S&P Global
Ratings

Credit Conditions Europe Q2 2024

Credit Heals, Defense Shields

March 27, 2024

This report does not constitute a rating action.

Key Takeaways

- **Overall:** Our base case centers on a soft landing in 2024. Labor markets will remain tight, while disinflation will continue, enabling the European Central Bank (ECB) to cut rates by 25 basis points (bps) three times in the second half of 2024. Ageing populations, low productivity growth, and questions about the full deployment of the NextGenerationEU program will likely hamper the economic rebound over 2025-2026.
- **Risks:** The main risks for Europe are regional geopolitical conflicts which could spread across borders. Beyond that, protectionism represents an increasing threat to European trade. Many fixed-rate borrowers remain exposed to higher refinancing costs, especially if rate cuts are deferred and bond yields are back up. After a turbulent couple of years, we now view an extended period of slow economic growth as the main macroeconomic downside risk.
- **Ratings:** Credit quality is stabilizing on the back of a more robust macroeconomic outlook and easing financing conditions. Pockets of risk will remain as the lagged effect of inflation and higher rates feed through to asset quality. Credit losses within the banking sector will likely normalize from a low level, while a few negative rating actions could emerge in residential mortgage-backed securities (RMBS) and auto asset-based securities (ABS). For corporates, stress will be largely contained to 'CCC' rated borrowers, with defaults amounting to about 3.5% at year-end 2024.

Editor's note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in Asia-Pacific, emerging markets, North America, and Europe. Discussions center on identifying credit risks and their potential ratings impact on various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the European Credit Conditions Committee on March 20, 2024.

At first glance, the credit outlook in Europe is improving. European economies proved to be remarkably resilient in light of the fallout from the pandemic, the resurgence in inflation, and the ECB's resulting policy response. Unemployment remains low and expectations for business activity improved considerably, supported by equity markets scaling new heights.

Financing conditions eased with the resurgence of primary bond market activity and a decline in the term risk premium. This enabled borrowers to reprice and refinance fixed-rate debt on less onerous terms and helped allay fears over the looming 2025-2026 maturity wall. Underwriting banks are back and compete with private debt providers in the mid-market leveraged lending segment. Private equity firms are taking the opportunity to return cash to their limited partners by offering portfolio companies to the stock market. Even so, we expect under our base case that it may take a few months before we see the first rate cuts, from either the ECB or the Bank of England (BoE). Central banks could yet delay rate cuts, given stubborn core inflation and tight labor markets.

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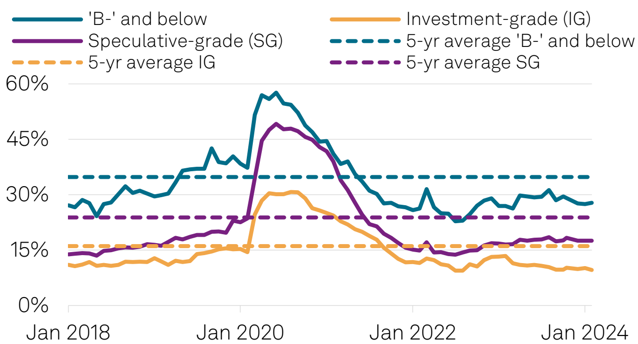
Contents

Overall, European rating actions have been quite balanced year to date, even for speculative grade issuers. Chemicals, telecommunications companies, and real estate companies accounted for most net downgrades, while the ratings on speculative-grade leisure names continue to improve. At the corporate level, the negative bias trend remains close to five-year lows for investment-grade issuers but increases at the lower end of the rating spectrum. Real estate, as well as metal, mining, and steel, are the two sectors that currently exhibit the highest negative bias (see charts 1 and 2).

Credit vulnerability in the corporate sector focuses on 'CCC' rated credits. 'CCC' rated credits account for 9% of speculative-grade ratings in the corporate sector, close to the five-year average. Given tighter credit standards and the higher cost of debt, many borrowers preferred amending and extending existing facilities over taking execution risk through a more orthodox refinancing exercise, if that is even possible. As a result, the number of distressed exchanges that classify as rating defaults under our criteria has increased. The European speculative-grade default reached 4.1% at the end of February 2024, from 3.5% at the start of the year. About two-thirds of the 36 defaults that happened over the past 12 months comprise distressed exchanges.

Chart 1

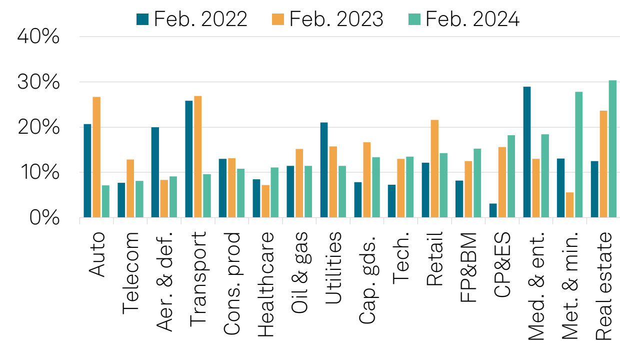
Negative bias is below five-year averages



Data as of Feb. 29, 2024; excludes sovereign, diversified, and financial institutions and only considers parent issuers. Source: S&P Global Ratings.

Chart 2

Negative bias remains elevated for a few sectors



Data as of Feb. 29, 2024; excludes sovereign and diversified institutions and only considers parent issuers. FP&BM—Forest products and building materials, CP&ES—chemicals, packaging and environmental services. Source: S&P Global Ratings Credit Research & Insights.

Notable credit developments we monitor

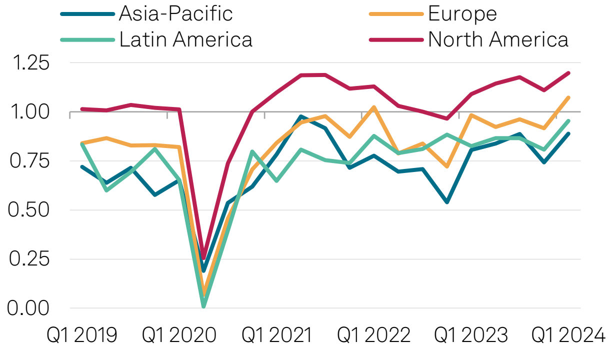
The outlook for 2024 for nonfinancial corporates is moving in a positive direction. After serious disruptions from surging inflation and higher interest rates, European business prospects are more favorable, judging by Q4 2023 earnings transcripts and the latest purchasing managers' index (PMI) surveys (see charts 3 and 4). We will monitor the following trends:

- **Some sectors protected earnings against high inflation by favoring prices over volumes and by adjusting their product mixes.** Consumer products, building materials, and auto original equipment manufacturers (OEMs) are among several sectors to have adopted this strategy. However, the challenge now consists of maintaining margins, given lower inflationary pressures, a more stable supply chain, and growing competition. For example, European auto makers face ferocious discounting activity in some European battery electric vehicle (BEV) markets, where softer demand clashes with model launches by Chinese OEMs and other BEV players. This is compounded by the phase-out of BEV purchase subsidies in countries such as Germany.

Chart 3

Corporate sentiment improves

Median net positivity score by region (%)

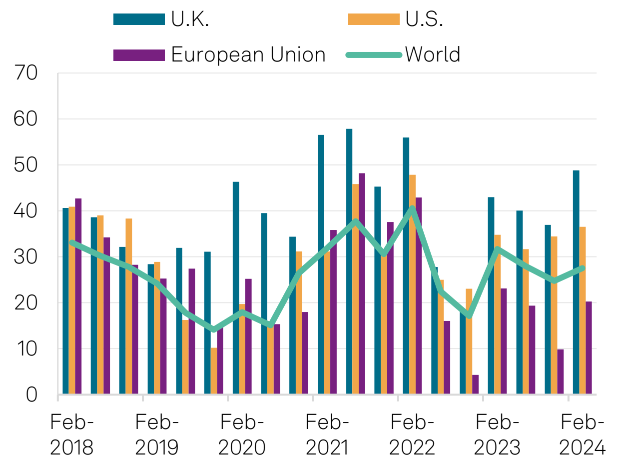


Sources: S&P Capital IQ Pro, S&P Global Ratings. Derived from transcripts and investor presentation sentiment analysis. The net positivity score shows the ratio of positive to negative words from the Loughran-McDonald Sentiment Word List, compared with the total number of words in a transcript. Most scores fall between -5% and 5%, with higher scores considered favorable. Values refer to earnings call transcripts and investor presentations given in the quarter shown, meaning they refer to earnings for the prior quarter. Data for Q1 2024 contains 1,634 scores.

Chart 4

PMI-based business activity expectations pick up

Net balance (%)



PMI--Purchasing managers' index. Source: S&P Global Market Intelligence.

- **Chemicals remain among the weaker sectors, with the ratings on about 30% of issuers on a negative outlook.** This is because of structurally higher energy and feedstock costs--especially compared with North America--softer demand, rising costs related to environmental targets, and excess capacity in some key commodity product lines in China. The petrochemical production outlook for Europe will likely remain weak over the next two years, prompting companies to curb or even close production facilities.
- **Unsurprisingly, aerospace and defense companies benefit from the regional conflicts.** Order backlogs stand at record highs and companies can handle inflation and cost pressures well, while maintaining margins. The main challenges consist of securing supply chains and finding skilled labor.

The ratings outlook on European banks remains largely stable, while non-bank ratings remain under pressure. Solid capitalization and liquidity, improved profitability, and still sound asset quality underpin our base case and provide ratings headroom for major banks' recently announced significant increase in dividends and share buybacks. We continue to expect a deterioration in asset quality over the course of the year that will help normalize credit provisions from low levels. Most European banks' commercial real estate (CRE) exposures remain manageable, although German and Swedish banks' CRE exposures are above average. CRE monoliners, such as Deutsche Pfandbriefbank, face more downside risks from a ratings perspective. Non-banks' main challenges include refinancing risk amid still elevated interest rates, tightening market liquidity, and business model issues in light of squeezed profitability.

In European structured finance, we raised almost 10% of ratings on a net basis over the past twelve months. The upgrades occurred even after elevated interest rates started to feed through to underlying borrowers, albeit the pace varied by country. So far, CMBS backed by office and mixed assets suffered most from the uptick in interest rates but we anticipate pressure on consumer-related sectors will increase, with the potential for a few negative rating actions in sectors such as RMBS and auto ABS. Another notable development consists of the rising prevalence of BEVs in auto ABS pools. This could impair recoveries and residual values as BEVs generally depreciate more quickly than their internal combustion engine equivalents.

