S&P Global Ratings

Credit Conditions Europe Q4 2024

# Turn In Credit Cycle Won't Be Plain Sailing

**Sept. 25, 2024**

*This report does not constitute a rating action.*

## Key Takeaways

- **Overall:** We continue to expect that EU growth will pick up gradually as higher real incomes spur consumption and employment remains high. Due to declining inflation, we expect the European Central Bank (ECB) will ease interest rates gradually by 25 basis points (bps) per quarter until the deposit rate will bottom out at about 2.5% in the third quarter of 2025.
- **Risks:** Geopolitical risk remains high because of potential escalations in Ukraine and the Middle East, as well as challenges that could arise if the U.S. election results in policy changes. Additionally, Europe's risk management increasingly focuses on ensuring economic security and a free and fair single market. Principal macro risks include a protracted period of subpar growth, wage pressures that prevent a further decline in inflation, and bouts of volatility if markets overestimate the pace of rate cuts.
- **Ratings:** Our ratings outlooks across banks, non-financial corporates, structured finance, and insurance appear stable for the most part, with issuers benefiting from easing financing conditions. More vulnerable segments include commercial real estate (CRE), with some arrears building in European commercial mortgage-backed securities (CMBS), and U.K. non-conforming and legacy buy-to-let (BTL). European sovereigns remain challenged by high debt levels, while corporates increasingly focus on strengthening the resilience of supply chains and improving their competitiveness.

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 Sept. 18, 2024.

**Developed economies have shown remarkable resilience to the rapid once-in-a-generation tightening of monetary policy to curb inflation.** Inflation has been the overarching concern for central banks and Western financial markets over the past 2.5 years. Now that inflation pressures have eased, the ECB and the Bank of England (BoE) have cautiously started to dial back their restrictive policy stance--cautious because the reversion in headline inflation primarily resulted from the food and energy sectors, while domestic inflation in the services sector and catch-up wage negotiations require continued vigilance. Nonetheless, the macro credit outlook for Europe differs little from that of the previous quarter and remains broadly constructive.

**This macro resilience is largely mirrored across the credit spectrum.** Corporate rating actions in Europe and the U.S. remained mainly positive for investment-grade and speculative-grade

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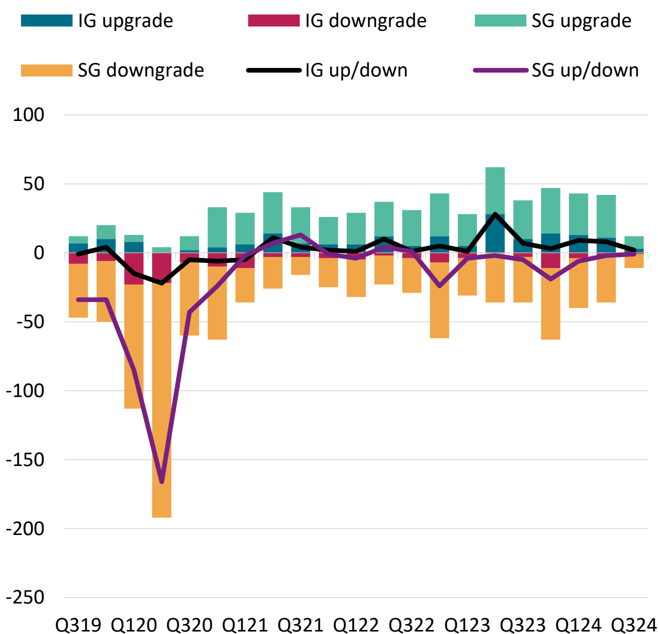
issuers (see chart 1). The extent of this positive sentiment varies across sectors. 60% of upgrades resulted from the speculative-grade universe, notably the consumer products and leisure sectors. Most downgrades occurred in the real estate and more energy-intensive sectors, where issuers tend to struggle with high interest rates, weak operating metrics, or unsustainable capital structures (see chart 2). That said, credit quality in European real estate is generally stabilizing as downward momentum behind valuations and tenant demand eases--albeit less so than in more vulnerable segments.

**Somewhat counterintuitively, the European high yield default rate remains elevated at 4.4% in August 2024, just below the three-year high of 4.8% seen in July 2024.** In large part, this reflects situations where businesses became overextended during the COVID-19 pandemic, and where capital structures were premised on low financing costs, meaning companies were unable to generate sufficient cash flow to delever. Notably, over 60% of rated high-yield defaults this year represented distressed exchanges, mainly debt buybacks at below par by 'CCC' rated companies. Nonetheless, under our base case, we expect the default rate will decline toward 4.25% by June 2025.

