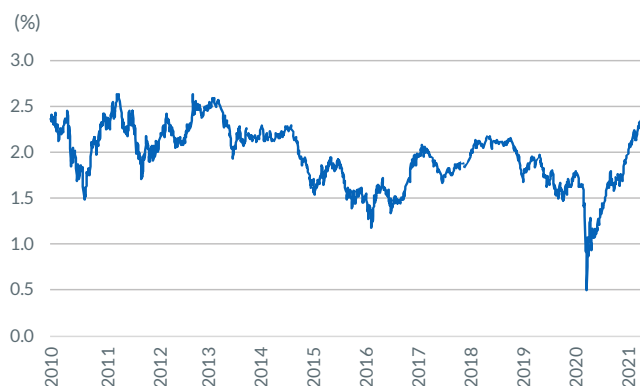
Inflation trends and associated risks around interest rates and exchange rates may have direct sovereign credit implications, and a critical question for government debt sustainability is how inflation will affect debt/GDP ratios.

Higher levels of global government debt as a result of the coronavirus pandemic have made sovereign creditworthiness increasingly sensitive to interest rate changes. Base effects, higher commodity prices, idiosyncratic effects of sectoral re-openings and pandemic-related supply-side disruption are contributing to higher inflation in many countries. Nevertheless, most central banks are taking the view that the rise in inflation will not last, and that now is not the right time to tighten financial conditions.

Longer-term rates matter more than policy rates for fiscal outcomes and debt sustainability, and there is no convincing evidence yet that bond markets disagree with central banks' inflation diagnosis. The US 10-year Treasury yield – the most important benchmark for global sovereign borrowing conditions – has been below 1.7% since early April. Relatively stable country-specific benchmark sovereign yields are currently the rule rather than the exception.

Fitch believes US inflation and bond yields will rise in the medium term, as higher inflation is a stated policy objective and the Fed will only react ex post. We forecast US inflation to be 2.5% at end-2023 and 10-year Treasuries to yield 2.3%, which is still low in a

US 10-Year Breakeven Inflation Rate



Sources: Haver Analytics, Fitch Ratings
Derived from 10-Year Constant Maturity Treasuries and 10-Year Inflation-Index Constant Maturity Treasuries

historical context relative to our nominal GDP projection of more than 4%. We expect global yields to follow US yields higher, though Japan has shown low yields can persist on country-specific factors for an extended period.

Higher inflation leads to higher nominal GDP, resulting in an immediate improvement in debt/GDP ratios; 'inflating debt away'. This is particularly the case if – as presently – there is a muted response from benchmark yields to higher inflation, thus lowering governments' real marginal borrowing costs. Even if benchmark yields rise in tandem with inflation and nominal GDP growth, it will take time for the effective (or average) cost of borrowing to catch up with the higher marginal cost, particularly for sovereigns with long average debt maturities. All else being equal, these inflation conditions are positive for sovereign credit.



Global Focus

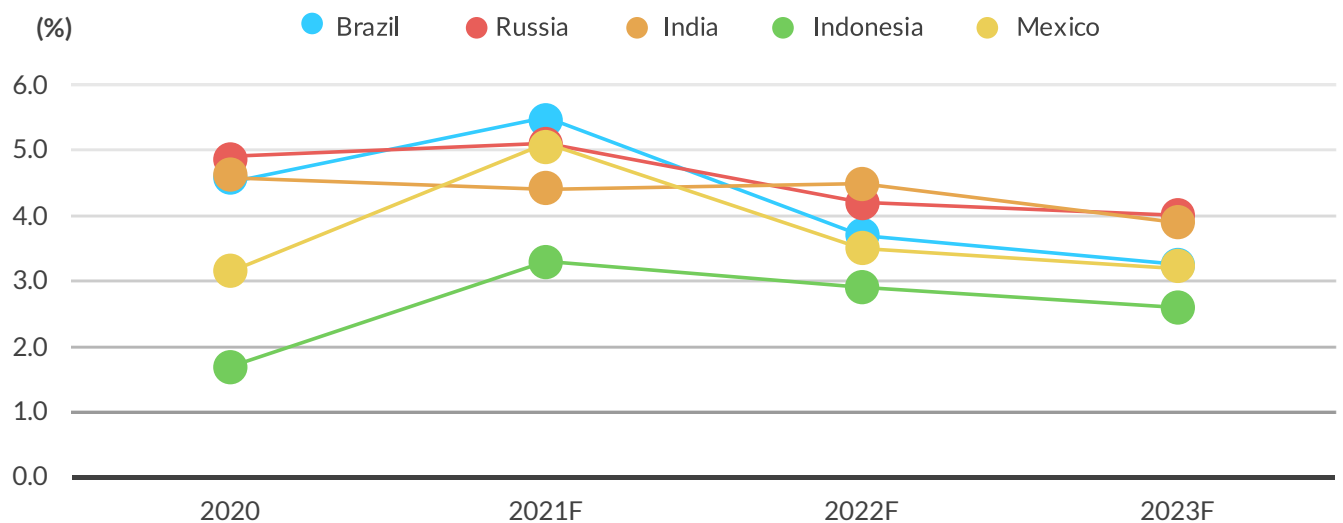
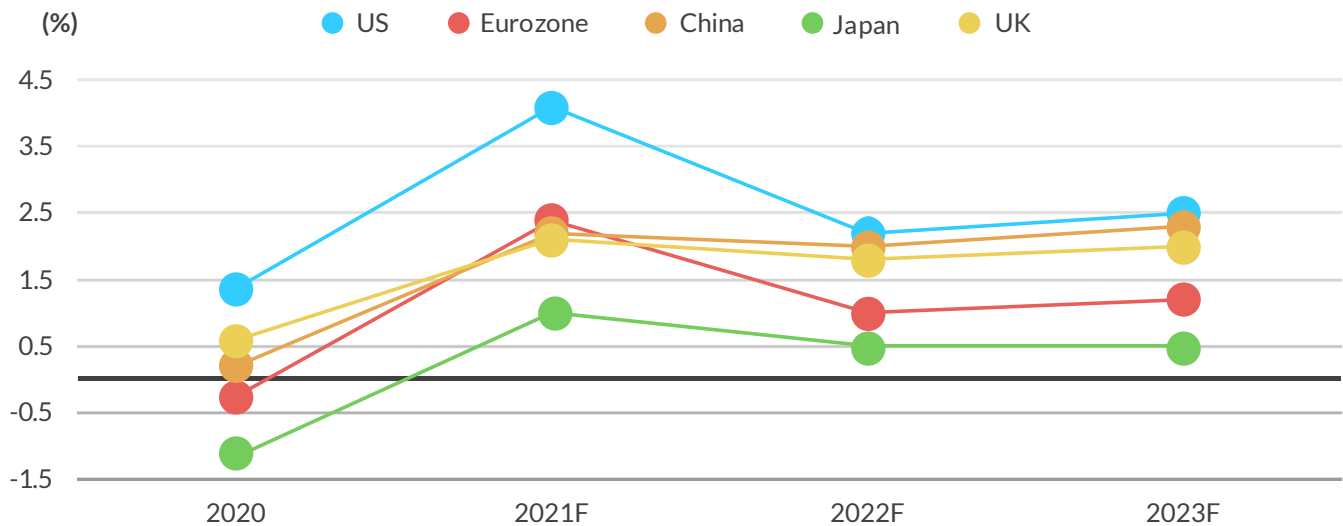
However, should inflation prove more persistent than transitory, markets may demand higher yields

to compensate for greater uncertainty around inflation outcomes. Increases in benchmark yields and corresponding effective rates may exceed the rise in inflation, meaning higher real interest rates for governments. In this case interest payments on government debt will, all else being equal, rise more rapidly than nominal GDP and the numerator of the

debt/GDP ratio will rise relative to the denominator, diminishing sovereign creditworthiness.