Hope Is Not A Geopolitical Strategy

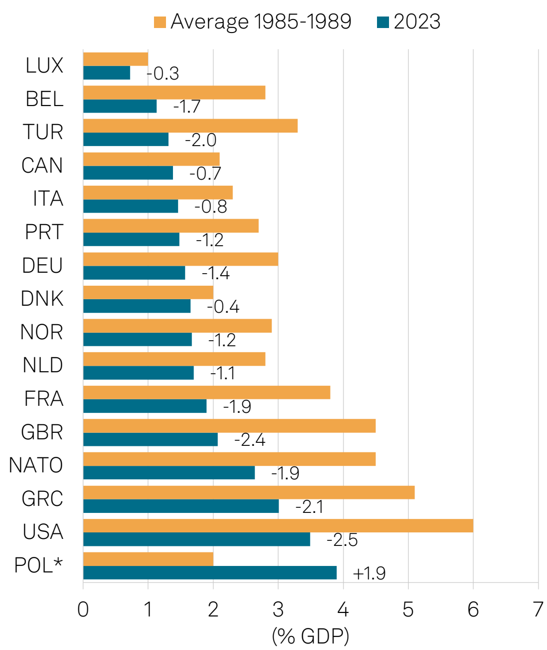
A dark cloud over this, and the most worrisome risk of all, is increasing geopolitical fragmentation. Military conflicts, primarily in Europe and the Middle East, and growing nationalism in autocratic states in Asia represent significant sources of uncertainty and are important to monitor. If they reach a trigger point, they could disrupt supply chains, spark risk aversion and a flight to quality, significantly increase volatility, and temporarily freeze up some financial markets. At the same time, questions are mounting about Western democracies' willingness to coalesce, provide security to their citizens, and uphold the principles of international law. Without this level of security, other critical challenges, such as protecting global common goods or the environment, become ever more intractable.

The preoccupation with NATO members' defense expenditures is important but misses the point for two reasons.

- **Firstly, while fiscal constraints limit many countries' ability to increase total public spending, the decline in military spending since the end of the Cold War pales in comparison with most Western countries' increase in social welfare or health expenditure.** In the U.S., defense expenditure has fallen by 2.5 percentage points (ppts), while public welfare spending increased by almost 6.0 ppts of GDP over 1985-2019 and rose again by more than 4.0 ppts in the subsequent two years. In France, defense spending has been scaled back by 2.0 ppts of GDP and social welfare has risen by about 5.5 ppts to almost 31% of GDP over the same period (see charts 5 and 6).

Chart 5

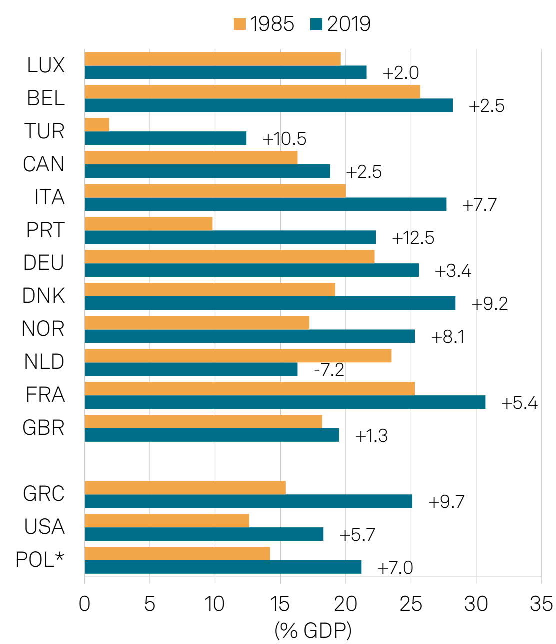
Defense expenditure in selected NATO countries



*Poland defense expenditure as of 1999, not 1985-1989.
Sources: NATO, S&P Global Ratings.

Chart 6

Public social expenditure in selected NATO countries



*Poland social welfare expenditure as of 1990, not 1985.
Sources: OECD (2023) Social Expenditure database, S&P Global Ratings.

- **The second reason, which is at least as important, is that a rapid increase in military capabilities, especially in Europe, would be difficult, even if the funding was provided.** A military ramp-up necessitates training military personnel and investments in long-term projects that require substantial contracts from governments to increase the production of highly sophisticated weapon systems at scale. Interoperability, as well as command and control capabilities, are also essential to facilitate an effective deterrence strategy. This is why the U.S. remain critical to the NATO's security umbrella.

Many European citizens do not seem to view Russia as a threat to the continent. This is illustrated by a recent NATO alliance survey highlighting that 60% of the European public think defense expenditure should remain the same or should be reduced. In Italy, the percentage is 72%. Most survey participants remain more concerned about economic, social, and climate issues.

Other systemic risks improved slightly, as detailed below:

- **Longer-than-expected restrictive interest rates:** The full effect of the increase in interest rates is still feeding through to borrowers with long-dated fixed maturities. Most borrowers had time to plan for the expected increase in debt service costs, which was partially mitigated by the rally in bond prices. Yet the challenge remains acute for more vulnerable issuers who struggle with failing business models, are burdened by high leverage or their inability to generate positive free cash flows, and will have to refinance over the next 12-18 months.
- **Extended period of low growth in Europe:** Under our base case, we expect the region will emerge from stagnation over the coming quarters. The combination of a gradual recovery--supported by tailwinds from the U.S.--low unemployment, and easing financing conditions means the likelihood of a macro-induced recession is lower than we envisaged three months ago. From a systemic risk perspective, we now assess this macro risk as elevated instead of high, considering the reduced negative effect of an extended period of slow economic growth. The NextGenerationEU program, if deployed effectively, can largely offset the negative regional effects of fiscal policy constraints through 2026, even though they will weigh on economic growth at a national level.

The downturn in real estate increases the risk of spillovers to the broader economy. Downside risks in certain segments and regions remain, particularly if interest rate cuts are delayed and bond yields increase again. We see spillover risks from this sector in Europe as moderate. While the market remains orderly, property transactions continue to be infrequent. This raises the risk of distressed sales, which could lead to a rapid repricing in some parts of the market and expose banks and investors to higher credit losses.

Top European Risks

Increasing geopolitical fragmentation

Risk level	Moderate	Elevated	**High**	Very high	**Risk trend**	Improving	Unchanged	**Worsening**

This risk is most pressing, with two wars continuing to traumatize the region. Geopolitical risk remains high as the conflicts drag on, with no end in sight. These conflicts carry the risk of drawing in other state and non-state combatants. Additionally, they could cause fragmentation among European allies in dealing with Russia or trigger protests and outbreaks of violence. These could be politically destabilizing across the Middle East and Europe, where migration is becoming a more divisive political issue. Beyond that, protectionism represents an increasing threat to European trade. Increasing geopolitical fragmentation runs the risk of disrupting supply chains, triggering risk aversion and a flight to quality, significantly increasing volatility, and temporarily freezing up some financial markets.

Restrictive interest rates persist longer than expected

Risk level	Moderate	Elevated	**High**	Very high	**Risk trend**	**Improving**	Unchanged	Worsening

Stubbornly high core inflation, particularly in services, combined with low unemployment even with subpar growth, could limit the scope for the ECB and BoE to ease policy rates. Although financing conditions eased in recent months, market sentiment can change quickly in an uncertain environment. An extended period of positive real rates could expose financial fragilities of vulnerable issuers who could face restricted financing and a prohibitive cost of debt service. Tightening credit standards for bank lending and central banks aiming to shrink their balance sheets could exacerbate the situation. This is a particularly the case for companies that must refinance 2025-2026 maturities generate minimal free operating cash flow, and whose interest coverage ratios are below 2x.

Extended period of low growth in Europe

Risk level	Moderate	**Elevated**	High	Very high	**Risk trend**	Improving	**Unchanged**	Worsening

After having absorbed the rise in inflation and rate shocks, with the labor market remaining tight, the likelihood of a macro-induced lapse into recession is relatively low. Yet in light of continuously high rates, elevated energy prices, eroded savings buffers, and fiscal headwinds, the risk of the European economy continuing to suffer an extended period of slow growth is meaningful. Given high public debt levels, few European governments have sufficient fiscal space for contra-cyclical support for the economy, even though the NextGenerationEU recovery plan still has funding capacity through 2026.

Real estate downturn heightens risk of spillovers to the broader economy

Risk level	Moderate	**Elevated**	High	Very high	**Risk trend**	Improving	**Unchanged**	Worsening

Even though the capital market sentiment for real estate issuers improved because of hopes that rates will stabilize, still high refinancing costs, falling valuations, and declining tenant demand in more vulnerable segments, such as non-prime office, continue to put pressure on credit quality in European real estate. A clear risk is that selective market access and elevated financing costs persist over an extended period. For residential property, higher mortgage rates are still feeding through to borrowers. These pressures could spill over to the broader economy and impair consumer confidence, spending, employment, and European banks' asset quality.

China's structural economic slowdown amplifies potential spillovers from international trade tensions

Risk level	**Moderate**	Elevated	High	Very high	**Risk trend**	Improving	Unchanged	**Worsening**

Further increases in trade tensions and protectionism, or any unexpectedly sharp economic slowdown in China, would be detrimental to the operating performance of European companies with material country risk exposure to China. This encompasses complex, high-value supply chains, especially relating to the energy transition. We also perceive a growing risk of artificially cheap imports from China to Europe. This is especially the case in sectors that suffer from excess capacity, which would only be exacerbated by higher blanket tariffs on Chinese imports into the U.S.

Structural risks

Disruptions linked to climate change and the energy transition could increase

Risk level	Moderate	Elevated	High	Very high	Risk trend	Improving	Unchanged	Worsening

Growing tensions between the goal to reduce net emissions in the EU by 57% by 2030 and the challenges of implementing all aspects of the European Green Deal raise the risk of abrupt, and potentially contradictory, changes in climate policies. These changes could disrupt industries and business models, notably in the automotive, building, cement, steel, chemicals, transportation, and utilities sectors.