Chart 1

### Nonfinancial corporate rating actions remain balanced

Number of rating actions

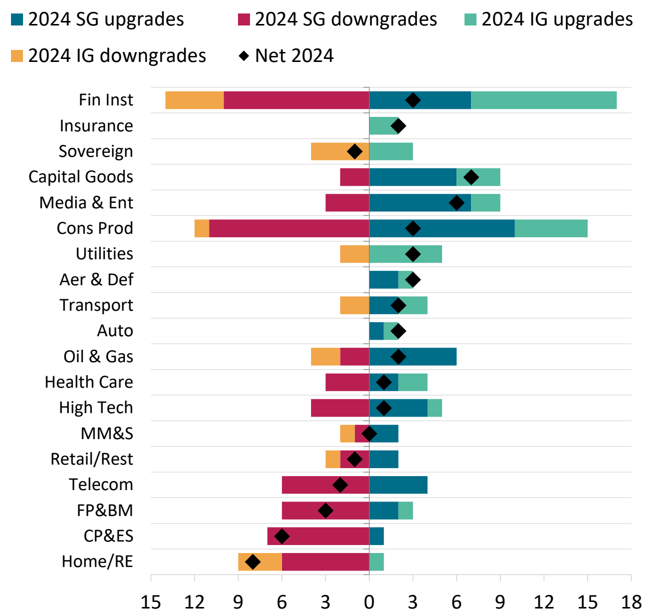



Data as of Aug. 31, 2024. IG--Investment-grade. SG--Speculative-grade. Source: S&P Global Ratings.

Chart 2

### Energy-intensive and interest rate-dependent sectors saw most negative rating actions in 2024

Number of rating actions




CP&ES--Chemicals, packaging, and environmental services. MM&S—Metals, mining and steel. FP&BM--Forest products and building materials. Data as of Aug. 31, 2024. IG--Investment-grade. SG--Speculative-grade. Source: S&P Global Ratings.

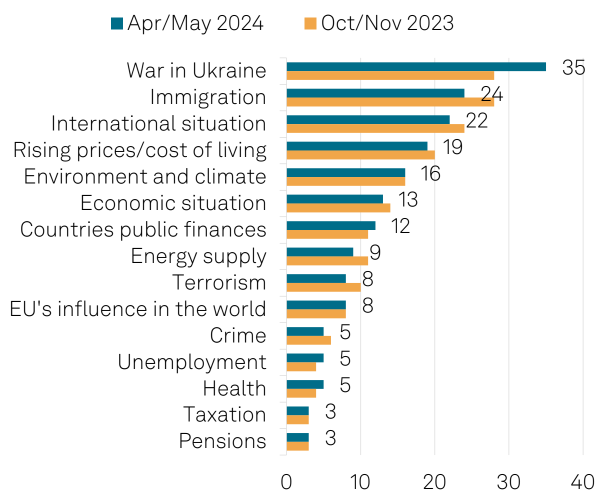
**Inflation no longer takes center stage.** While the turn in the credit cycle will bring some welcome relief to businesses and households, it also means that plenty of other issues and vulnerabilities will come to the fore and shape business and credit outlooks. In Europe, these include geopolitical risk related to the wars in the region and challenges to free trade as economic security and technological leadership increasingly dominate domestic policy. More structural in nature but important in a global context are concerns about the effects of underinvestment, low productivity, and an ageing workforce on Europe's competitiveness and ability to decarbonize, digitalize, and rearm.

**Regional wars will influence the macro credit outlook in Europe over the next 12 months.**

- **Ukraine:** We think the war in Ukraine will remain at a stalemate, although this depends on sufficient military and financial support from the Western Alliance. While Russia has already moved to a war footing, the Western Alliance is providing more sophisticated weaponry and logistical support to Ukraine to make Russia aware of the futility and mounting costs of its aggression. This approach is unlikely to sway Russian President Vladimir Putin, whose legitimacy largely depends on the outcome of the war. Most European governments and citizens acknowledge that the war in Ukraine represents the largest threat to peace, security, and the preservation of European values (see charts 3 and 4). We note that European leaders have not yet prepared European citizens for the sacrifices that may be necessary to address Russia's aggression, particularly if the U.S. scales back support by adopting a more isolationist stance or by shifting the focus to the Indo-Pacific region after the election.
- **The Middle East:** A lasting political settlement on the Palestine question is currently unlikely. Our base case of continued and limited cross-border strikes between Israel and military proxies in the region hinges on local governments' military restraint and a hostage deal that presages a durable ceasefire. This could lower tensions, provide an opportunity to restore stability in the region, and allow elections in Israel that could lead to a more representative government. The alternative would be a devastating conflagration in the region that embroils Iran and the U.S. This would create enormous uncertainty that could disrupt commodity markets and global supply chains.

Chart 3

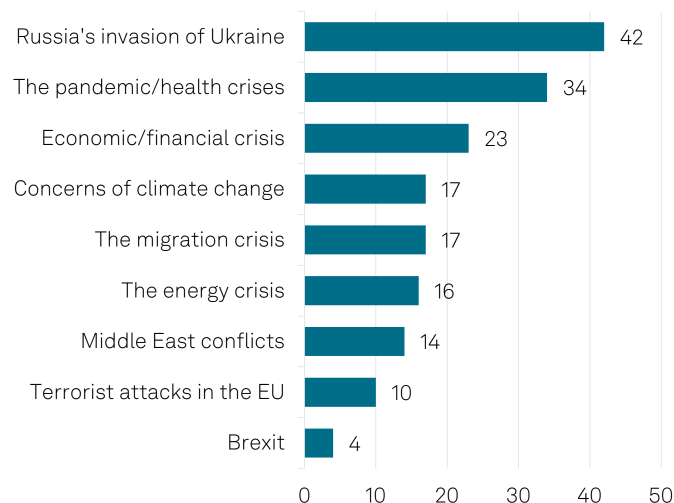
EU-27 citizens consider the war in Ukraine is currently the most important issue (%)




Source: Eurobarometer (ST101 April/May 2024); answers to the survey question: "What do you think are the two most important issues facing the EU-27 at the moment?"