Both policy-rate decisions and adjustments to quantitative easing (QE) strategies may affect bond yields. The QE policies of the US Federal Reserve and ECB have received the most attention, but higher inflation will also spur discussion around programmes being wound down in emerging markets. Sovereign bond yields generally fell in emerging markets on

Fitch Consumer Price Inflation Forecasts



Source: Fitch Ratings

QE announcements, implying that there is a risk of symmetric market reactions to exit strategy announcements.

Interactions between inflation, policy and market interest rates, as well as QE, can also affect exchange rates, which are particularly important for emerging markets' government debt sustainability. QE in emerging markets has been limited to jurisdictions with larger and more sophisticated domestic bond markets, upon which governments rely for funding, reducing the importance of exchange rates to public debt dynamics. However, few emerging market sovereigns are entirely immune from exchange-rate risk, so investors will need to monitor carefully QE exit strategies and relative monetary policy postures more generally.

Faster World Recovery Boosting Prices, but Runaway Inflation Unlikely

A faster-than-expected global economic recovery is boosting prices as supply chains have struggled to keep up with rapidly expanding consumer durables demand and world merchandise trade. However, slower growth, supply adjustments in bottleneck sectors, a switch back towards services consumption, and fading impacts from US fiscal stimulus should see the rate of inflation decline in 2022.

Fitch now expects world GDP to grow by 6.3% in 2021, revised up by 0.2pp since the March GEO. Incoming data, earlier-than-expected services sector reopening in the US and Europe, and the impact of policy support lie behind the revision.

World growth is expected to slow to 4.3% in 2022. We have raised our 2021 growth forecasts for most developed economies, with the US revised up to 6.8% from 6.2%, the eurozone to 5.0% from 4.7%, and the UK to 6.6% from 5.0%. Only Japan has seen a reduction, to 2.5% from 3.6% in the previous GEO, but this has been accompanied by an upward revision in 2022. China's forecast is unchanged at 8.4%, but we have trimmed growth in emerging markets excluding China to 5.9%

from 6.0%. This reflects a large reduction in India's forecast and cuts to Indonesia and Turkey, partly offset by upward revisions to Brazil, Mexico, South Africa and Korea.

We now expect the Fed to hike rates over a year earlier than our previous expectation.

A host of indicators point to the reopening of face-to-face services in the past couple of months in Europe and the US, as new cases and hospitalisation rates have declined and vaccination rollout has progressed.

Germany and Italy have announced significant further fiscal policy-easing measures since the previous GEO and investment plans using the EU's Next Generation EU fund have been firmed up. We have also now incorporated an estimate of the impact of President Biden's infrastructure plans in our US forecasts for 2022 and 2023.

The effect of the US March stimulus has become clearer, including its contribution to the boom in US consumer durables spending, now a staggering 30% higher than pre-pandemic levels. Durables strength has pushed up US merchandise imports, helping EM manufacturing exporters and the recovery in world trade. Alongside the synchronous global recovery, this has fuelled a sharp rise in global commodity prices, similar to 2010.

We have revised up significantly our US and global inflation forecasts. We expect US CPI inflation to fall from 4.1% at end-2021 to 2.2% by end-2022, but then to rise again to 2.5% in 2023 as output moves further above potential after the labour market fully recovers in late-2022. We now expect the Fed to hike rates over a year earlier than our previous expectation. The ECB will not follow suit and will likely continue asset purchases through 2023 as eurozone inflation remains below target.

Global Focus

Sovereign Rating Implications of Full Dollarisation

The wide spread of dollarised sovereigns' ratings across the ratings spectrum indicates that this currency regime on its own is not strongly correlated with creditworthiness and that other factors play decisive roles. That said, the interplay of dollarisation – a currency regime in which a sovereign adopts a foreign currency as legal tender in place of its own – with other macroeconomic policies has rating implications.

The regime can be an anchor for stability in terms of inflation and the financial sector, but when accompanied by inconsistent policies (fiscal, macroprudential, salary, monetary), the combination can create challenges to sovereign repayment capacity.

Fitch analysed the inner workings and rating implications of dollarisation and focuses on the five dollarised sovereigns rated by Fitch: Andorra (BBB+/Stable), Ecuador (B-/Stable), El Salvador (B-/Negative), Panama (BBB-/Negative) and San Marino (BB+/Negative).

Recent negative rating actions in Ecuador, El Salvador, Panama and San Marino highlight that the regime has not ensured broad fiscal discipline or avoided other relevant macroeconomic challenges. Only Andorra has avoided negative rating actions in recent years.

Ecuador's recent bond restructuring and Defense of Dollarization Law have shone a light on the mechanics



of dollarisation and how it does not automatically serve as a hard constraint against heterodox policymaking. In the past decade, its central bank has engaged in inorganic expansion of the local money supply to boost growth and fund the fiscal deficit. But a larger domestic money supply adds to pressures on external liquidity that is crucial to ensure local dollars can be used globally, posing a risk to macroeconomic and financial stability. The Defense of Dollarization Law seeks to reverse this damage, and bring domestic and external dollar liquidity into a healthy equilibrium.

Strong Global Goods Demand Has Helped EM Exports Through the Pandemic

The strength of global goods demand in the past year was a boon for several emerging markets' (EMs) current account balances, but may not be sustained as demand patterns normalise post-pandemic.

The bulk of the trade gains were driven by exports from East Asia.

The strength of global goods demand has helped some major emerging markets return to current account surpluses after several years spent in deficit, while for developed countries it has meant a noticeable deterioration in their current account balances.

The bulk of the trade gains were driven by exports from East Asia, as homebound western consumers stocked up on electronic consumer goods and governments bought medical equipment.

US stimulus support looks to have boosted US demand for goods disproportionately, while Covid-19 social-distancing measures have constrained US consumption of services.

As developed economies reduce mobility restrictions, it is likely that improvements in EM current account balances will unwind over time. An easing in developed economies' restrictions will enable consumers to switch some of their spending away from imported goods



towards domestic services, resulting in a moderation in EM export growth. EM trade surpluses will also unwind as their import volumes recover.

The pandemic-related challenges that EM countries face will delay the recovery in international services trade (including travel and tourism). International tourist arrivals collapsed in 2020 and although volumes have increased recently, these remain significantly below the pre-pandemic period. Commercial flights and hotel vacancy rates also remain low.

Global remittances from workers declined only slightly last year, largely due to fiscal stimulus packages that led to better-than-expected economic conditions in host countries and a greater use of digital and formal channels, among other factors. According to the World Bank, remittances fell in East Asia & the Pacific (7.9%) and Europe & Central Asia (9.7%), but recorded positive growth in Latin America & the Caribbean (6.5%), South Asia (5.2%), the Middle East & North Africa (2.3%), and sub-Saharan Africa ex-Nigeria (2.3%), helping to offset some of the shortfalls in tourism earnings.

Stranded Assets a Long-Term Risk for Major Fossil Fuel Exporters

Fossil exporters face a loss of GDP, government revenue and export receipts from the transition to a lower-carbon economy over the coming decades. For the most-exposed sovereigns and those that do not adequately prepare for it, climate change stranded-asset risk is likely to lead to rating downgrades as the effects become clearer, closer and more material.

The extent and speed of the decline in demand for fossil fuels is uncertain. Excess potential global supply will weigh on prices, potentially compounding the loss from lower volumes. Coal will face a faster and fuller loss of market than oil and particularly gas. High-cost producers will be squeezed out first. Sovereigns with strong balance sheets and potential to diversify their economies are better-placed. Political instability and rising financing costs could amplify challenges.