Cyber risks are gaining ground

Risk level	Moderate	Elevated	High	Very high	Risk trend	Improving	Unchanged	Worsening

The pace of digitalization--including the advance of artificial intelligence--in the global economy and heightened geopolitical discord in Europe, the Middle East, and Africa (EMEA) expose corporates and countries to mounting cyber risks, with targets ranging from utilities to insurers and government agencies. This can weigh on credit quality, result in substantial monetary losses, and undermine public confidence in key institutions and infrastructure.

Source: S&P Global Ratings.
Risk levels may be classified as moderate, elevated, high, or very high. They are evaluated by considering both the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base-case rating assumptions, unless the risk level is very high.
Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.

Macroeconomic Outlook

- In light of high interest rates still curbing demand, we forecast modest eurozone GDP growth of 0.7% in 2024 and 1.3% over 2025-2026. We see an increasing likelihood of a soft landing for the eurozone economy, with labor markets remaining robust.
- Inflation is falling but price stability is still some way off. We expect inflation will only return to the ECB's 2% target in mid-2025. This means that the ECB has less scope than before to continue cutting rates after 2024. We expect the ECB deposit rate will decline to 2.5% by the end of 2025.
- Over the medium term, the economic recovery may be less strong than we expected, given that investments related to the NextGenerationEU program fell behind schedule and in light of growth uncertainties after the pandemic and the energy price shock.

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Eurozone

Developments over the past three months have largely confirmed our view that the eurozone economy is on the verge of a soft landing. As a result, we slightly amended our short-term forecasts. We continue to expect modest GDP growth of about 0.7% this year, compared with 0.8% in our previous forecast. This amendment mainly results from a weaker carry-over effect from 2023 GDP. While we continue to believe that the medium-term outlook is brighter than the short-term outlook, we are less convinced that the rebound in growth will be strong and forecast GDP growth of 1.3% in 2025, compared with 1.5% previously. We also revised downward our forecast for 2026 to 1.3%, from 1.4%. The speed of disinflation in recent months has prompted us to revise downward our consumer price forecast for 2024 to 2.6%, from 2.9%, but we do not expect that disinflation will continue at the current pace. On the contrary, tight labor market conditions and bottlenecks in international trade meant we slightly revised upward our inflation expectations to 2.1%, from 2.0%, in 2025 and 1.9%, from 1.7%, in 2026.

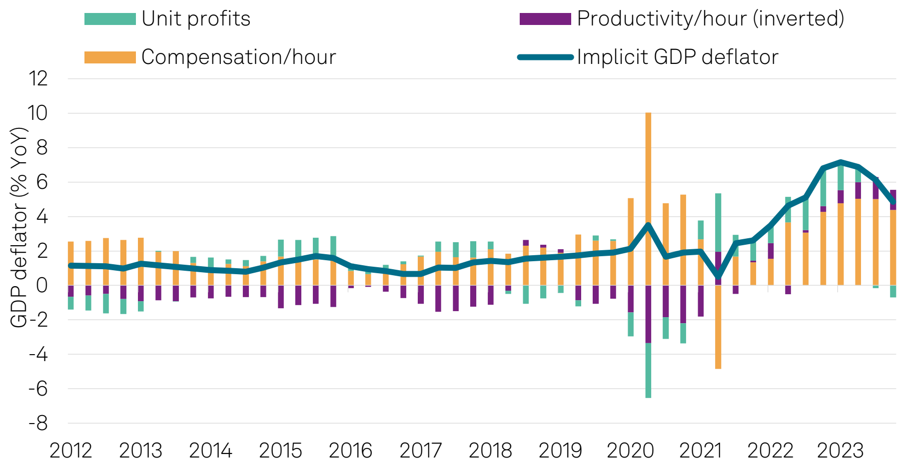
Because of higher inflation over the medium term and after three rate cuts this year starting in June, we believe the ECB will have less scope to continue its rate-cutting cycle through 2025. We expect the deposit rate will decline to 2.5% by the end of 2025, from 4.0% currently, and compared with our previous forecast of 2.0%. Additionally, the ECB's new operational framework is more of the same, which means an acceleration in the pace of the ECB's balance sheet reduction is less likely to exert upward pressure on the term premium of long-term bond yields. Considering our less upbeat medium-term growth forecasts, we lowered our projection for average benchmark 10-year German government bond yields to 2.4%, from 2.9%, this year.

In our short-term outlook, we continue to expect an improvement in business activity and a moderation in employment. The eurozone economy continued to stagnate over the fourth quarter of 2023. Business investments made the largest positive contribution. Inventories and net trade impaired GDP growth and household consumption remained largely unchanged. While we expect business activity will pick up over the coming quarters, employment growth will likely moderate. Employment was again strong and increased by 0.3% in the fourth quarter of 2023, driven by hiring in the service sector. Wage growth has probably passed its peak but remains at 4.4% year-on-year, well above productivity growth of minus 1.2% year-on-year. Soaring unit labor costs are now better absorbed by falling unit profits, allowing inflation to recede (see chart 7). This rebalancing of the income distribution in favor of wages and away from profits suggests that the hiring cycle will weaken further.

Chart 7

Inflation recedes as unit profits absorb rising labor costs

Eurozone economy



YoY--Year on year. Source: S&P Global Ratings.

The medium-term rebound may be weaker than we expected. Although a soft landing remains the most likely scenario in the short-term--barring another external shock--we are less convinced about the strength of the GDP growth rebound over 2025-2026. This is based on two reasons:

- **Firstly, the implementation of the European Commission's plan to foster the green and digital transitions as part of the NextGenerationEU program through public investments and reforms fell behind schedule.** It remains to be seen whether governments can make up for the delay or request an extension beyond 2026. We believe the second option has become more likely.
- **Secondly, uncertainty about economic growth after the pandemic and the energy price shock abounds.** Productivity has recently fallen below expectations but it is too early to say whether the decline is cyclical or structural. What is more, the decline in the working-age population will likely reduce potential growth over the coming years.

Record-high labor costs limit the scope for disinflation. While inflation has fallen more than we anticipated over the past three months--to 2.6% in February, from 2.9% in October--we believe it will not return to 2.0% before mid-2025. Inflation now largely stems from domestic components, with labor costs setting the pace. Marginal wage growth barely slowed and remained close to 4.0%, which is well above the expected rebound in productivity and therefore does not provide much scope for a rapid return of core inflation to 2.0%. Moreover, geopolitical conflicts continue to hamper trade in the Red Sea and force ships to take longer routes, which are associated with higher costs.

We revised upward our medium-term inflation forecast. This is based on prolonged high wage growth, sluggish productivity, and negative trade developments and despite the fact that disinflation has been faster than we expected in recent months. The upward revision mainly results from labor market developments.

U.K.

Supply-side weakness compounds demand-side pressures but the outlook is improving. We expect low growth and high inflation will gradually ease this year. A slow increase in the labor force will likely keep wage pressures well above productivity gains, even as vacancies drop further. Consequently, borrowing costs, which will remain elevated as the BoE seeks to reduce inflationary pressures, will continue to weigh on investments. We forecast GDP will expand by 0.3% in 2024, from 0.1% in 2023, while inflation will average 3.0% in 2024 and 2.3% in 2025, exceeding that of economic peers.

The main drags on growth are receding. Disinflation improves consumer purchasing power, while terms of trade benefit from lower energy bills. With slower price rises on track, we expect the BoE will reduce interest rates from August 2024. Financing conditions have already eased. Lower interest rates will encourage a gradual acceleration in corporate and housing investments. That said, we expect the monetary policy easing will mainly materialize in 2025, meaning its maximum effect on growth will unfold over 2026-2027, with growth recovering to its potential of 1.7%.

Key assumptions

- Geopolitical developments, mostly the conflicts in Ukraine and the Gaza strip, do not escalate.
- Energy supplies remain stable and trade bottlenecks in the Red Sea do not disrupt supply chains.
- The Chinese economy stabilizes.
- Financing conditions remain orderly.

Key risks

- Longer duration and escalation of the conflicts in Ukraine or the Gaza strip that could test the resilience of the European economy even more.
- Unwarranted and disorderly tightening of global financing conditions, with central banks slow to cut policy rates.
- Higher-than-expected rise in the unemployment rate due to the sharp rise in unit labor costs that weigh on corporate profits.

What we look out for over the next quarter

Beyond geopolitical developments and the European Parliament elections, we will closely monitor if labor markets remain resilient, whether productivity catches up with wage growth, and how the rate-cutting cycle that the ECB will likely start before the end of the second quarter will play out.

Financing Conditions

- Financing conditions will likely remain constructive as credit sentiment remains positive. Investors seek to lock in attractive returns, while issuers take advantage of market stability before a potential rise in volatility as the year progresses.
- Investment-grade issuers dominated primary markets but speculative-grade bond issuances could increase to compliment the recent healthy leveraged loan supply.
- Near-term refinancing risk continues to fall but borrowers at the lower end of the rating spectrum may struggle as rating pressures remain and yields of 'CCC' rated bonds decoupled further from those of other speculative-grade bonds.

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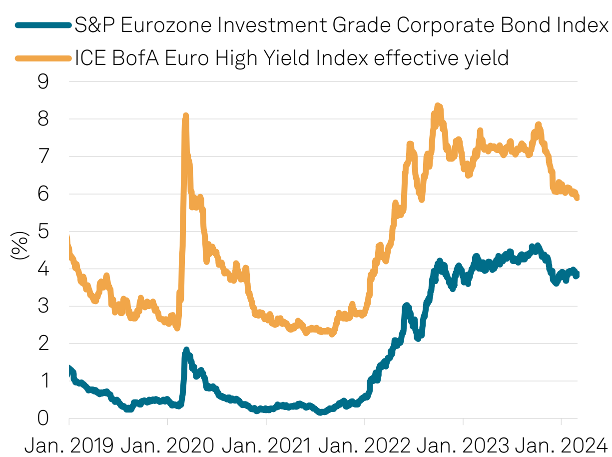
The favorable credit market momentum in late 2023 has carried over into early 2024. Markets are becoming more confident about a soft-landing scenario and remain confident about prospects for lower interest rates. Corporate yields have fallen, driven by strong credit sentiment--the iTraxx Crossover index is at its lowest level since February 2022--and robust credit inflows (see chart 8). This has resulted in favorable credit pricing trends. Credit spreads have fallen across the investment-grade and speculative-grade universe and are now substantially below the highs of 2022.