Chart 4

The war in Ukraine had a larger effect on EU-27 citizens' outlook than the COVID-19 pandemic (%)




Source: Eurobarometer (ST101 April/May 2024), answers to the survey question: "In recent years, the world has had to deal with a number of crises. Which of the following have had the greatest influence on the way you look at the future?"

**Geopolitical risk has reached another dimension, not least due to global free trade challenges.**
Europe's stance on China differs from that of the U.S., which treat China as a systemic threat to their military and economic supremacy. In contrast, Europe--as a free trade bloc that upholds the World Trade Organization's standards--sees China more as a partner and competitor, given the scale of their trading relationship. This is reflected in Europe's mantra of derisking, not decoupling. However, the relationship between Europe and China is changing as Europe's

overdependence on China in certain critical product areas could impair its economic resilience. Concerns about economic security increased when China showed signs of supporting Russia politically and economically in its onslaught of Ukraine and its proxy war against the West.

**Clarion call to improve productivity and growth.** Geopolitical fragmentation, the financial hangover from the pandemic, and the energy and inflation crises have sounded a wake-up call for Europe to improve its competitiveness, increase productivity, and accelerate growth. These improvements are necessary for Europe to afford expenditures on the key priorities of digitalization, decarbonization, and defense, particularly against the backdrop of limited fiscal space.

**Competitiveness, which is critical for maintaining a prosperous European economy, is a key element in our credit quality assessment of sectors that are exposed to international trade.** Two corporate sectors illustrate the scale of the challenges involved:

- **Low electrification and softwarization in the auto sector:** The importance of the sector to the European industrial base cannot be understated. It employs 12.9 million people and provides 8.3% of all manufacturing jobs in the EU, according to the European Automobile Manufacturers Association (ACEA). Additionally, it generates over 7% of EU GDP and, as a key sector for innovation, accounts for almost one-third of research and development (R&D) expenditure in the region (€59 billion annually). Yet Europe is concerned that its auto sector cannot keep up with China's in the mandated transition from internal combustion engine vehicles to software-defined electric vehicles (EVs). Chinese EV manufacturers have already established a market leadership position in time to market and operate with significantly lower development and production costs than their European peers. This weak competitive position of the European EV auto industry is compounded by the gigafactories established in China to produce lithium-ion batteries at scale.

  **Consequently, the market share of Chinese original equipment manufacturers (OEMs) in the EU is set to rise.** That said, the most relevant producer, SAIC Motors, accounted for slightly less than 1.5% of the EU passenger car market in July 2024, according to ACEA. While the proposed introduction of countervailing duties on EVs produced in China will buy some time for the European auto industry to address the scale of the challenge, it will inevitably lead to major changes in Europe's production footprint. The mounting pressures are evident in the form of Volkswagen's recent announcement that they are negotiating with the unions to cut costs in Germany by potentially closing two manufacturing plants, in addition to the already announced closure of Audi's plant in Brussels. Auto suppliers are even more exposed to electrification and softwarization as they must evolve from hardware vendors to solution providers, diversify product ranges, and win new clients.

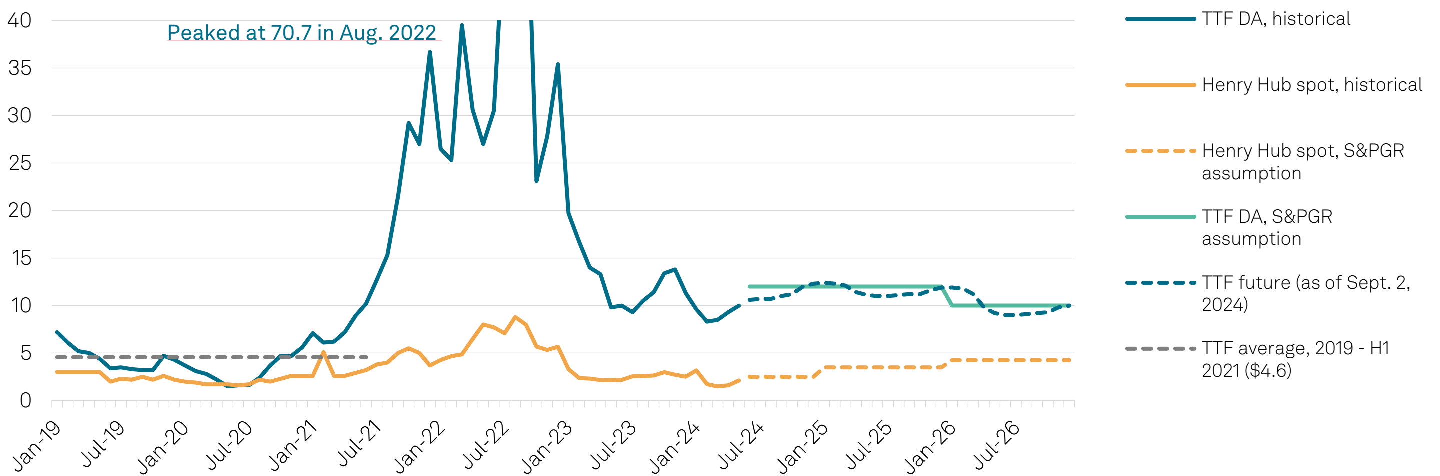
- **Relatively high energy prices:** A key factor contributing to the loss of competitiveness in Europe are the relatively high energy prices, which have exceeded normal levels since late 2021, not least due to Russia cutting off gas supplies to Germany in the second quarter of 2022. While European gas prices have declined dramatically since peaking in August 2022, Title Transfer Facility (TTF) spot prices remain 4x-5x higher than in the U.S. (see chart 5). This is important as Europe will import 150 billion cubic meters (bcm) to 160 bcm of liquefied natural gas annually from 2025, mostly on spot markets, while gas-fired power generation sets the marginal price for electricity, despite the rapid increase in renewables (see "The Energy Transition, Geopolitics, And Cannibalization Are Shaping Europe's Power Prices," Sept. 12, 2024). This also means that, under the Emissions Trading System, the embedded carbon cost amounts to about 10% of EU industrial retail electricity prices, which is higher than in other competing countries. Consequently, electricity prices in Europe are 2x-3x higher than in the U.S., albeit with material supply-mix differences across regions. This provides a competitive advantage to Northern Scandinavia but is to the detriment of Italy