From a sovereign rating standpoint, the transition could be a similar shock to oil revenue as occurred in 2013-2016 and again in 2018-2020.

Under a plausible scenario, the transition would be a similar shock to oil revenue as occurred in 2013-2016 and again in 2018-2020. During this period two oil exporters defaulted and a further three were downgraded by at least four notches. Being much slower, it would give sovereigns more capacity to adjust, but it would be permanent. A simulation on Fitch's Sovereign Rating Model suggests it could lead to a fall in the SRM output by around one rating notch by 2040 and two to three notches by 2050 for a major oil exporter.

Ratings typically place more weight on current developments and we will be more circumspect in taking forward-looking rating actions the more distant and uncertain are future events.

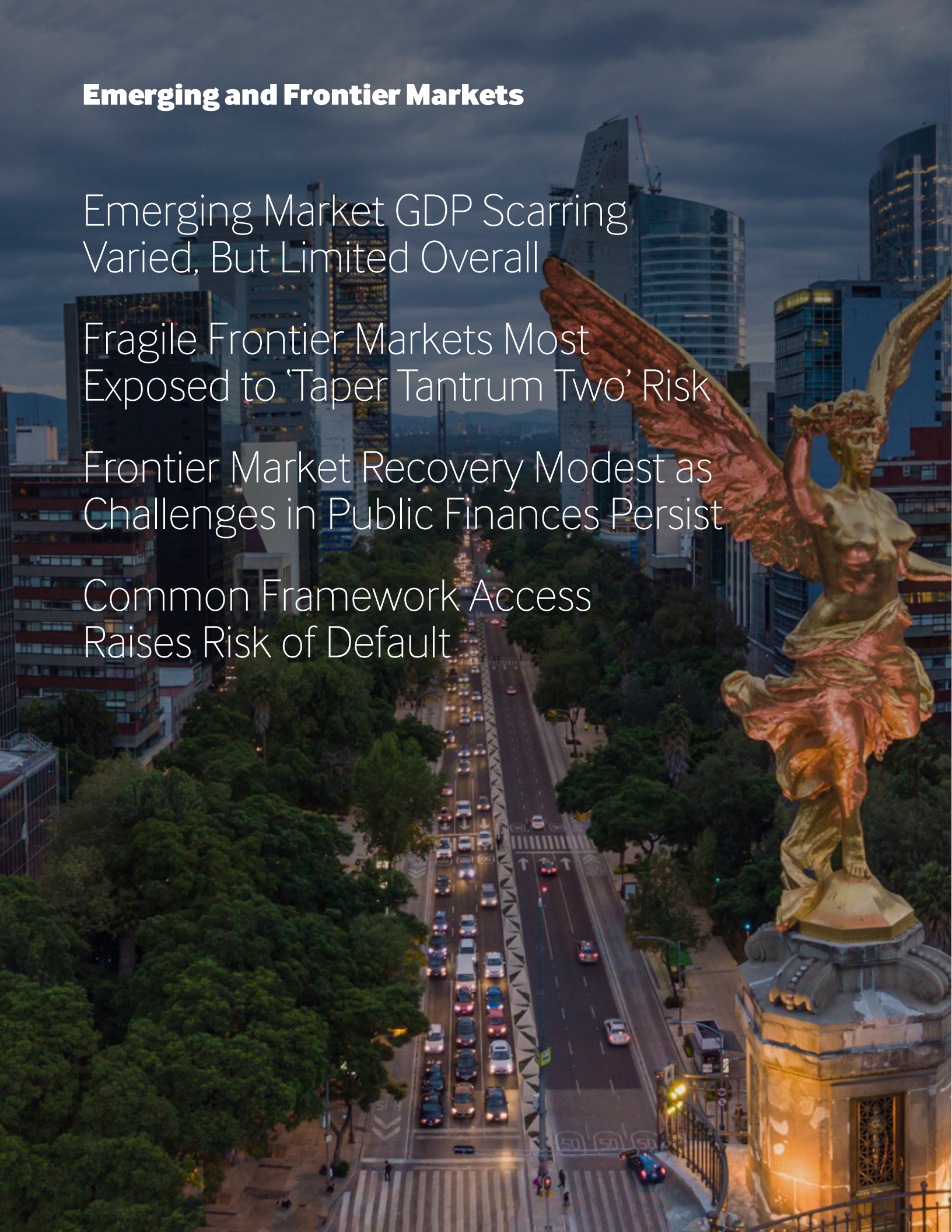
Emerging and Frontier Markets

Emerging Market GDP Scarring
Varied, But Limited Overall

Fragile Frontier Markets Most
Exposed to 'Taper Tantrum Two' Risk

Frontier Market Recovery Modest as
Challenges in Public Finances Persist

Common Framework Access
Raises Risk of Default



Emerging and Frontier Markets

Emerging Market GDP Scarring Varied, But Limited Overall

The pandemic shock is likely to have lasting impacts on supply-side GDP potential in some of the largest emerging market (EM) economies, but such “scarring” effects will be limited overall.

Shocks to GDP on the scale of those seen in 2020 can result in scarring through reduced business investment and credit availability, widespread bankruptcies and human capital losses through labour market detachment.

However, several factors mitigate the risk of scarring for EMs as a whole. The pandemic was not preceded by the build-up of large macro or financial imbalances. Moreover, the scale and speed of the macro policy response has been unprecedented.

Nevertheless, India, South Africa, Indonesia and Mexico look more vulnerable to permanent GDP losses. This partly reflects a much sharper GDP shock as they rolled out less policy support in the early stages of the crisis. The investment shock was also particularly large in these countries. In India we see a fragile banking system limiting the investment recovery in coming years.



India, South Africa, Indonesia and Mexico look more vulnerable to permanent GDP losses.

India, South Africa, Indonesia and Mexico saw the largest downward revisions to potential growth compared with our previous projections published in 2019. We moderately reduced our projections for China, Korea and Turkey, reflecting weakening demographic trends, and slightly cut the projection for Brazil. Poland's potential growth rate is unchanged. We slightly raised the estimate for Russia following pension reforms that are improving the outlook for labour supply growth.

For Brazil, Russia, India, Indonesia and Mexico, our latest short-term forecasts imply that GDP will remain significantly below potential in 2023. This means that actual output should be able to grow somewhat more quickly than supply-side potential over 2024 to 2026 as the output gap closes.

Fragile Frontier Markets Most Exposed to ‘Taper Tantrum Two’ Risk

A long tail of smaller and low-rated Frontier Markets is more exposed to rising US bond yields than larger mainstream EMs, reflecting larger external financing needs and high levels of foreign-currency government debt.

Fitch expects the Fed to announce a tapering of its asset purchase programme in 2H21. This and the rise in US bond yields has raised the risk of a repeat of 2013's ‘taper tantrum’. Nevertheless, we expect the rise in US bond yields to be gradual and for global financial conditions to remain supportive by historical standards.

In 2013, there was material spillover to the so-called ‘fragile five’ of Brazil, India, Indonesia, South Africa and Turkey, which had sizeable current account deficits. But the decline in capital flows was relatively quickly retraced, as initial fears over the extent of Fed tightening proved overdone and some EMs raised policy rates. None of the five suffered a full-blown balance-of-

Emerging and Frontier Markets

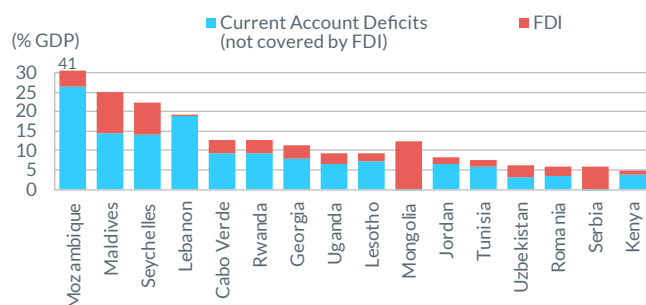
payments crisis and Fitch did not downgrade any of their sovereign ratings.