Primary market activity remains healthy, particularly for investment-grade issuers. This is mainly because investors aim to lock in attractive yields, while issuers seek to take advantage of high market demand before a potential spike in market volatility. Rated bond issuance is robust and increased by about 12% in the first two months of 2024, compared with the same period in 2023. This was especially the case for investment-grade issuers, who accounted for almost 90% of rated bond issuances. Trends for speculative-grade issuers diverge as bond issuances lag leveraged loan issuances and primarily focus on the higher end of the rating spectrum. 'BB' rated companies issued 64% of speculative-grade bonds so far in 2024. With better visibility on the likely path for interest rate cuts, speculative-grade bond issuances could pick-up in the second quarter.

Chart 8

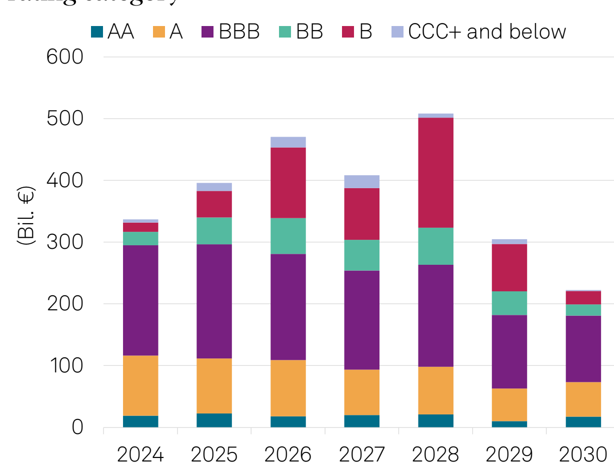
Corporate bond yields have fallen from October highs



Data as of March 14, 2024. Sources: FRED, S&P Global Market Intelligence.

Chart 9

European nonfinancial corporate debt maturities by rating category



Data as of Jan. 1, 2024. Includes European nonfinancial corporate issuers' bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. Foreign currencies are converted to euro at the exchange rate on Jan. 1, 2024. Source: S&P Global Ratings Credit Research & Insights.

The near-term refinancing risk has dropped markedly but pockets of trouble remain. Constructive primary markets enabled nonfinancial corporate issuers to continue reducing the amount of debt maturing over the next two years. Higher-quality investment-grade names continue to have better access to financing, compared with speculative-grade issuers. That said, strong activity in 2023 enabled speculative-grade nonfinancial companies to reduce maturities in 2024 by 53% and in 2025 by 35%. However, challenges remain at the lower end of the rating spectrum, with limited primary issuances from 'CCC' rated companies. Lower financing costs as a result of expected declines in interest rates may benefit some issuers but will still be too high for others. Current market yields are roughly 2% higher than those on existing debt, yet the yields of 'CCC' rated bonds have increasingly diverged from those on other speculative-grade bonds and are now at about 14%. Yields at these levels make it difficult for lower-rated issuers to refinance. Speculative-grade nonfinancial maturities will peak at close to €230 billion in 2026 (see chart 9) and while primary markets currently remain constructive market volatility could pick up, considering two ongoing regional conflicts and the U.S. presidential election later this year.

Credit Cycle Indicator (CCI)

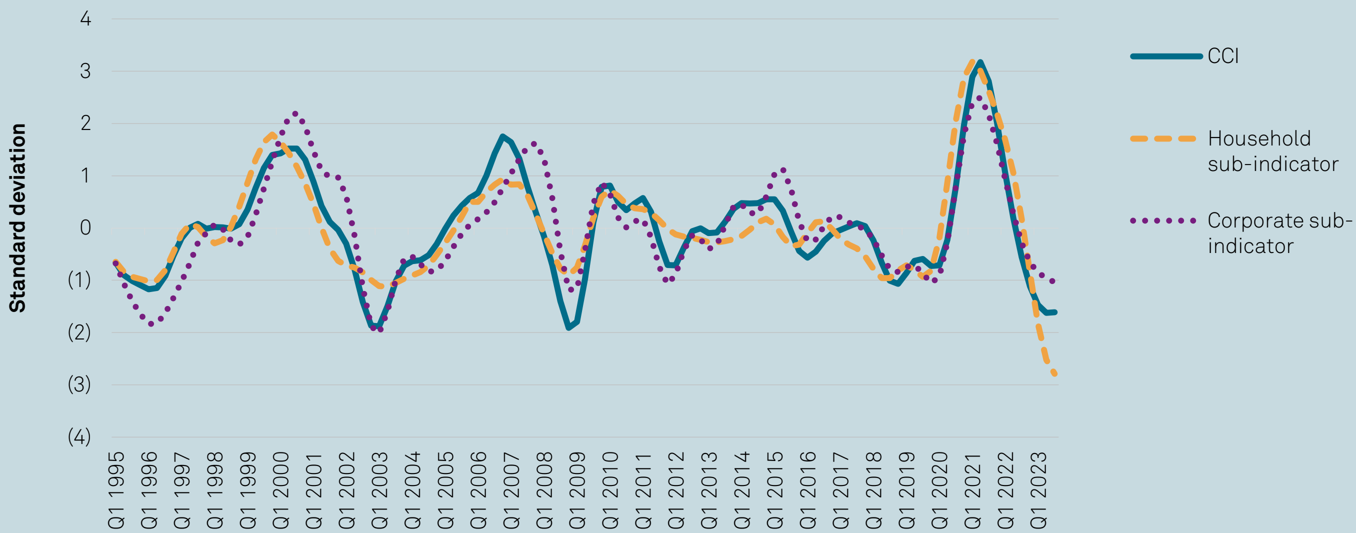
A credit upturn could be in sight, even though headwinds abound

Our eurozone CCI shows signs of a trough (see chart 10), signaling a possible turning of the credit cycle in 2025. Bank lending conditions moderate, while risk sentiment has improved somewhat. We expect eurozone growth will increase by 1.3% in 2025, from 0.7% in 2024.

However, the lagged effects of the ongoing credit correction could persist through 2024. Investors remain selective, while the full effect of higher interest rates is still feeding through to businesses and households. The risks of a prolonged growth slowdown and a spillover of escalating conflicts in Europe to neighboring countries could dampen confidence and economic recovery.

Chart 10

Eurozone credit cycle indicator



CCI--Credit cycle indicator. Peaks in the CCI tend to lead credit stresses by six to 10 quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. Sources: Bank for International Settlements, Bloomberg, S&P Global Ratings. Data as of the third quarter of 2023.

Corporates: The eurozone corporate sub-indicator descended to minus 1.0 standard deviations in the third quarter of 2023, after peaking at 2.5 in the second quarter of 2021. The economic and inflationary rebound from the pandemic spurred nominal growth across the eurozone and substantially helped reduce the corporate-credit-to-GDP ratio to below pre-pandemic levels. According to the Bank for International Settlements, the ratio was 96% in the third quarter of 2023, from a pandemic peak of 111% in the first quarter of 2021. While the decline in the CCI signals moderating stress, higher rates, more selective financing conditions, and weak economic growth may expose financial vulnerabilities in certain segments of the nonfinancial corporate sector over the near term.

Households: The trend for the household sub-indicator is more pronounced than that of corporates, in that a peak of 3.2 standard deviations in the first quarter of 2021 was followed by a significant decline to minus 2.8 in the third quarter of 2023. Over that period, total credit to eurozone households as a percentage of GDP decreased to a pre-pandemic level of 56% by the first quarter of 2023 and now stands at 54%. To some extent, this moderation reflects the benefits of a strong labor market and the lagged effect of higher rates feeding through to end-users. As the effect of rate rises on debt repayments materializes, households with minimal savings could struggle to access credit, especially in the event of an economic downturn and rising unemployment.

Financial Institutions

- Our outlook for European banks remains largely stable. Solid capitalization and liquidity, improved profitability, and still sound asset quality should support their creditworthiness in the case of a soft-landing scenario.
- Asset quality will likely weaken through 2024, particularly for more vulnerable portfolios, including loans to small and midsize enterprises (SMEs), unsecured consumer credit, and CRE exposures. Yet a deterioration should be limited, with credit costs normalizing from low levels.
- Profitability will not improve further but will hold up well. The focus will lie on cost management as revenues flatten because of muted volume growth and likely declining rates. Banks will be able to maintain planned shareholder distributions without suffering from a decline in solvency.
- Key risks include tighter liquidity conditions that could increase funding costs for some banks, market turbulence, which could destabilize weaker banks and non-banks, and a harder economic landing that could intensify asset quality deterioration.

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Key developments

Except for French banks, most banks reported a significant, long overdue improvement in profitability in 2023, supported by the shift in monetary policy. Net interest margins ballooned as assets repriced faster than liabilities, enabling banks to more than offset higher operating costs at a time when credit provisions remained contained. Earnings upside has probably peaked in most cases but banks will likely continue to report solid profits in 2024. The focus in 2024, however, will shift from earnings to cost control.

Distributions to shareholders will be sizeable. Stronger profits, comfortable capital headroom, modest expected balance sheet growth, and the manageable effect of Basel III amendments on bank capital supported higher distributions to shareholders. Major listed European banks announced over €100 billion in dividends and share buybacks, a significant increase from 2022. As banks continue performing solidly, these distributions are unlikely to weigh on ratings.

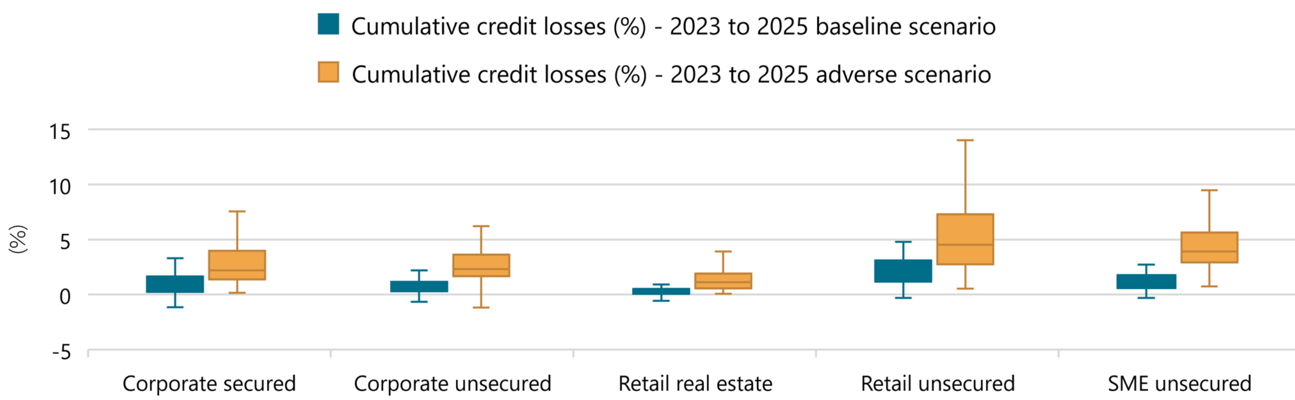
Lending growth remains muted. The annual growth rate of eurozone banks' loans to the resident private sector was a mere 0.5% at the end of 2023, well below the 5.4% at the start of the year. Tighter monetary policy and weaker economic activity will weigh on credit demand and supply. Banks' credit standards remain tight, according to the ECB's latest bank lending survey, and are unlikely to change, at least over the first half of this year.