and large parts of Central Europe. According to Mario Draghi's report "The future of European competitiveness," published on Sept. 9, 2024, 60% of European companies see high energy prices as a major drag on investments. For more energy-intensive industries, this is a decisive factor that determines competitiveness compared with the rest of the world. Our base-case assumption is that TTF gas prices will settle at $10 per one million British thermal units over the medium term. This is 17% lower than December 2024 futures prices but still 2.0x-2.5x higher than Henry Hub natural gas spot prices. We expect it will take the best part of a decade before the build-out of renewables and the related infrastructure can consistently replace gas-fired power plants as the marginal cost producer in the merit order.

Chart 5

### European gas prices will likely remain 2x higher than pre-COVID-19 and U.S. futures

Monthly DA average (US$/MMBtu)




DA--Day ahead. H1--First-half. MMBtu--One million British thermal units. S&PGR--S&P Global Ratings. TTF--Title transfer facility. Sources: EIA, S&P Global Commodity Insights, S&P Global Ratings.

# Top European Risks

### Regional wars spill over

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

Geopolitical risk remains high as casualties and damage from two regional wars increase, with no lasting resolution in sight. While we continue to expect a stalemate in the Russia-Ukraine war, this depends on sufficient military and financial support from the Western Alliance continuing even after the U.S. election. A material decline in support could undermine Ukraine's ability to defend itself from Russia's increasingly aggressive attacks on vital civilian infrastructure ahead of the winter, lower Ukrainians' morale, and enable Russia to achieve many of its war aims over the next 12 months. Russia's victory could challenge EU and NATO cohesion and embolden Russia to deploy troops into Moldova. In the Middle East, a lasting political settlement on the Palestine question is currently unlikely. Our base case of continued and limited cross-border strikes hinges on regional powers exercising military restraint and a hostage deal that presages a durable ceasefire. The war in Gaza is stoking ethnic tensions across the world, risking outbreaks of violence and more terrorism. These geopolitical confrontations represent a significant source of event risk that could disrupt supply chains, trigger risk aversion and a flight to quality, and shift governments' spending priorities.

### International trade tensions extend to Europe

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

Ongoing trade tensions between the U.S. and China put Europe in a difficult position since it is an open trading block and exponent of free and fair trade. As trade policy now encapsulates security, climate, and economic considerations, the EU must balance China's importance as a trade partner with building resilience in critical supply chains and protecting the integrity of the single market. It remains uncertain whether trade protection measures to counter state subsidies provided to key strategic industries in China will buy sufficient time for affected European industries to improve their competitive position. Among the main risks are Europe's potential embroilment in a burgeoning trade war with China and the emergence of significant trade barriers if the U.S. adopt an isolationist stance after the election. Disagreements among EU member states constitute another material risk, with some countries soliciting Chinese foreign direct investments to establish local production facilities--for example for batteries and battery EVs--to avoid tariffs.

### Period of low growth in Europe continues

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

As an open and free trading region, eroding industrial competitiveness--particularly due to a lack of investments in key strategic growth industries--trade tensions due to geopolitical uncertainty, slowing growth in China and the U.S., and more secular headwinds, such as a decline in working age population, mean that there is a meaningful risk of the European economy continuing to experience an extended period of subpar growth. While not necessarily detrimental to corporate credit performance, sovereign debt ratios could become more vulnerable to subdued growth since public debt is already high and few European governments have sufficient fiscal space for contra-cyclical support. Furthermore, additional common EU borrowing to accelerate and scale up the provision of public goods related to defense and climate mitigation remains contentious.

### Rates could settle above neutral levels

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

The European economy's resilience to date and the prospect of some further growth momentum--despite the rapid rise in rates in nominal and real terms over the past few years--raises the question of how low nominal rates need to fall. One risk is that interest rates settle at a higher terminal rate than financial markets expect. Barring some threat to financial stability, this may surprise markets, lead to an increase in financial market volatility, and lead to a modest tightening of financing conditions that disproportionately affects more vulnerable borrowers with weak cash flows, excessive leverage, and refinancing needs through 2026.