The 'fragile five' and most large EMs have smaller current account deficits than in 2013 (or even surpluses) and only low-to-moderate exposure to external financing risks. Overall, the macro-financial backdrop is more favourable than in 2013.

We forecast the median current account deficits of the 81 Fitch-rated EMs at 1.3% of GDP in 2021 compared with 3.2% in 2013. Seven EMs will run current account deficits of 10% of GDP or more this year, but fewer have current account deficits of more than 5% of GDP compared with 2013.

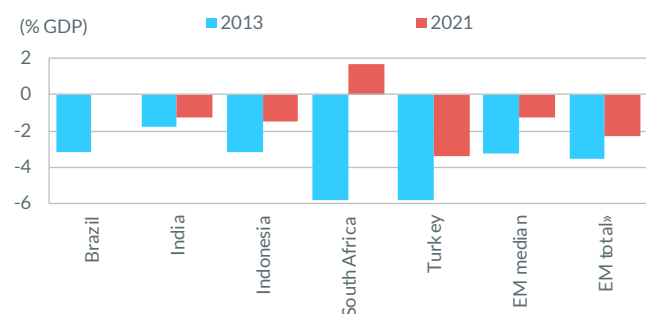
However, EM Eurobond amortisations of USD78 billion in 2021 are triple 2013's. Median EM total government debt rose to 64%/GDP at end-2020 from 34% at end-2012, making EMs more sensitive to higher global and local interest rates.

Largest Current Account Deficits, 2021



Source: Fitch Ratings

EM Current Account Balances: 2013 and 2021



*Deficit countries only
Source: Fitch Ratings

There are many weaker, less prominent EMs that have high levels of vulnerability. Sovereign median foreign currency debt represented about 2/3 of total government debt and 40% of GDP at end-2020 for smaller Fitch-rated EMs. This compares with 19% of GDP at end-2012 and 17% now for the largest 30 EMs, making depreciation against the US dollar more problematic for Frontier Markets.

There are many weaker, less prominent EMs that have high levels of vulnerability.

Depreciation of local currencies adversely affects amortisation/refinancing, while delivering less benefit in terms of correcting current account deficits. Greater reliance of Frontier Markets on official financing provides some insulation from global interest rate hikes, but official lending is not guaranteed, as lenders may deem debt unsustainable and policies incompatible with large loan disbursements.

There were five defaults in 2020 and a record 47% of EM ratings are in the 'B'/'C'/'D' categories. The G20 Debt Service Suspension Initiative (DSSI) and Common Framework, and a new Special Drawing Rights allocation highlight the external liquidity needs of many poorer EM sovereigns.

Frontier Market Recovery Modest as Challenges in Public Finances Persist

A recovery from 2020's pandemic-induced recession is underway but will be modest against a low base, as GDP growth is constrained by limited fiscal space in most Frontier Markets. Risks from the pandemic persist due to slow vaccination rates across all regions, with renewed COVID-19 waves continuing to hamper external receipts, public finances, employment and GDP growth. However, the impact on sovereign creditworthiness should be less severe, as economies have adapted, allowing for more targeted COVID-19 containment measures.

Emerging and Frontier Markets



External Liquidity Strains Easing for Some Frontier Markets

In many cases, import compression due to lockdowns and a hit to personal income more than offset the impact on current account balances in 2020 from a drop in exports and tourism receipts last year. The exceptions tended to be Frontier Markets dependent on either oil exports, such as Angola, Gabon, Iraq and Azerbaijan, or tourism receipts, such as Jordan, Georgia and the Maldives. While most of the former have seen a significant improvement in external balances in 2021 due to higher oil prices, the latter are still grappling with large current account deficits, as tourism remains scarred by the pandemic. For example, Georgia's tourism revenues in 2021 are expected to reach only 30% of 2019 levels.

Other tourism-dependent Frontier Markets, like Jamaica and Costa Rica, have benefited from resilient remittances due to large fiscal stimulus packages providing economic support in host countries, the use of more formal delivery channels while travel restrictions apply, and overseas workers' tendency to increase their financial support when families face hardships at home. Remittances also remained strong in Pakistan, with inflows up 33.5% yoy in May 2021, mitigating the sharp increase in its trade deficit in

1Q21, which was partly driven by the higher cost of oil imports.

Fiscal Scars a Legacy of the Pandemic

Public finances were the key negative rating driver for most Frontier Markets, as the pandemic exacerbated underlying weak fiscal trends predating 2020. Government deficits and debt burdens increased across all regions, with Iraq, Tunisia, Ghana, Mozambique, Namibia, Zambia, El Salvador, Bolivia, Suriname, Azerbaijan and Mongolia showing the largest deterioration in 2020. Economic recovery, higher commodity prices, and in some cases withdrawal of fiscal relief packages should lead to a decline in fiscal deficits or a return to fiscal surpluses (Azerbaijan and Angola) in 2021. Among the few exceptions are Suriname, Kenya, Ethiopia, Uzbekistan and Armenia.

The pandemic exacerbated underlying weak fiscal trends predating 2020.

Mongolia, Iraq, Angola, Gabon, Jamaica and Suriname will be among the few Frontier Markets to exhibit a drop in government debt ratios this year, but debt levels will generally remain high, with Angola, Jamaica and Suriname's still in the vicinity of 100% of GDP. Public

Emerging and Frontier Markets

debt stabilisation will elude most Frontier Markets, as the pandemic has exacerbated pre-existing fiscal challenges from low revenue bases and rising spending pressures. With the pandemic still hampering structural consolidation, and several countries re-imposing restrictions due to a rebound in infections in 1H21, fiscal consolidation may be less of an immediate priority in IMF negotiations, although medium-term debt sustainability, structural reforms and revenue mobilisation will still be encouraged.

Frontier Markets will benefit from the IMF's Special Drawing Rights allocation, which was approved by its Board of Governors on 2 August. The USD650 billion allocation will raise FX reserves for IMF member states without creating new debt or requiring conditions to be met. In addition, there are proposals for richer members to use their new Special Drawing Rights to support low-income countries, with the US, China and several European countries already expressing support.

Most IMF loans to low-income countries in 2020 were under the Rapid Credit Facility, without conditionality, but further lending will increasingly fall under regular programmes such as the Extended Credit Facility, with conditionality. A large number of regular programmes are likely to be concluded in 2021, backed by recent IMF decisions allowing for larger IMF loans to low-income countries. The prospect of increased IMF financing could also incentivise some countries in distress or at high risk of distress to restructure under the G20 Common Framework.



Common Framework Access Raises Risk of Default

The Common Framework, launched in Nov.'20 by the G20 and Paris Club, is meant to provide debt relief to low-income countries with a challenging debt burden. The Common Framework requires countries to seek debt treatment by private creditors comparable to that of official bilateral creditors. This raises the possibility of a restructuring of debt to the private sector that would qualify as a distressed debt exchange under Fitch's sovereign rating criteria. As a result, a decision to seek debt restructuring under the Common Framework is unlikely to be compatible with a rating higher than 'CCC'.

There are still scenarios under which an intention to seek Common Framework treatment might not entail private-sector restructuring. The G20/Paris Club official-sector creditors could, for example, make an exception to the requirement of private-sector treatment, depending on the specific circumstances of a sovereign, or could consider an issuance followed by a debt buyback as comparable treatment. In addition, a sovereign might not follow through on a decision to apply for Common Framework treatment. Nonetheless, we do not consider exemptions of all private-sector creditors likely, given that the G20 has repeatedly encouraged private sector participation in the DSSI.