CRE risk is taking a toll on monoline banks. In aggregate, we see European banks' exposure to CRE, which on average accounts for around 11% of loans, as manageable. As a result, we expect banks' creditworthiness will resist sector-specific adverse developments. That said, monoline CRE lenders are clearly more vulnerable, particularly those that have exposures to U.S. CRE, which faces material pressure. We recently downgraded German CRE lender Deutsche Pfandbriefbank to 'BBB-/A-3' because of its deteriorating asset quality and reduced earnings. The outlook on the ratings remains negative, highlighting further potential downside. In Europe, German and Swedish banks have the highest CRE exposures, which, in some cases, are more than double the banks' common equity tier 1 capital.

European banks' asset quality remains solid so far but some problem loans could emerge over the course of the year. The slowdown in economic activity and still high financing costs will put pressure on borrowers, particularly in the case of highly leveraged SMEs and unsecured lending to low-income retail customers (see chart 11). We expect mortgage asset quality will remain resilient. We note that corporate bankruptcies in Europe have increased and are back at pre-pandemic levels, while our default rate is also on the rise. We thus expect banks' credit provisions will normalize from very low levels. Banks' increasing use of synthetic securitizations to transfer credit risks to third-party investors--mainly used for capital purposes--could also help contain banks' credit losses.

Chart 11

The EBA stress test illustrates how unsecured retail and SME portfolios suffer higher credit losses in an adverse scenario



Three-year cumulative credit loss projections for the 70 EU banks included in the exercise. Shaded areas show the distance between the 25th and 75th percentile of banks. The line shows the median. EBA--European Banking Authority. SME--Small and midsize enterprises. Sources: 2023 EBA stress test, S&P Global Ratings.

Revised business models led some banks to make small acquisitions, while others exited small locations. For example, Deutsche Bank announced in 2023 the acquisition of U.K. corporate bank Numis, Barclays agreed to buy Tesco Bank, HSBC bought Silicon Valley Bank's U.K. operations and Citi's Chinese wealth management unit, and Nordea bought Danske Bank's Norwegian retail operations. On the other hand, OTP, Handelsbanken, and BNPP will exit subscale foreign presences in Romania, Finland, and the Czech Republic, respectively. M&A activity has been limited so far. Yet banks' excess capital, the recent, though modest, increase in valuations, and banks' drive to maintain profits could lead to larger, most likely in-market, transactions. For example, Nationwide's offer for Virgin Money in the U.K. represents a more transformational deal.

The legislative approval of the EU Banking Package, which finalizes the implementation of Basel III capital standards in the EU, has no effect on bank ratings. A long transition period until the full implementation in 2032 and several deviations from the Basel standards will dilute the effect of some changes, namely the introduction of the output floor for banks that use internal rating models. Accordingly, the effect on banks' regulatory capitalization will be modest. We do not expect significant changes to our risk-adjusted capital calculations.

The ECB's new operational framework will not tighten conditions for banks to access central bank liquidity and should prove supportive of bank funding and profitability. Minimum reserve requirements remain unchanged, while the spread between the ECB's main refinancing operations rate and its deposit facility rate will decrease to 15 bps, from 50 bps, by September this year. Considering this narrowing spread and preferential conditions in terms of collateral and full allotment, banks have little incentives to turn to interbank markets for their financing needs. The narrowing spread could also encourage banks to hold eligible lower-quality assets--for example, certain corporate bonds--and swap them for central bank liquidity, which could benefit credit spreads.

Rating pressure on non-bank financial institutions remains. The main challenges for non-banks consist of refinancing risks amid still elevated interest rates, tightening market liquidity, profitability declines, and the need to revise business models. For example, distressed debt purchaser AFE completed a debt restructuring that we considered tantamount to a default.

Additionally, we lowered the ratings on Nordic debt collector Intrum AB by one notch because of its delay in reducing leverage.

Key risks

Tighter liquidity leading to higher funding costs and market turbulence: Some banks could struggle with higher funding costs particularly if they lack deep franchises. Beyond that, heightened geopolitical risks or unexpected monetary policy decisions, for example, an acceleration in central banks' balance sheet reductions, could lead to market turbulence. The latter could destabilize financial institutions with weaker funding structures--especially non-bank financial institutions with high refinancing needs--and expose banks to higher counterparty credit risks.

A protracted, painful recession: This could undermine the financial health of corporates and households, weaken banks' asset quality--particularly the performance of more vulnerable portfolios--and cloud business prospects beyond our expectations.

Commercially and operationally fragile business models: These will become an issue if banks are unable to tackle inefficiencies, digitalize their business, and sustain cyber resilience.

Nonfinancial Corporates

- Nonfinancial corporates' 2023 results were broadly in line with our expectations. Most companies proved resilient to slower economic conditions and increases in the cost of debt. Our outlook for 2024 is cautious but not negative for most corporate sectors, with 77% of corporate ratings in EMEA on a stable outlook.
- The outlook on 30% of ratings in the real estate and commodity chemicals sectors continues to be negative. The ratings outlook on other sectors, such as leisure and sports and consumer durables, is similar but not because of structural issues.
- Speculative-grade corporates are quicker to align cost of debt to higher interest rates than investment-grade corporates, whose outstanding debt has longer maturities.
- Refinancing activity picked up in recent months and credit spreads narrowed, particularly for lower-rated corporates. Fundamentals rank high in investors' preferences, although refinancing costs remains well above pre-pandemic levels.

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Key developments

In 2023, European companies proved resilient to the modest economic slowdown that started in the second half of the year. Inflation put pressure on volumes in industrial and consumer-focused sectors. In most cases, price increases offset this contraction, as demonstrated by companies in the consumer goods and building materials sectors. Leisure, media, auto, aerospace and defense, and business and consumer services are among the sectors that reported the most solid results in 2023.

For 2024, in most sectors companies' expectations seem cautious but not pessimistic. In our view, demand for goods and services will not accelerate and inflationary pressures will be limited. Companies will have much less scope to increase prices and will seek to stem decreases in volumes. Many companies are focused on protecting operating margins while revenue growth will likely remain modest. Most distorting factors from recent years, such as supply chain disruptions and spikes in energy costs, have dissipated but labor costs are still an inflationary factor in most European countries. Their net effect will likely be higher in labor-intensive sectors with limited or no physical production, as these sectors will not directly benefit from the deflationary effects of raw material prices. At this stage, increasing geopolitical tensions have no direct effects on most corporate sectors. The shipping sector is a notable exception and has experienced another increase in freight rates. The most immediate potential risk is another shock on supply chains.

The real estate sector remains in the spotlight. About 30% of rating outlooks in the EMEA portfolio are negative after more than 20 negative rating actions since January 2023. Positive developments in recent months, however, include tightened bond yields that support refinancing for the strongest companies in the sector. Investor sentiment is slowly improving, and we expect pressure on asset valuations will ease from the second half of this year. Approaching large debt maturities were the main driver for our recent negative rating actions. The structural increase in interest rates remains the key medium-term challenge due to the high amount of debt that most companies in the sector carry.

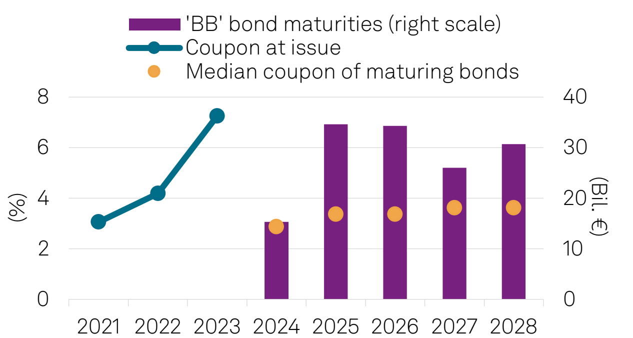
In the chemical sector, about 30% of rating outlooks in the EMEA portfolio is negative. Recent negative rating actions include the downgrades of Solvay to 'BBB-' in December and of Synthomer to 'BB-' in January. Heubach and IGM Resins decided to restructure their balance sheets, which resulted in defaults under our criteria as they did not meet the initial contractual obligations on the debt. Some companies are considering rationalizing their production footprints to reduce excess capacity at less efficient plants to mitigate pressures from higher energy costs, softer demand, and rising costs related to environmental targets. The petrochemical sector probably suffers the most in that regard due to its high energy needs.

Other sectors also exhibit a high percentage of negative rating outlooks but structural issues do not exist. About 30% of ratings outlooks in the leisure and sports sector are negative. Yet we took several positive rating actions in recent months and many rated companies' 2023 results were solid. Still, 65% of ratings in the leisure and sports sector are 'B' or below. The slowdown in demand and the increase in financing costs will be more significant for the respective issuers. In the durable goods sector, the proportion of negative outlooks exceeds 30% and partially reflects the retracement in demand after the spike during the pandemic. The ratings on about 50% of companies in the durable goods sector are 'B' or below.

The increase in financing costs is faster for speculative-grade companies than investment-grade companies. This is due to an elevated percentage of floating-rate debt, which accounts for about 50% of the total, the need to refinance debt maturities well in advance, and the fact that these companies typically have one or two significant maturities to refinance. For investment-grade companies, the increase is materializing more gradually because the number of long-term maturities is markedly higher. The difference between the current market yield and the average coupon remains significant but we expect it will gradually narrow (see charts 12 and 13). We do not envisage widespread pressure on investment-grade ratings. For highly indebted companies, however, the higher cost of debt will reduce the cash available for investments or shareholder distributions.