### Real estate risk to the broader economy increases

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

Financing conditions for real estate issuers are improving, supported by the prospect of declining short-term rates. As downward momentum behind valuations and tenant demand eases, credit quality in European real estate is generally stabilizing, albeit less so in more vulnerable segments, such as non-prime office. Selective market access and elevated financing costs could persist over an extended period, which could lead to distressed sales. For residential property, higher mortgage rates are still feeding through to borrowers. More adverse developments could spill over to the broader economy and impair consumer confidence, spending, employment, and European banks' asset quality.

## 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 arising from the goal to reduce the EU's net emissions by 55% before 2030 and the need to improve industrial competitiveness increase the risks of political pushback and disruptive changes in climate targets and regulations. This could derail business plans and deter necessary investments in decarbonization in key industries in Europe, 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 expose corporates and countries to mounting cyber risks, with targets ranging from utilities to insurers and government agencies. While an advanced cyber security defense strategy acts as a strong mitigant, this cyber arms race can still result in substantial business disruption, monetary loss, and reputational damage. This could weigh on credit quality and, more broadly, undermine public confidence in key institutions and infrastructure. A particular concern centers on the spread of misinformation and hacktivism through malicious cyber activities to influence voters during elections.

**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.

Source: S&P Global Ratings.

# Macroeconomic Outlook

- Our base case remains that EU growth will pick up gradually as consumer spending increases, reflecting the rise in real incomes and high employment rates.
- The sharp moderation in headline inflation has given the ECB the flexibility to cut rates gradually at a pace of 25 bps per quarter, until the deposit rate bottoms out at 2.5% in the third quarter of 2025.
- Upside inflation risks persist due to relatively high inflation in the services sector and wage settings.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## Eurozone

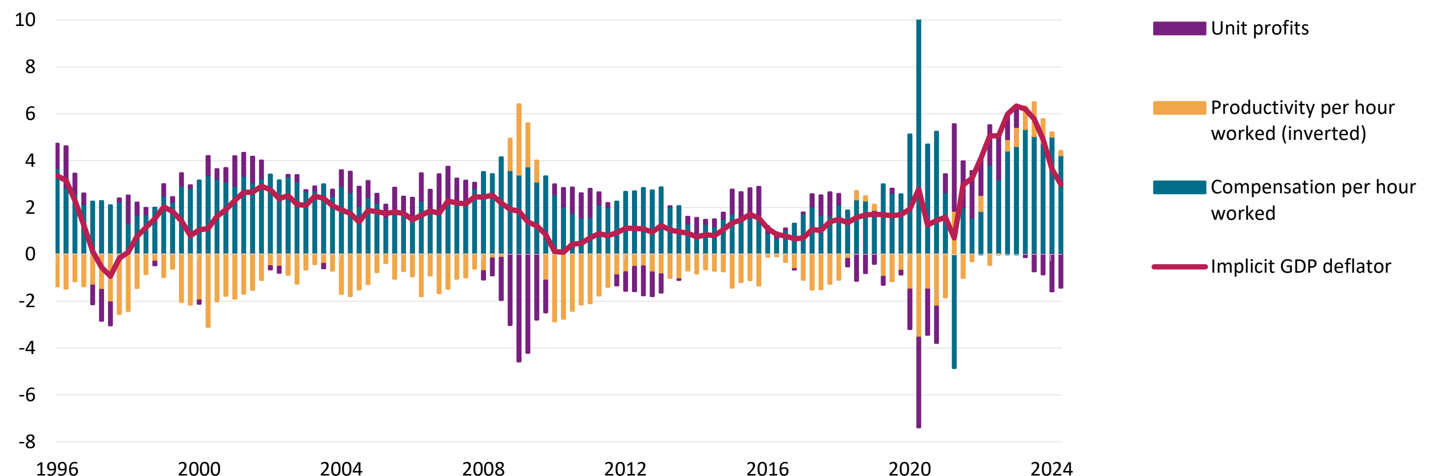
**Our base-case scenario for growth, inflation, and monetary policy still holds true.** We forecast eurozone GDP growth of 0.8% in 2024 and 1.3% in 2025, compared with our previous expectations of 0.7% and 1.4%, respectively. In contrast to our previous forecast, we now expect stronger growth for Spain and France, and weaker growth for Germany this year. Consumer spending and, subsequently, investment should be the main drivers of expansion as real income growth accelerates, consumer perceptions of disinflation improve, and interest rates decline. While survey data point to a less sustained recovery than we had expected for the second half of this year, hard data remain positive. For instance, the transmission of the first-rate cuts to the European economy is faster than usual, with a recovery in loan demand already taking shape, six months earlier than previous rate cutting cycles suggested. Earlier market expectations for the start of the Federal Reserve's (Fed's) easing cycle have also pushed down long-term yields in Europe, supporting domestic demand, and led the euro to appreciate faster than expected, with a positive effect on short-term disinflation.

**We confirm our inflation forecasts of 2.5% in 2024 and 2.1% in 2025.** Inflation has moderated further to 2.2% in August, compared with 2.5% in June. The energy sector remains the main driver of disinflation. We expect inflation is unlikely to recede to 2.0% before the second half of 2025 as labor costs continue to rise rapidly--due to strong wage growth and weak productivity--and profits absorb a large part of labor costs (see chart 6). Inflation risks therefore remain on the upside, as demonstrated by the re-acceleration in services inflation to 4.1% in August.

Chart 6

### Eurozone inflation recedes slowly as unit profits absorb rising labor costs

GDP deflator, year-over-year (%)




Source: S&P Global Ratings.