In assessing which countries may request a Common Framework treatment, the IMF's Debt Sustainability Analysis and the need for IMF funding are key, as IMF funding may be conditional on debt restructuring. Additional factors that could influence access to the Common Framework (including private-sector restructuring) are whether there are policy issues that would make negotiating an IMF programme difficult or whether countries rely heavily on international market access, which could be disrupted by private-sector restructuring.



Regional Coverage

Developed Europe

Emerging Europe

Middle East & Africa

Asia-Pacific

Latin America

North America

Regional Coverage

Developed Europe: ECB Strategy Review Underscores Likelihood of Sustained Easing

The conclusion of the ECB's Strategy Review on monetary policy increases the likelihood that the bank will continue buying assets on a large-scale once its Pandemic Emergency Purchase Programme (PEPP) is scheduled to come to an end in March 2022. The shift to a symmetric 2% inflation target from its previous "below, but close to 2%" objective makes it easier for the bank to tolerate inflation rates above 2%, at least temporarily.

It's likely that the ECB will raise purchases under the Asset Purchase Programme (APP) from the spring of 2022 when the PEPP expires.

Unlike the Fed's recent adoption of its Average Inflation Target, the ECB will not actively seek to make up for lost ground. In other words, it will not let inflation run higher to compensate for past episodes of very low inflation.

Nevertheless, the ECB stated its readiness to carry out "especially forceful monetary policy measures" when the economy is close to the zero bound on interest rates, if warranted by "large adverse shocks". Such circumstances might, according to the ECB, entail a "transitory period in which inflation is moderately above target", although the more hawkish members



of the Governing Council have emphasised the word "moderately".

A key problem for the ECB in recent years has been its past poor record on inflation forecasting with outturns persistently falling well short of its target. This has threatened a loss of credibility over time, with low inflation outturns feeding into lower inflation expectations in the private sector. With eurozone inflation expected to remain below target over the medium term, the more "forceful" approach now signalled by the ECB makes it even more likely that the ECB will raise purchases under the Asset Purchase Programme (APP) from the spring of 2022 when the PEPP expires.

Emerging Europe: Rule of Law Issues Yet to Directly Affect CEE Sovereign Ratings

The rule of law has been a contentious issue in the EU in recent years. There are concerns over the potential undermining of institutions and erosion of independent checks and balances in some member states, and the lack of an effective sanctioning system.

The concerns are most pronounced regarding the Central and Eastern Europe (CEE) region, particularly Hungary (BBB/Stable) and Poland (A-/Stable). To a lesser extent, governance standards in Bulgaria (BBB/Positive) and Romania (BBB-/Negative) have also appeared on the radar.

Rule of law considerations are taking on additional importance given the associated conditionalities under the Next Generation EU Funds (NGEU) facility, which is set to be an important driver of economic recovery for the region.

Fitch analysed the interplay between rule of law and broader governance issues, and sovereign ratings. Measuring rule of law is complex and inexact. Quantitatively, governance indicators (as measured by the World Bank's worldwide governance indicators) form the largest component among all variables in Fitch's Sovereign Rating Model, which is the starting point of assessment for most sovereign ratings. As a result,



governance standards are an important consideration in analysing sovereign creditworthiness. Levels of, and movements in, the World Bank's rule of law indicator appear consistent with country developments in CEE.

No CEE sovereign ratings have been changed directly due to rule of law issues in recent years, but rule of law/governance considerations are negative rating sensitivities for Hungary and Poland, and positive sensitivities for the Czech Republic.

Middle East & Africa: ESG Investing in Sub-Saharan Africa is Tied to Sustainable Development

The approach to ESG investing in sub-Saharan Africa is closely linked to longer-term sustainable development benchmarks. This shapes how borrowers in the region frame sustainable investment opportunities and which types of issuers source financing through the international capital markets.

The historically significant role of development finance institutions as sources of capital into sub-Saharan Africa has shaped the way investment into the region is positioned. Core infrastructure financing needs can be described as contributing to sustainable development objectives, which are closely aligned with many ESG investment frameworks. For example, electrification programmes increasingly include renewable energy generation, or housing estates developments designed to have less environmental impact. New investors,

including bondholders, non-traditional bilateral lending countries, and commercial banks, have also made efforts to incorporate sustainability into their investment strategies in Africa.

A challenge for ESG investors in Africa is the dominance of extractive industries.

Many of Africa's economic centres and industries are exposed to physical climate change risks. Large cities, including Lagos in Nigeria and Cape Town in South Africa, are affected by rising sea levels. Droughts and floods as a result of changing rainfall patterns have direct economic costs to agriculture-dependent economies, and social costs related to individual livelihoods and food security.

A challenge for ESG investors in Africa is the dominance of extractive industries. Sub-Saharan Africa is home to some of the world's largest reserves of oil and gas, coal, and metals and minerals. While investors in developed economies are increasingly excluding new investments into fossil fuels businesses, these sectors are sizeable contributors to GDP and export earnings. Several African governments are planning to issue green or sustainability bonds in the next year, but it is unclear how the market will perceive these in the context of a largely commodity-dependent economy.

Regional Coverage

Asia-Pacific: Pandemic Debt Impact Varies Widely Across APAC Sovereigns

Pandemic-induced fiscal responses and economic contractions have led to a sharp rise in public debt among rated sovereigns in the Asia-Pacific (APAC) region, but there is significant variation between individual sovereigns' performance.

Between 2019 and 2021, the increases in general government debt have varied widely.

Healthcare expenditures among APAC sovereigns have increased, and to varying degrees authorities have spent heavily to mitigate the shock to household and corporate balance sheets associated with the crisis, on measures ranging from furlough schemes to stimulus payments. Revenues have meanwhile been hit by the pandemic-driven drop in economic activity, along with temporary tax cuts and deferrals.

The resulting increases in general government debt have nevertheless varied widely. Between 2019 and 2021, general government debt/GDP is projected to rise by around 45pp in the Maldives and 27pp in Japan, but by just 3.0pp in Vietnam and 1.2pp in Taiwan. Much of the variation in the ratios can be accounted for by either the extent of the fiscal response (affecting the numerator), or changes in nominal GDP (the denominator) - or both.

Relative success in containing the pandemic has both bolstered GDP and reduced the pressure on governments to provide support, helping to limit increases in general government debt/GDP ratios over 2019-2021 in places like China, Hong Kong, South Korea, Singapore, Taiwan and Vietnam.

However, some countries where COVID case counts have been relatively low have still seen debt/GDP rise by more than the median for APAC, due partly to generous stimulus and support packages. This includes developed markets such as Australia, Japan and New Zealand.

The increase in Japan's general government debt, to a forecast 258% of GDP in 2021, also reflects a weak GDP performance in 2020-2021. The rise is notable, given that it already had the highest debt/GDP ratio of any Fitch-rated sovereign prior to the pandemic.

Among emerging markets, strong nominal GDP growth in 2020-2021 and relative fiscal restraint help to explain why general government debt/GDP ratios have risen more slowly in Bangladesh, Pakistan and Vietnam, than in sovereigns like the Maldives, the Philippines and Thailand, where tourism sectors suffered in the pandemic.

New waves of COVID infections continue to pose further fiscal risk, particularly in the majority of APAC sovereigns where vaccination programmes are not well advanced. Illustrating this, governments in India, Malaysia, Taiwan and Thailand have announced additional fiscal stimulus in response to rising numbers of COVID cases in their jurisdictions. Partly as a result, we have widened our projections for fiscal deficits in Thailand and Taiwan in our latest quarterly forecast update.