Chart 12

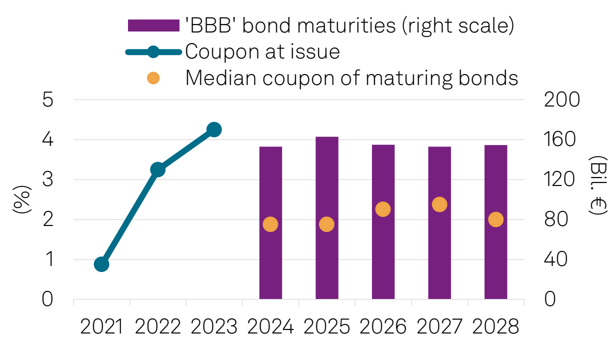
Median coupon of newly issued and maturing corporate bonds in the 'BB' category



Includes European nonfinancial corporate bonds and notes rated 'BB+', 'BB', or 'BB-' by S&P Global Ratings. Sources: Refinitiv, S&P Market Intelligence, S&P Global Ratings Credit Research & Insights.

Chart 13

Median coupon of newly issued and maturing corporate bonds in the 'BBB' category



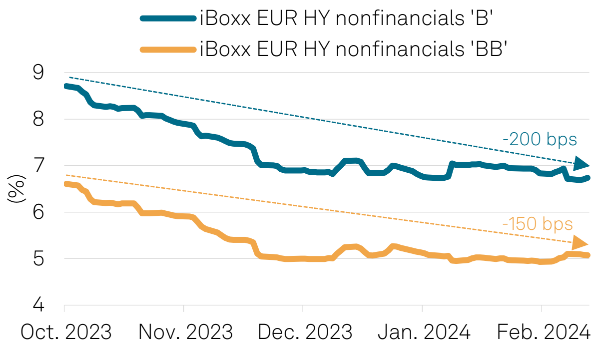
Includes European nonfinancial corporate bonds and notes rated 'BBB+', 'BBB', or 'BBB-' by S&P Global Ratings. Sources: Refinitiv, S&P Market Intelligence, S&P Global Ratings Credit Research & Insights.

Since October 2023, speculative-grade financing costs and risk premia have steadily and progressively decreased. The most notable tightening occurred in the 'B' category, where the iBoxx 3–5-year nonfinancial index shows that yields fell by approximately 200 bps to below 6.8%. 'BB' category yields also dropped sharply by 150 bps to just above 5.0% (see charts 14 and 15).

Chart 14

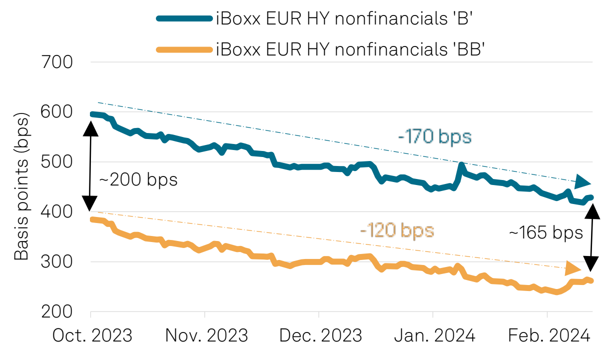
Chart 15

Yields of 'B' and 'BB' rated bonds have decreased since October 2023



bps--Basis points. Source: S&P Global Ratings.

Spreads in the 'B' category tightened most rapidly



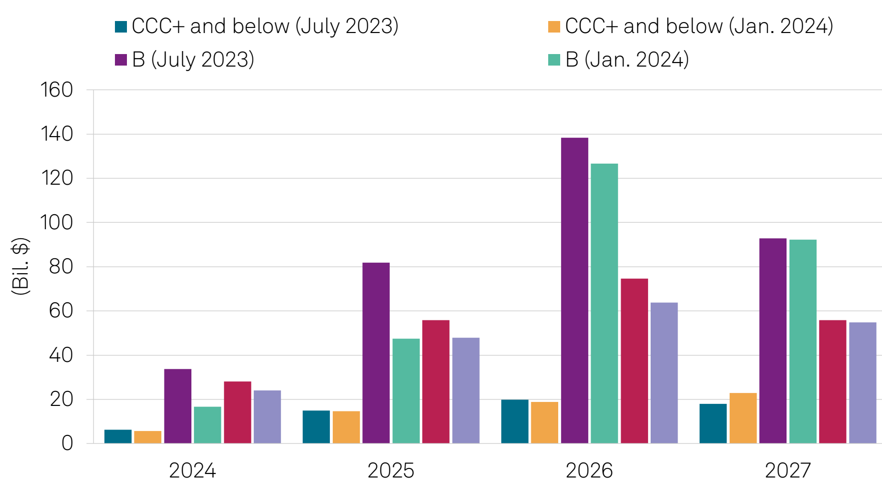
Source: S&P Global Ratings.

The tightening in risk premia alleviated refinancing concerns for all but the most vulnerable credits in the speculative-grade space. 'B' rated nonfinancial European corporates have already refinanced nearly half of the outstanding debt due in 2024-2025 as of July 2023, reducing the outstanding amount to an equivalent of $64 billion (see chart 16). Data by Pitchbook LCD suggests another equivalent of $25 billion has been refinanced year to date, via broadly syndicated loans or high-yield bond issuances. A repricing wave of already extended debt maturities in 2023 provided half of the syndicated loan activity in January and February 2024, with predominantly 'B' rated issuers reducing the cost of debt by an average of 50 bps.

Chart 16

European nonfinancial corporate debt maturities by rating category

Six-month comparison



Source: S&P Global Ratings.

The cost of debt chasm for 'CCC' rated issuers remains. The outcome for these issuers will likely consist of equity support from owners to prop up the capital structure, lenders taking ownership, or, increasingly, a stalemate between the two until a buyer is found. Examples include Ideal Standard, Keter, and Accolade Wines.

Tightening spreads also lead to refinancing unitranches and privately financed club deals with broadly syndicated loans. April Group, group.one, and IVI-RMA already raised €3 billion. In the process, they cut the cost of debt by 2.5%. Increasingly, private debt is playing a constructive part in refinancing over-levered issuers. Private debt provides payment-in-kind facilities to replace cash-pay debt, either first- or second-lien, and thereby alleviates cash coverage metrics.

This, alongside equity cheques, reduces downward rating pressure on credits that are rated 'B-' or below, face debt maturities within two years, and have run out of ways to deliver the required recovery.

Key risks

Weaker-than-expected economic conditions: Slower demand could hit volumes, revenues, and operating margins, while putting pressure on credit ratios and ratings, especially for lower-rated companies.

Sudden worsening of the geopolitical situation: This can trigger new pressure on supply chains and disproportionately hit sectors that are more exposed to exports outside Europe.

Sovereigns

- High government debt at a time of increasing security and defense challenges from geopolitical uncertainty add pressure on European sovereigns' balance sheets.
- While governments look for avenues to increase economic growth, they may look to boost tax receipts from the less-leveraged private sector over the near term, for example by continuing windfall taxes on banks which benefit from higher rates.
- Several electoral events in 2024 will likely intensify pressure and scrutiny on fiscal strength. Election outcomes could increase political fragmentation and complicate decision-making at a European and individual country level.

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Key developments

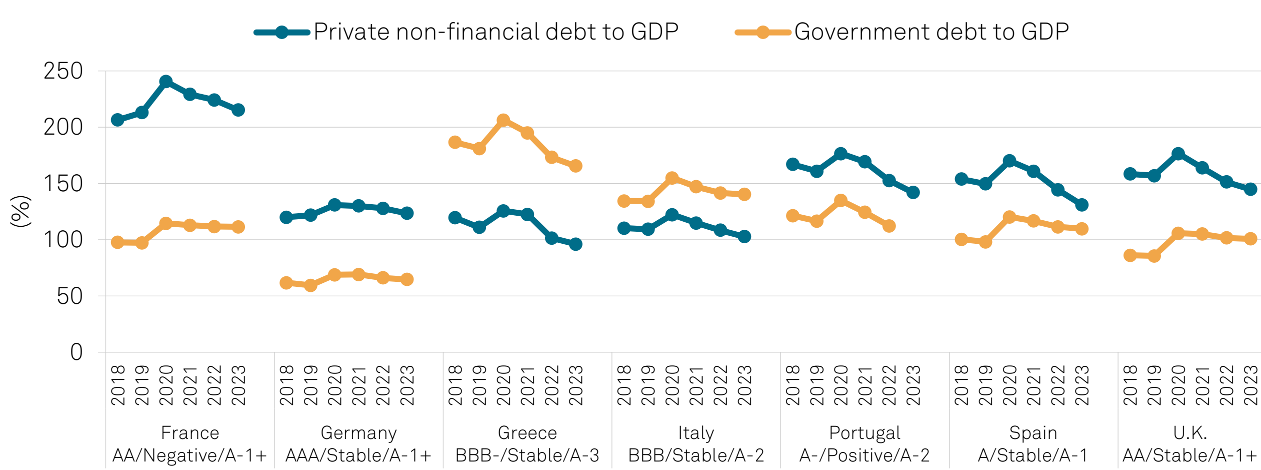
European governments began 2024 with higher debt levels. These were about 6 percentage points of GDP higher than at the end of 2019, with the average government debt at 90% of GDP. Still, European governments' debt levels and the rates of the debt increases are slightly below the average for all advanced economies and the G20.

Private nonfinancial debt in the eurozone declined by 7.8 percentage points between the end of 2019 and the beginning of 2024. This stood in stark contrast to public debt, which increased sharply over the same period. Due to limited additional fiscal space, governments will increasingly look to the private sector to share a larger percentage of the burden of bringing debt down to pre-pandemic levels. Given pressures to spend more on defense and continue to manage the costs of the energy transition, this is going to be neither easy nor linear.

European sovereigns' balance sheets differ (see chart 17). The increase in government debt in the U.K. and France between end 2019 and last year considerably exceeds that of peers, at 15 and 14 percentage points of GDP, respectively--an increase that even surpasses that in the U.S. This reflects weaker post-pandemic growth relative to the U.S. and the scale of fiscal interventions. In the case of France, private sector debt increased over the same period, meaning total debt (government debt plus private nonfinancial sector debt at nominal value as a proportion of GDP) increased to 327% of GDP, from 310%. Overall, total debt in France increased by 16.5 percentage points since the pandemic. Higher debt increases only occurred in Asia, notably China and Japan, and some emerging markets, such as Hungary, and Saudi Arabia.