**We continue to expect that the ECB will cut rates by 25 bps per quarter until the deposit rate reaches 2.5% in the third quarter of 2025, compared with 3.5% currently.** We understand that 2.5% is at the upper end of estimates for a neutral rate. This means that monetary policy, albeit gradually becoming less restrictive, will only turn neutral in late 2025. We believe the ECB's new operational framework does not provide the conditions for accelerating the pace of quantitative tightening.

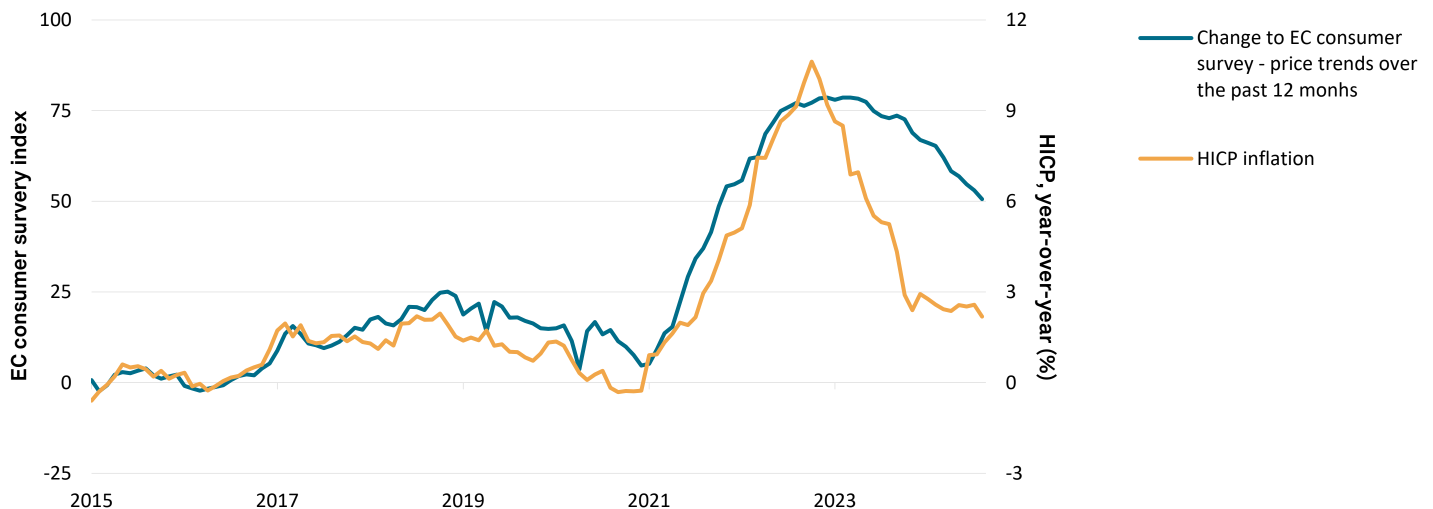
**The consumer comes to the rescue.** The main point of our base-case scenario for the coming quarters is that consumer spending should strengthen. The labor market remains robust, with the unemployment rate having reached a new all-time low of 6.4% in July, year-over-year employment growth of 1.0%, and year-over-year wage-per-capita growth of 4.3%. The eurozone consumption deflator declined to 2.7% over the same period, implying real income growth of almost 3.0%. At the same time, consumer spending barely increased at 0.1% year over year and remained at the same level as before the pandemic. Our expectation of consumer spending catching up with purchasing power is based on the following assumptions:

- Households are still getting used to the idea that inflation is declining (see chart 7), but consumer confidence should improve over the coming quarters.
- Interest rates are decreasing. Since the ECB began raising rates in mid-2022, households have saved more money than usual to take advantage of higher return on their savings. The personal savings rate increased to 15.4% of gross disposable income in early 2024, from 12.8% in mid-2022. Flow-of-funds statistics show that European households invested up to 3.5 percentage points of gross disposable income in debt securities over that period. Now that interest rates have started to decline, however, household spending will likely increase.

Chart 7

## European consumers are slow to embrace disinflation

Perceived versus measured inflation




EC--European Commission. HICP--Harmonized index of consumer prices. Source: S&P Global Ratings.