Many Asian sovereigns entered the pandemic with low general government debt/GDP levels relative to their respective rating peers, including New Zealand, Thailand, the Philippines, Indonesia, Vietnam and Bangladesh. Over 2020-2021, that gap has widened in Vietnam and Bangladesh, but has narrowed in New Zealand and the Philippines - though in neither of the latter two has debt risen above the peer median.

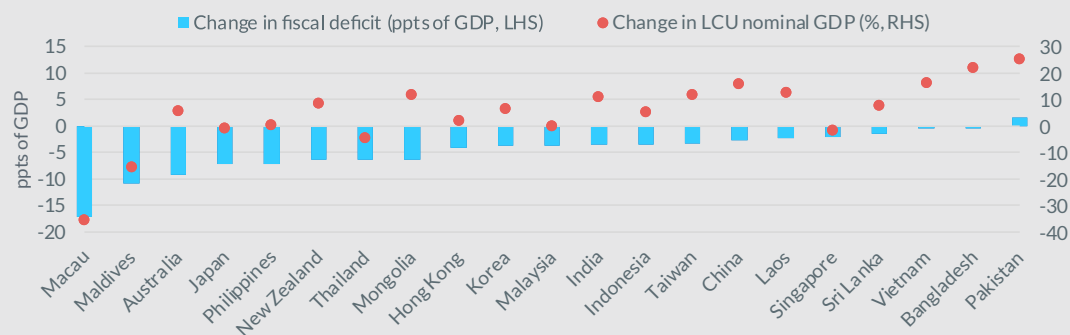
In China and Taiwan, headroom relative to rating peers, which was marginal in 2019, has widened over the course of the pandemic. By contrast, Australia's generous fiscal support programme means that its general government debt/GDP levels have moved from being broadly in line with peers to being higher than them.

Among the few APAC sovereigns where general government debt/GDP was already high relative to peers prior to the pandemic, the differential has widened in India and more significantly in Sri Lanka, but narrowed in Malaysia and more substantially in Pakistan. In the Maldives, general government debt/GDP surged during the crisis, which contributed to the deterioration in its rating, to 'CCC' at present, from 'B+' in 2019.

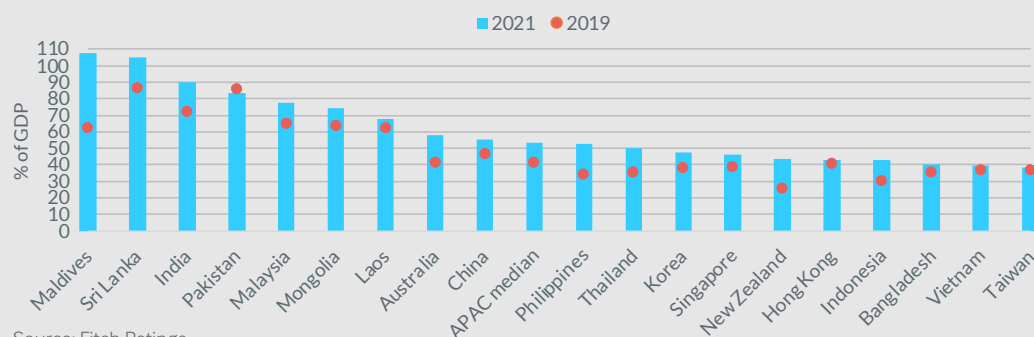
Regional Coverage

Change in Public Finances over the Pandemic

Public finances, 2021 vs 2019



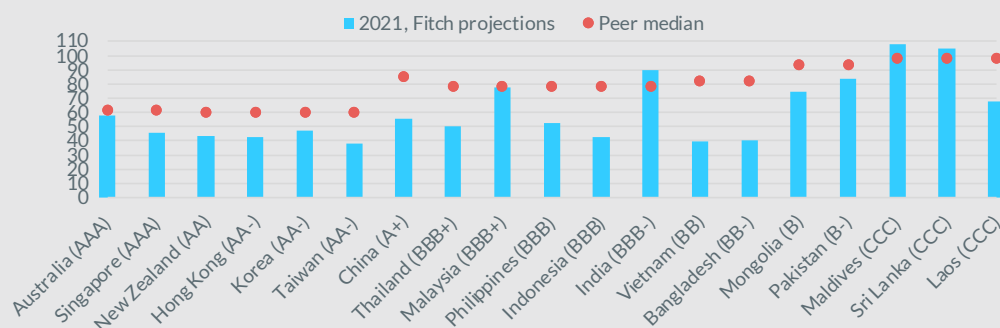
General Government Debt/GDP 2021 vs 2019



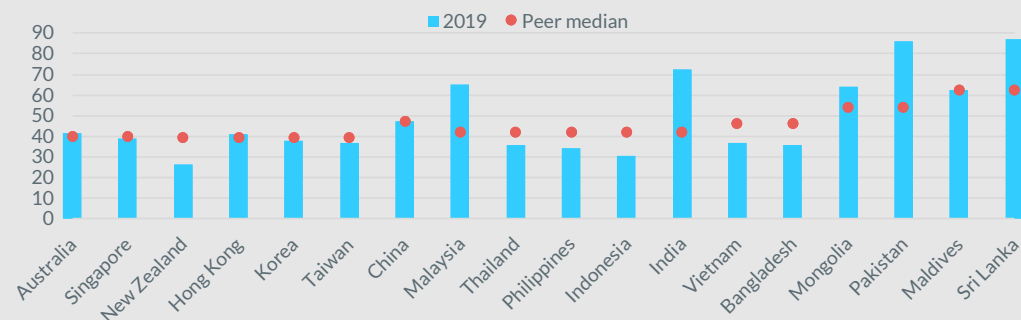
Source: Fitch Ratings

General Government Debt/GDP vs Peer Medians, 2021 & 2019

2021 General Government Debt/GDP



2019 General Government Debt/GDP



Note: General government debt/GDP ratios for Japan (A) are 258.4% for 2021, 231.2% for 2019. 2019 General government debt compared against peer medians for sovereign's current rating level.

Source: Fitch Ratings: 2021 projections from June 2021 Sovereign Data Comparator, 2019 data from March 2021 Sovereign Data Comparator

Regional Coverage

Latin America: Political Risk Puts Pressure on Some Latin American Sovereigns

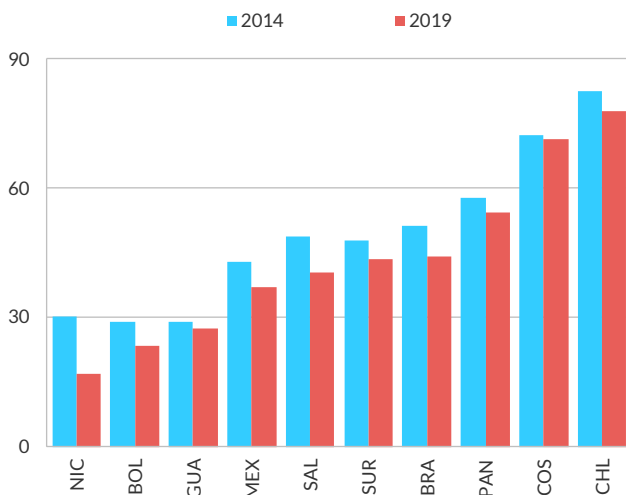
The rise in political risks in Latin America has pressured some sovereign ratings. Any rating impact depends on current ratings headroom, the speed of perceived changes and the extent of the damage stemming from political and social stability risks.

Latin America faces four main political challenges in 2021-2022: social mobilizations; governance challenges including fragmented congresses; erosion of checks and balances that can weaken institutional strength; and elections that could shift economic policy orientation.