Chart 17

The diverging paths of public and private (corporate plus household) debt in Europe



Data for 2023 is for Q3 2023. Ratings as of March 25, 2024. Sources: BIS, S&P Global Ratings.

Total debt in the eurozone declined by nearly 8% of GDP between the end of 2019 and the beginning of 2024. In some smaller eurozone countries, notably Greece, Ireland, and Portugal, total debt levels declined by over 25 percentage points of GDP since the end of 2019, not least due to their stronger growth trajectories since the pandemic. Exactly how larger European economies can find that growth remains to be seen. But the fact that smaller European economies have managed it suggests it is achievable.

Key risks

Challenging geopolitics, a potential shift of U.S. support for NATO, and the need to finance competitiveness-enhancing reforms: All these developments imply that the eurozone may, yet again, embark on joint bond issuances to finance the public spending required to meet these challenges. That said, eurozone member states disagree on when and how to do this. The uncertain growth outlook in the eurozone's largest manufacturing economies Germany and Italy suggests the approach toward mandating the EU to issue more debt will be very cautious.

Large debt on governments' balance sheets: Unlike other major economies, such as China, Japan, and the U.S., the eurozone is less leveraged today than it was before the pandemic. Even so, debt is more focused on governments' balance sheets and less on private sector companies' balance sheets. Governments will look for ways to reverse that, which may include maintaining one-off windfall taxes on sectors, principally banks, that benefit from higher rates.

Several elections in 2024: These include the EU elections in June. Since 2024 is the first year that new fiscal rules are being re-activated, the level of scrutiny on underlying fiscal positions, especially those of large member states, will be high.

Structured Finance

- Despite headline rate rises, many borrowers backing European RMBS have still not seen an increase in their monthly payments, given the prevalence of fixed-rate loans.
- However, arrears rise in U.K. nonconforming and buy-to-let (BTL) RMBS--which have many floating-rate, interest-only loans--and some borrowers with few refinancing options.
- The rising prevalence of electric vehicles (EVs) in auto ABS pools could reduce recoveries and residual values, as BEVs are generally depreciating more quickly than their internal combustion engine equivalents.
- We lowered only 1.5% of our European structured finance ratings over the past 12 months, while we raised 11%.

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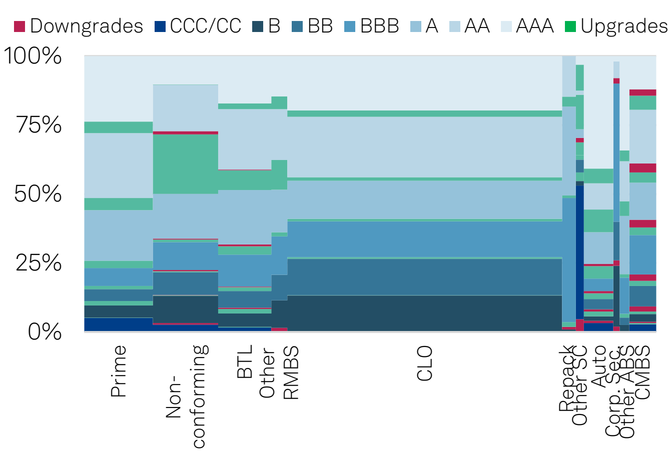
Key developments

In European structured finance, ratings generally trended higher over the past 12 months, despite elevated interest rates increasingly feeding through to underlying borrowers. We lowered only 1.5% of our securitization ratings in the 12 months to the end of February 2024, while we raised 11% (see chart 18). CMBS backed by office and mixed assets were most affected by downgrades, although this sector constitutes a small portion of our outstanding European securitization ratings and also saw upgrades as some transactions delevered. Other signs of weakness were idiosyncratic spread across underlying sectors. Although households are under pressure--with potential implications for sectors backed by consumer credit--this has so far generally not led to many negative rating actions for RMBS or auto ABS.

Chart 18

Upgrades have continued across many sectors

European structured finance ratings heatmap

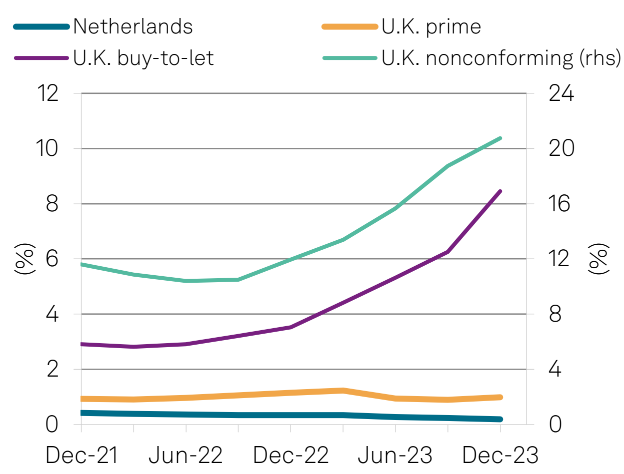


BTL--Buy-to-let. SC—Structured credit. Based on the cumulative count of rating actions between March 1, 2023, and Feb. 29, 2024. Source: S&P Global Ratings.

Chart 19

Arrears rises restricted to specialized subsectors

European RMBS total arrears rate, selected sectors



RMBS--Residential mortgage-backed security. Source: S&P Global Ratings.

Key risks

With interest rates remaining at 15-year highs, pressure continues to build on household borrowers whose loans back European structured finance transactions. In general, arrears reported for loan pools backing consumer-related securitizations have not increased significantly since rates have started to rise. The U.K. nonconforming and BTL subsectors are exceptions (see chart 19).

Despite headline rate rises since the end of 2021, many borrowers have not yet been exposed to an increase in their monthly payments. This is because of the prevalence of fixed-rate products, which varies significantly by country. Rate rises have passed through quickly to borrowers in Spain and Portugal. Yet in most other mortgage markets, borrowers' ability to service their debt will likely increase due to wage growth before they are effectively exposed to the new rate environment.

Among RMBS markets, this lag effect is largest in the U.K., where the average existing borrower has suffered a rate shock of only about 1.4 percentage points. This corresponds to one-third of the 3.6 percentage point rate increase that has occurred on new lending over the same period. When rate rises began in early 2022, 82% of outstanding U.K. mortgage balances paid a fixed interest rate. Two years on at the end of 2023, about 40% of those balances remained on the same fixed-rate contracts and have therefore been fully insulated from rate rises. By the end of 2024, this will still apply to more than 25% of pre-2022 fixed-rate loan balances. Even borrowers who refinanced to a new fix at their rate reset date have seen an average rate increase of only 1.7 percentage points. For most, the rate shock experienced is well within affordability stresses typically applied at loan origination.

The U.K. nonconforming and BTL RMBS sectors include a significant number of legacy loans originated before the financial crisis. These were subject to looser underwriting standards than more recent lending. Many of the related borrowers may now be so-called "mortgage prisoners," typically paying a floating rate and unable to qualify for potentially more favorable rates on new loan products. The securitized loan universe is therefore not representative of the wider cross-section of outstanding mortgage loans. In addition, almost all securitized BTL mortgage loans make payments on an interest-only basis, meaning any rate rise affecting the loans since early 2022 has had a directly proportional effect on the borrowers' monthly instalments.

Outside the U.K., the risk of a deterioration in mortgage loan collateral is limited because it tends to be long-term fixed, as is the case in the Netherlands, or highly seasoned, for example in Spain. Arrears will likely continue to increase as more fixed-rate periods end and borrowers refinance into the higher-rate environment. However, proactive servicing and forbearance may lead to higher collection rates on delinquent loans than in prior periods of stress.

In the auto ABS sector, observable credit deterioration has been minimal so far. Yet we recently noted that the rising prevalence of EVs brings new risks for auto ABS over the medium term. EVs represent a growing share of new vehicle sales across all major European auto ABS markets. Data suggests that BEVs have generally depreciated more quickly than their internal combustion engine equivalents, potentially reducing recoveries and residual values in securitized pools of EV loans and leases. Secondhand values could continue to face pressure over the near term, as demand for used EVs may not keep pace with the growth in new registrations, given falling new vehicle prices and ongoing improvements in battery technology and range. Demand for internal combustion engine vehicles will likely drop at some point and reverse this effect, though not within the tenor of current auto ABS transactions.

International Public Finance

- Many European local and regional governments (LRGs) continue to show resilience to the slow economic recovery. However, they will likely reduce capital spending due to higher operating spending and constraints from balanced budget requirements.
- Similarly, European social housing companies largely cut their development plans and are more proactive in asset management, despite pressure to deliver more affordable housing units.
- Universities may need to adjust strategies if geopolitical risks and the rising dependence on international students result in slower revenue growth.

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Key developments

The ongoing economic weakness continues to strain LRGs' operating budgets. Revenues are growing slowly, while increases in wages and utility bills, as well as higher interest rates, raise operating spending. As a result, we project many LRGs will cut local infrastructure investments (see chart 20), even though they will continue to exceed 2017 levels. The notable exception is Italy, where LRGs will intensify the absorption of EU capital grants.

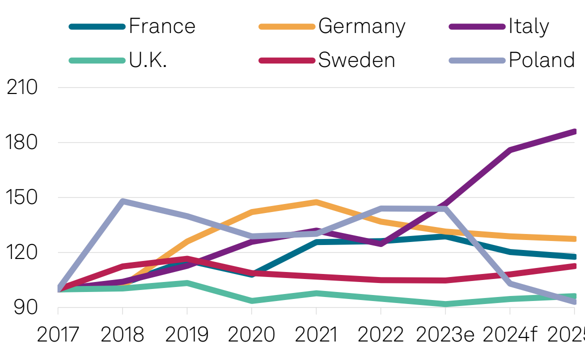
A very cautious recovery in the real estate sector reduces proceeds from property transaction fees. French departments and large cities will suffer more than other European LRGs from this.

We expect U.K. social housing entities will remain cautious when creating their development plans. Borrowings will increase to record levels in 2025 but mainly because of refinancing. Net borrowings to co-finance capital spending will decline over the next two years (see chart 21).