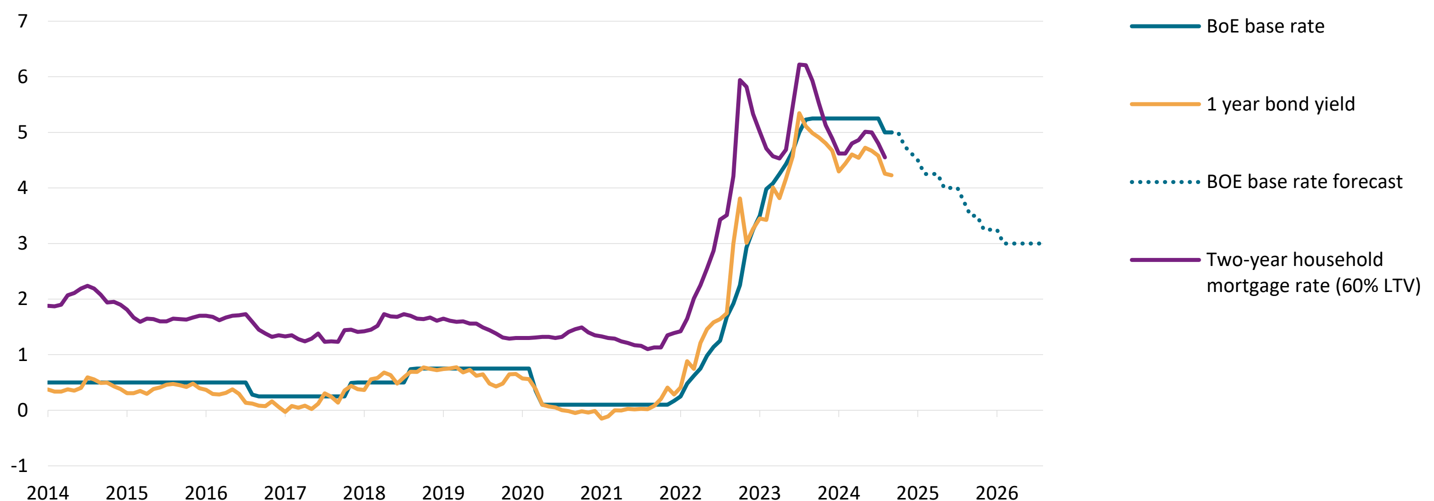
## U.K.

**Even though economic dynamics in the U.K. are similar to those in the eurozone, more persistent inflation suggests that the BoE will ease monetary policy at a slower pace than the ECB.** The U.K.'s resilient labor market continues to put upward pressure on inflation, while market expectations of rate cuts have already prompted a rebound in investments, for example in the housing market. Combined with the higher-than-expected economic activity--the quarter-over-quarter increase in GDP was 0.7% in the first quarter and 0.6% in the second quarter--this will prevent the Monetary Policy Committee from cutting rates too quickly.

**We now project the economy will expand by 1.0% this year and 1.3% in 2025.** That said, disinflation outside the U.K., falling profit margins, and relatively weak retail sales have not yet left their mark on headline inflation, which should enable the BoE to ease rates to 3.0% by the start of 2026 (see chart 8). Along with a recovery in household spending, easing financing conditions should prompt a recovery in investments.

Chart 8

Financing conditions have already eased as markets expect the BoE to cut rates further (%)




BoE--Bank of England. LTV--Loan to value. Source: S&P Global Ratings.

## Key assumptions

- **No escalation of the wars in Ukraine and the Gaza strip**
- **Decline in political uncertainties:** Political uncertainties in Europe will reduce after the French and U.K. elections and the appointment of a new European Commission. The ECB's Transmission Protection Instrument is a credible bulwark for smoothing spreads.
- **Stable relations between China and the EU:** Relations between China and the EU do not escalate into a trade war after the European Commission imposed tariffs on imports of Chinese EVs and China retaliated by initiating an anti-dumping investigation into certain European products.
- **Alignment in monetary policies:** Monetary policies on both sides of the Atlantic are beginning to converge, with the Fed having more headroom than the ECB to cut rates next year.
- **Stable energy supplies:** Energy supplies remain stable and trade bottlenecks in the Red Sea do not disrupt supply chains significantly.

## Key risks

- **Prolonged and potentially escalating wars in Ukraine and the Gaza strip:** This could test the resilience of the European economy even more.
- **Increasing political uncertainties in Germany:** Regional elections this year could impair the political landscape in the country.
- **Deteriorating trade relations between China and the U.S.**
- **Weaker-than-expected labor markets:** The increase in unit labor costs is already high by historical standards and has been absorbed by profits over the past 12 months.
- **More restrictive fiscal policy in 2025:** This could be the outcome of the European Commission's proposed excessive deficit procedures against five eurozone countries, including France, Italy, and Belgium.

## What to look out for in the next quarter

- **Outcome of the U.S. election:** The Republican candidate proposed tariff increases on European imports. We estimate that a 10% increase in U.S. tariffs on imports from Europe would result in a loss of about 0.2% of eurozone GDP.
- **Potential sharp rise in unemployment:** Unemployment rates could increase significantly in industries where labor costs are rising faster than elsewhere.
- **Budget discussions:** We will particularly focus on European countries for which the European Commission proposed to initiate an excessive deficit procedure.

# Financing Conditions

- Financing conditions will likely remain constructive, despite bouts of market volatility. European economies have resumed growth and further rate cuts are expected. Corporate yields continue to decline gradually.
- Strong year-to-date issuance volumes--which increased by 16%, compared with last year--will likely slow by the end of this year, as refinancing in the second half is unlikely to match first-half levels and the U.S election dominates the agenda.
- The surge in issuance reduced near-term refinancing risk but came at a cost. We estimate that median financing costs of 'BBB' and 'BB' rated bonds maturing this year could rise about 2.5 percentage points.
- Though defaults remain elevated, we expect the default rate in Europe will decline to 4.25% by June 2025, following improvements in issuers' aggregate credit quality, resilient earnings, and the expected decline in interest rates.

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**Resilience persists, despite bouts of volatility.** The volatility in early August was short-lived and the outlook for credit markets in Europe remains constructive. The credit picture is underpinned by European economies' return to growth this year, a trend that will likely continue in the fourth quarter. What's more, the ECB has begun to cut rates by 50 bps to date. We expect one more cut by the end of 2024 and three further cuts in 2025.