Political risks affect sovereign ratings directly via the World Bank Worldwide Governance Indicators, which are an input into our Sovereign Rating Model (SRM). They also usually affect the SRM score via macro, fiscal and external variables as political shocks and social dislocations are generally associated with weaker and

Latin American Sovereigns with Declines in Governance Indicators

Overall Governance Percentile



Source: Fitch Ratings, World Bank

more volatile GDP growth, more adverse public debt trajectories and capital outflows.

Fitch also employs a Qualitative Overlay (QO) designed to adjust for factors that are not reflected or not fully reflected in the SRM output for any individual rating. For example, political risks may become evident before they are captured by World Bank Indicators. Risks also arise if sovereign authorities lack the political capacity and the will to address economic and fiscal challenges or mobilize resources necessary to honour their financial obligations.

Latin American sovereigns' governance indicators are generally weak and embedded in their rating profiles, with recent declines partly captured in their SRM scores. Only Brazil and Costa Rica have a negative 1 notch adjustment for political risk in our Qualitative Overlays, partly because congressional fragmentation has hampered public finance reforms.

Examples of political and social risks contributing to downgrades include Colombia in July 2021, where a popular backlash saw proposed tax reforms withdrawn, and Chile in October 2020, where we think socio-political tensions will make post-pandemic fiscal adjustment harder.

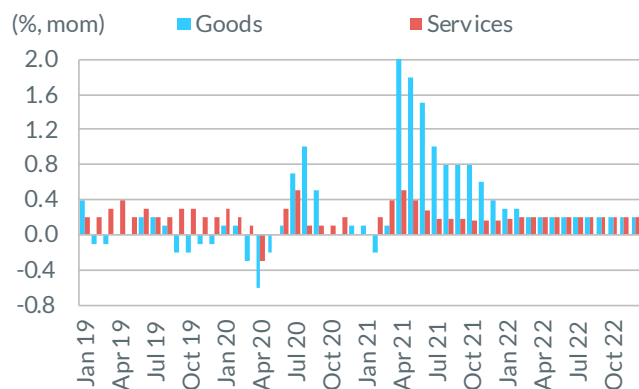
North America: US Core CPI Inflation to Rise Further Before Easing in 2022; Job Market Slack to Persist until Late 2020

US core CPI inflation will remain elevated on a year-on-year (yoy) basis through the rest of this year before falling back in 2022. Supply-chain pressures show no sign of abating and core goods prices will continue to rise quite sharply in the next several months.

Rising goods prices were the dominant factor behind the jump in US core CPI inflation to 4.5% yoy in June, the highest since the early 1990s. This reflected supply-chain pressures, felt most intensely in the autos sector, where strong demand and production constraints due to semiconductor shortages caused used car prices to

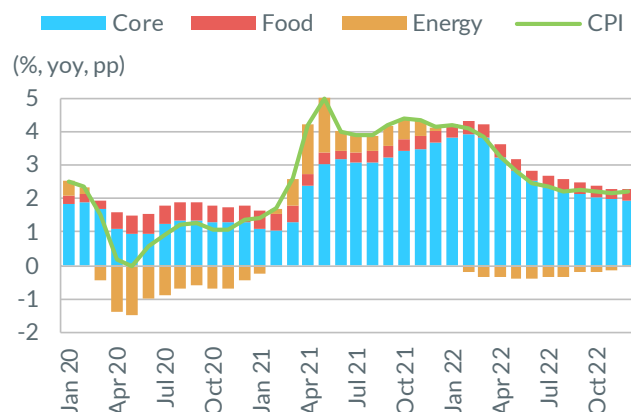
Regional Coverage

Outlook for Monthly Core CPI Inflation



Source: Fitch Ratings

Outlook for U.S. Headline CPI Inflation



Source: Fitch Ratings

surge. We do not expect supply-chain pressures to ease significantly until 2022.

Services prices have also increased sharply since early 2021, though narrowly based in transportation and hotel tariffs. Airfares and hotel rates have climbed recently as restrictions were eased, but remain somewhat below pre-pandemic levels. Medical services and rent (shelter) inflation have remained subdued through the recovery.

Services prices will experience some further reopening pressure, but we expect this to fade by 4Q21. Services prices are closely tied to wages. Labour demand has recovered strongly and households' inflation expectations have increased, but we do not expect wages to accelerate sharply at the aggregate level given labour market slack. Rent inflation (42% weight in core CPI) remains low and historically tracks wages more closely than house prices, which have risen rapidly recently.

Our forecasts show core CPI inflation around 4.5% yoy by end-2021, although we forecast headline CPI to fall to 4.1% on the basis of our oil price outlook. We expect core inflation to fall to 2.5% yoy from mid-2022 assuming no surge in wage or rent inflation.

U.S. Job Market Slack Will Persist Until Late 2022

Full employment in the US is not expected to return until late 2022 and will require the creation of more than six million additional jobs. Labour-market slack will limit upward pressures on wage inflation.

Full employment in the US is not expected to return until late 2022.

The job market was hit particularly hard by the pandemic in April 2020 and the recovery in employment has lagged output. The huge shock to labour-intensive leisure and transport industries hit demand for labour very hard.

Massive job market disruption in 2020 is likely to lead to some medium-term 'scarring' and reduced labour supply as long-term unemployment rises and some older workers are permanently discouraged from labour force activity. However, even allowing for this, it will take quite a while for the labour market to regain balance.

Regional Coverage

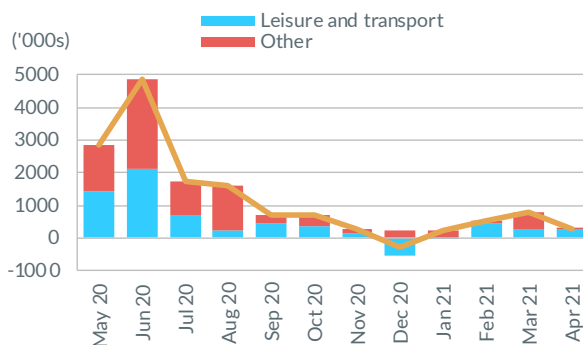
Stimulus measures and the reopening of face-to-face service industries are now boosting labour demand strongly. But the speed at which unemployment falls will be dampened by a relatively swift recovery in labour force participation as social distancing recedes.

We do not see a return to 'full' or 'maximum' employment – with the unemployment rate back down to its non-inflationary rate and labour force participation rates back to sustainable mid-cycle levels – until 4Q22.

With the employment-to-working age population ratio remaining well below 60%, upward pressures on wage inflation should be contained until late 2022. Aggregate measures are yet to show material signs of increasing wage inflation. Reports of labour market shortages are more reflective of sector-specific dynamics and the pace of reopening, and are likely to be fairly short-lived.

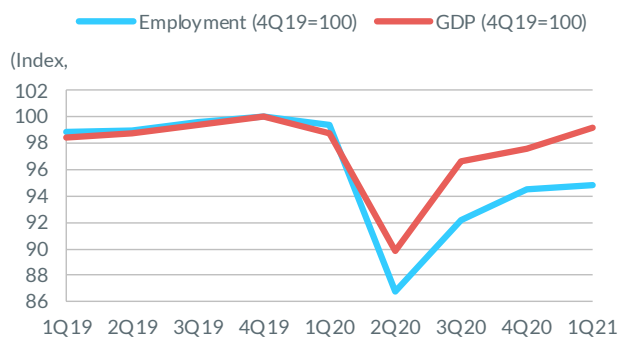
The continuing jobs shortfall is likely to heavily influence macro policy choices over the next year or so, particularly as any pandemic setback entails bigger risks for the job market than for GDP as a whole. The Federal Reserve is unlikely to increase its policy rate until at least 2023 and is currently signalling 2024.