Chart 20

Many European LRGs' capex will decline

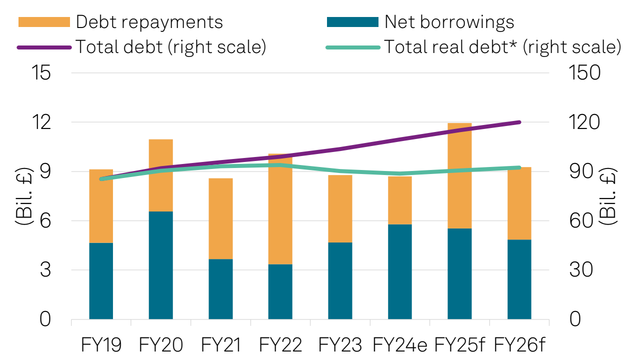
Real-term capex* by country, indexed (2017=100)



*In 2017 prices. Capex--Capital expenditure. e--Estimate. f--Forecast. LRG--Local and regional government. Source: S&P Global Ratings.

Chart 21

Net borrowing in the U.K. social housing sector will decrease



*In 2019 prices. e--Estimate. f--Forecast. Source: S&P Global Ratings.

Key risks

Deterioration in public services: Projected declines in capital investments could worsen the quality of public services, while demand for them will rise due to increasing and ageing populations.

Escalation of geopolitical risks: Higher demand for defense spending and still elevated price levels could add pressure on public finances.

Insurance

- For European insurers, 2024 started with some tailwinds from favorable investment returns and further premium rate increases.
- Robust capital adequacy, often prudent asset allocation, sophisticated risk management, and pricing capabilities support our view of stable ratings in the sector.
- The reinsurance contract renewal round on Jan. 1, 2024, showed robust premium rate improvements in property reinsurance lines. The pace of improvements was lower than in the 12 months to Jan. 1, 2023. Renewals for casualty reinsurance lines remained favorable and confirmed our stable view of the reinsurance subsector.
- We believe geopolitical and economic risks could impair the valuation of European insurers' investments.

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Key developments

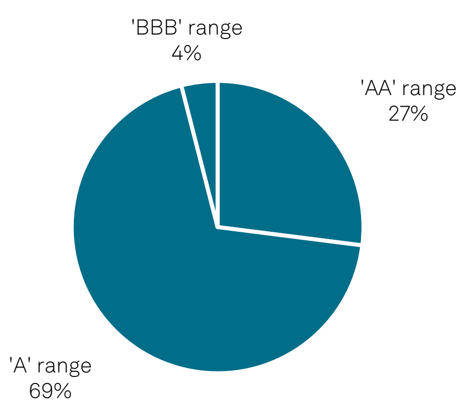
The European insurance sector is in a good position to withstand external challenges (see charts 22 and 23). The primary life insurance sector benefits from higher reinvestment rates. Yet it will take many years for the pull to par to reverse long-dated bond investments' unrealized losses. Many primary non-life insurers have already increased premium rates amid claim inflation but more need to follow their example.

After reinsurance premium rates hardened last year, 2024 started with positive and more orderly renewals. We maintain our stable view on the reinsurance subsector and expect profitability will meet the cost of capital over 2024-2025.

European insurers' investments are exposed to many risks, including higher refinancing costs. Insurers' investments in the CRE sector might suffer, as was the case when Austrian property company Signa Holding GmbH failed. However, we do not expect impairments to materially weaken affected insurers' capital positions.

Chart 22

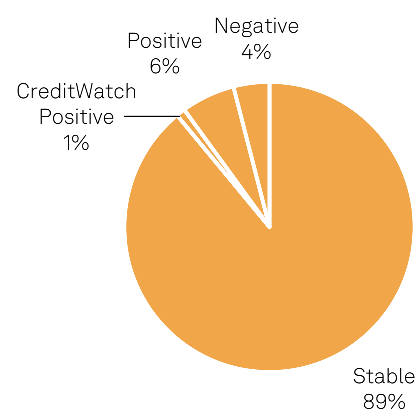
Financial strength ratings on European insurers



Data as of March 11, 2024. Source: S&P Global Ratings.

Chart 23

Outlook on the ratings on European insurers



Data as of March 11, 2024. Source: S&P Global Ratings.

Key risks

External factors: Although their direct exposures to geopolitical and economic risks are limited, insurers are major investors in capital markets. As evidenced in prior crises, a prolonged capital market downturn could burden insurers' balance sheets.

Heightened impairments on illiquid investments: Life insurers increased their exposures to illiquid assets in search for yield during the low-interest-rate era. Private equity, private debt, and some real estate investments might see further asset value declines.

Related Research

- Economic Outlook Eurozone Q2 2024: Labor Costs Hinder Disinflation As Rate Cuts Loom, March 26, 2024
- Economic Outlook Q2 2024: The U.K. Is Slowly Turning A Corner, March 26, 2024
- Corporate Results Roundup Q4 2023: Earnings Show Signs Of Stabilizing, March 21, 2024
- Global Shadow Banks Face Scrutiny As Risks Rise, March 20, 2024
- Your Three Minutes In Banking: European Banks' Earnings Top Equity Costs, For Now, March 19, 2024
- Ten Takeaways From The Big European Bank Giveaway, March 15, 2024
- Eurozone Banks: ECB's Operational Framework Review Backs The Status Quo, March 14, 2024
- Sovereign Debt 2024: Developed European Governments To Borrow About $1.84 Trillion in 2024, Feb. 27, 2024
- EMEA Structured Finance: Chart Book, Feb. 26, 2024
- Default, Transition, and Recovery: European Speculative-Grade Default Rate To Stabilize At 3.5% By December 2024, Feb. 15, 2024
- EU Sovereign Debt 2024: Mixed Outlook And New Rules, Feb. 7, 2024
- Global Refinancing: Maturity Wall Looms Higher For Speculative-Grade Debt, Feb. 5, 2024
- Short-Tail Lines' Pricing Remains Firm While Reinsurers Keep An Eye On Casualty, Feb. 1, 2024

Appendix: Q2 2024 Economic Data And Forecast Summaries

Table 1

Real GDP (%)

	Eurozone	Germany	France	Italy	Spain	Netherlands	Belgium	Switzerland	U.K.
2022	3.5	1.9	2.5	4.1	5.8	4.4	3.0	2.7	4.3
2023	0.5	-0.1	0.9	1.0	2.5	0.1	1.5	0.8	0.1
2024f	0.7	0.3	0.8	0.6	1.8	0.5	1.4	1.0	0.3
2025f	1.3	1.2	1.4	1.1	1.9	1.4	1.4	1.4	1.4
2026f	1.3	1.2	1.4	1.1	2	1.5	1.3	1.4	1.7
2027f	1.3	1.1	1.3	1.0	2.1	1.5	1.3	1.5	1.7

f--Forecast, annual average. Source: S&P Global Ratings Research.

Table 2

CPI inflation (%)

	Eurozone	Germany	France	Italy	Spain	Netherlands	Belgium	Switzerland	U.K.
2022	8.4	8.7	5.9	8.7	8.3	11.6	10.3	2.9	9.1
2023	5.5	6	5.7	5.9	3.4	4.1	2.3	2.2	7.3
2024f	2.6	2.7	2.7	1.9	3	2.7	3.3	1.5	3
2025f	2.1	2.2	1.9	1.9	2	2.4	2.2	1.4	2.3
2026f	1.9	1.9	1.9	1.9	2	2	2	1.2	2.1
2027f	1.8	1.9	1.8	1.9	1.8	2	1.9	1.1	2

CPI--Consumer price index. f--Forecast, annual average. Source: S&P Global Ratings Research.

Table 3

Unemployment rate (%)

	Eurozone	Germany	France	Italy	Spain	Netherlands	Belgium	Switzerland	U.K.
2022	6.7	3.1	7.3	8.1	12.9	3.5	5.6	4.3	3.9
2023	6.5	3	7.3	7.6	12.1	3.5	5.5	4	4
2024f	6.6	3.3	7.7	7.5	11.5	3.8	5.5	4.4	4.3
2025f	6.6	3.2	7.6	7.6	11.4	4	5.5	4.3	4.3
2026f	6.5	3	7.5	7.5	11.3	3.9	5.5	4.1	4.2
2027f	6.4	3.1	7.4	7.4	11.2	3.8	5.4	4	4.2

f--Forecast, annual average. Source: S&P Global Ratings Research.

Table 4

10-year government bond yields (% annual average)

	Eurozone	Germany	France	Italy	Spain	Netherlands	Belgium	Switzerland	U.K.
2022	1.9	1.2	1.5	3.2	2.2	1.4	1.7	0.8	2.3
2023	3.1	2.5	2.9	4.3	3.5	2.8	3.1	1.1	3.9
2024f	3.4	2.4	2.8	4	3.4	2.7	3	1	3.8
2025f	3.1	2.4	2.9	4	3.5	2.8	3	1.2	3.4
2026f	3.1	2.5	3	4.1	3.5	2.8	3.1	1.2	3.3
2027f	3.1	2.5	3	4.1	3.5	2.8	3.1	1.2	3.2

f--Forecast. Source: S&P Global Ratings Research.

Table 5

Exchange rates (annual average)

	----Eurozone----		----U.K.----		----Switzerland----	
	USD/EUR	EUR/USD	USD/GBP	EUR/GBP	CHF/USD	CHF/EUR
2022	1.05	0.95	1.23	1.17	0.96	1.00
2023	1.08	0.92	1.24	1.15	0.90	0.97
2024f	1.10	0.91	1.28	1.16	0.88	0.97
2025f	1.14	0.88	1.37	1.20	0.90	1.03
2026f	1.17	0.86	1.38	1.19	0.91	1.06
2027f	1.18	0.85	1.37	1.16	0.91	1.07

f--Forecast. Source: S&P Global Ratings Research.

Table 6

Policy interest rates (% end-of-year)

	----Eurozone (ECB)----		U.K. (BoE)	Switzerland (SNB)
Policy rates	Refinancing rate	Deposit rate	Bank rate	Policy rate
2022	2.5	2.0	3.25	1.0
2023	4.5	4.0	5.25	1.75
2024f	3.4	3.25	4.5	1.0
2025f	2.65	2.5	3	1.0
2026f	2.65	2.5	2.75	1.0
2027f	2.65	2.5	2.75	1.0

BoE--Bank of England. f--Forecast. SNB--Swiss National Bank. Source: S&P Global Ratings Research.