U.S. Jobs Recovery - Monthly Change in Payrolls



Source: Fitch Rating, BLS, Havers

U.S. Real GDP and Employment



Source: Fitch Ratings, BLS, BEA, Haver Analytics



Meet the Analyst

Q&A with James McCormack

Meet the Analyst



James McCormack
Global Head of Sovereign and
Supranational Ratings

Q&A with James McCormack

How has COVID transformed the sovereign credit landscape?

Crises are characterized by sharp economic contractions almost by definition, and COVID has been no different. What has distinguished COVID is that some countries experienced relatively fast recoveries while others have had to deal with more prolonged downturns. These differences are roughly aligned with sovereign rating implications, as extended periods of weak economic activity affect both government revenue and spending. Long-term economic and fiscal effects can reinforce each other.

The most obvious sovereign credit considerations with respect to COVID have been larger government deficits and the consequent surge in government debt.

The most obvious sovereign credit considerations with respect to COVID have been larger government deficits and the consequent surge in government debt. With nearly every sovereign's debt rising, peer medians we use to compare relative credit metrics have

been affected as well. This is something we expect to persist, as the outlook for benchmark global interest rates suggests debt affordability will remain favourable, at least in the short term, putting less pressure on sovereigns to bring debt levels lower.

With higher debt burdens across-the-board today, is it possible to compare sovereign ratings over time?

There are many ways to compare ratings. Simple point-in-time comparisons of sovereigns are the most common, as rating categories reflect rank-ordered credit profiles. Comparisons over time are complicated by the fact that many nominal variables change based on economic growth and inflation, and ratios can exhibit long-term trends of either rising or falling across a large number of sovereigns.

But comparing ratings over time is still possible, since they are never based on a single variable and it is the mix of variables that matters. Fitch's sovereign rating model is reviewed and re-estimated annually, but the variables in the model and their relative weights have not changed much over time. The implication is that ratings are, in fact, comparable over time, as it is the same model assessing the same variables that the rating committee will consider during rating reviews.

Are there any notable changes in the relationships between sovereigns and supnationals?

This is something that has changed quite a lot with COVID. Several supnationals engaged when the pandemic struck, as multilateral development banks looked to do more, the IMF rolled out emergency funding that disbursed quickly and European Union institutions established new funding facilities for member states.

We believe at least some of these initiatives could carry on beyond the COVID relief period. Even if actual funding flows wind down or are no longer needed, the programme infrastructure will still exist, meaning

Meet the Analyst

they could be redeployed if circumstances warrant. And with government debt levels expected to remain elevated, supranationals' roles and relationships with governments could be subject to further refinements in the years ahead.

What are the biggest risks facing sovereigns?

One of the biggest risks for any highly-indebted entity, including a sovereign, is rising interest rates. While central banks exert control over short-term interest rates, they typically have less influence over long-term rates, which are more important for governments' cost of funds. In a rising interest rate environment, sovereigns whose debt stocks have longer average maturities will be affected more slowly – a fact that

favours developed-market over emerging-market sovereigns.

A second risk is more of a certainty, but with unknown timing. Inevitably, there will be another economic cycle and another recession, though country experiences will probably be less synchronized than was the case at the outset of COVID. The risk for some sovereigns is that they will not have re-established the policy space necessary to undertake meaningful counter-cyclical actions to protect businesses and households from a new downturn. This is not an immediate post-COVID consideration but definitely something for policymakers to consider as recoveries extend and become subject to invariable cyclical influences.



News and Awards

Fitch Ratings Credit Research

Fitch Wins Five Rating Agency of
The Year Awards

Fitch Ratings Wins CFI.co Best Credit
Services Global Award

Fitch Ratings Granted License from UAE's
Securities and Commodities Authority



Fitch Ratings Credit Research

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Get an instant overview of the key quantitative and qualitative factors assessed to arrive at an entity's credit rating. Includes the ESG scoring system which factors in the impact of ESG on fundamental credit. The Ratings Navigator is part of Fitch Ratings analytical process and clearly articulates how a rating is constructed.

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Make sure you have your finger on the pulse of the factors that are driving shifts in the rated landscape. Reports on thematic issues and trends in sectors, regions, and issuance, highlighting credit-relevant topics and broader macro issues that may have potential credit impact.

Fitch Wins Five Rating Agency of The Year Awards

Fitch Ratings has been recognised as the Corporate, ESG, Public Finance and Sovereign Rating Agency of The Year by The Asset, a leading financial magazine in the Asia-Pacific region. The agency also earned a special award for its response to the COVID-19 pandemic in 2020.

The Asset's board of editors evaluated the submissions for the awards, along with CFOs, treasurers and other treasury professionals who also provided input in selecting the winners. Criteria for the awards included transparency of methodology and number of ratings conducted, default and stability rates, surveillance process, and investor outreach.

The Asset awarded Fitch a special citation for its response to the pandemic, saying in a media release that the agency received "high marks for being pro-active in its engagement with investors under the prevailing market environment with its series of webinars, roundtables and other events across the Asia-Pacific region.



News and Awards

Fitch Ratings Wins CFI.co Best Credit Services Global Award

Capital Finance International magazine (CFI.co) has awarded its Best Credit Services Global 2021 Award to Fitch Ratings.

In its citation for the award, CFI.co highlighted Fitch Ratings' on-the-ground presence in over 30 countries and referenced its "thorough analysis, independent perspective, transparent methodology and ongoing surveillance."

CFI.co also cited Fitch's extensive emerging market coverage across all major asset classes, as well as what it believes to be Fitch's key differentiators of "people, processes and presence".



Fitch Ratings Granted License from UAE's Securities and Commodities Authority

Fitch Ratings is pleased to announce that Fitch Ratings Ltd (FRL)'s Dubai branch has been granted a license from the UAE's federal credit rating agency (CRA) regulator, the Securities and Commodities Authority (SCA), effective from April 6, 2021.

In being licensed by the SCA, FRL's Dubai branch now has approval from the SCA to provide credit ratings to "onshore" entities listed in the UAE SCA-controlled stock exchanges. This includes those listed on the Dubai Financial Market (DFM) and Abu Dhabi Securities Exchange (ADX).

In accordance with the license requirements, FRL Dubai moved its office onshore last year from Dubai Media City Free Zone to the Dubai World Trade Centre. As a branch of Fitch's UK-registered Fitch Ratings Ltd, it also continues to be regulated by the Financial Conduct Authority (FCA).

"Fitch's new SCA license is another key milestone in our ongoing commitment to the Middle East region," said Jay Leitner, Head of Fitch Ratings Business and Relationship Management, Middle East & Sub-Saharan Africa.

"Our credit ratings can help support the development of local capital markets through bringing greater transparency to investors, debt issuers and broader market participants alike. We look forward to developing our relationship with the SCA going forwards," added Leitner.

Fitch Ratings has a well-established presence in the Middle East, having opened its regional hub in Dubai in 2006. Its rating portfolio includes over 125 issuers in 10 Middle Eastern countries across a diverse range of sectors. Fitch Ratings opened a second regional office in Riyadh, Saudi Arabia, in 2017.



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Business Contacts



Mark Oline
Global Head of Business &
Relationship Management
+1 312 368 2073
mark.oline@fitchratings.com



Aymeric Poizot, CFA, CAIA
Global Head of
Investor Development
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com



Frank Laurents
Global Strategist, Investor Development
Emerging Markets, Sovereigns, Economics
+1 212 908 9127
frank.laurents@fitchratings.com



James McCormack
Global Head of Sovereign and
Supranational Ratings
+852 2263 9625
james.mccormack@fitchratings.com



Brian Coulton
Chief Economist
+44 20 3530 1140
brian.coulton@fitchratings.com

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