**Corporate yields continue to decline, with yields on 'BBB' rated bonds having decreased by close to 50 bps since June.** That said, they have remained elevated since the start of 2024. The ECB's cautious approach toward additional rate cuts and credit spreads, which remain close to their lowest level since January 2022, could limit further declines in yields, at least over the short term. European speculative-grade spreads are roughly 40 bps tighter than they were at the start of 2024.

**Strong year-to-date issuance trends will likely slow over the fourth quarter.** The surge in market demand has resulted in strong bond issuance growth in Europe this year, with year-to-date issuance volumes at their highest level since 2019. Leveraged loan volumes also rebounded in the first half of 2024, nearly doubling year over year, and reached the highest year-to-date volumes since 2022.

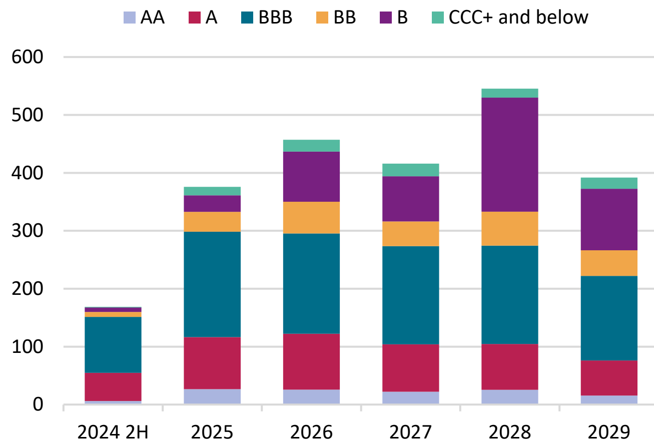
**Rated bond issuances increased by 16% year over year, with 66% coming from financial institutions.** While investment-grade bond issuances increased by 9%, speculative-grade bond issuances rose 87%, following a period of subdued activity in the first half of 2023. Yet issuances could slow as more than 70% of speculative-grade issuances to date resulted from refinancing needs. Rated bond issuances at the lowest end of the credit spectrum, 'CCC+' and below, remain anemic at only €1.7 billion to date.

**This year's surge in issuances reduced near-term refinancing risk but came at a price.** The wave of refinancing activity in 2024 has materially reduced near-term liquidity pressures for many issuers (see chart 9). The reduction in maturities was most pronounced among lower-rated issuers due to strong investor demand in the first half of 2024. As of July 1, 2024, only around €94.6 billion of speculative-grade debt was set to mature before the end of 2025. This represents a decline in outstanding speculative-grade debt of 59% in 2024 and 22% in 2025 since the start of this year. Even so, the high issuance volumes increased borrowing costs, which could put pressure on lower-rated borrowers. We estimate that median financing costs of 'BBB' and 'BB' rated bonds maturing this year could rise about 2.5 percentage points if they are refinanced at the current rates.

Chart 9

### Near-term pressure eases

European nonfinancial corporate debt maturities by rating category (bil. €)

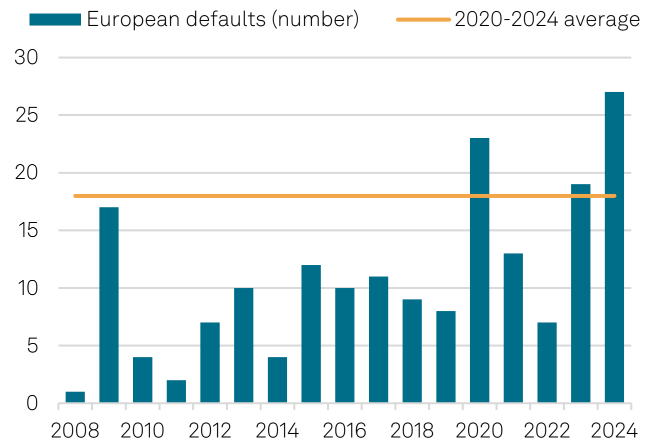



Data as of July 1, 2024. Includes nonfinancial corporate issuers' bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. Excludes debt instruments that do not have a global scale rating. Foreign currencies are converted to U.S. dollars at the exchange rate on close of business on July 1, 2024. Source: S&P Global Ratings Credit Research & Insights.

Chart 10

### Defaults remain elevated

Year-to-date number of defaults




Data as of Aug. 31, 2024. Data has been updated to reflect confidential issuers. Source: S&P Global Ratings Credit Research & Insights.

**We expect the number of defaults will decline from currently elevated levels, while divergence becomes less pronounced.** The number of corporate defaults in Europe, which amounted to 27 through August, remains elevated (see chart 10). Although default rates will remain elevated over the short to medium term, we expect the European trailing-12-month speculative-grade corporate default rate will decline to 4.25% by June 2025, from 4.70% in June 2024. This is due to improving credit quality, resilient earnings, and an expected decline in interest rates.

**Aggregate credit quality continued to improve, with the sustained pace of net upgrades reaching its highest level in two years.** So far, close to 60% of upgrades have come from the speculative-grade universe, notably consumer-facing sectors, such as consumer products and media and entertainment. Most downgrades occurred in the real estate, forest products, and chemical sectors, where issuers remain vulnerable, primarily due to weak operating metrics or unsustainable capital structures.

# Credit Cycle Indicator (CCI)

### Leverage is stabilizing across Europe as economic prospects improve

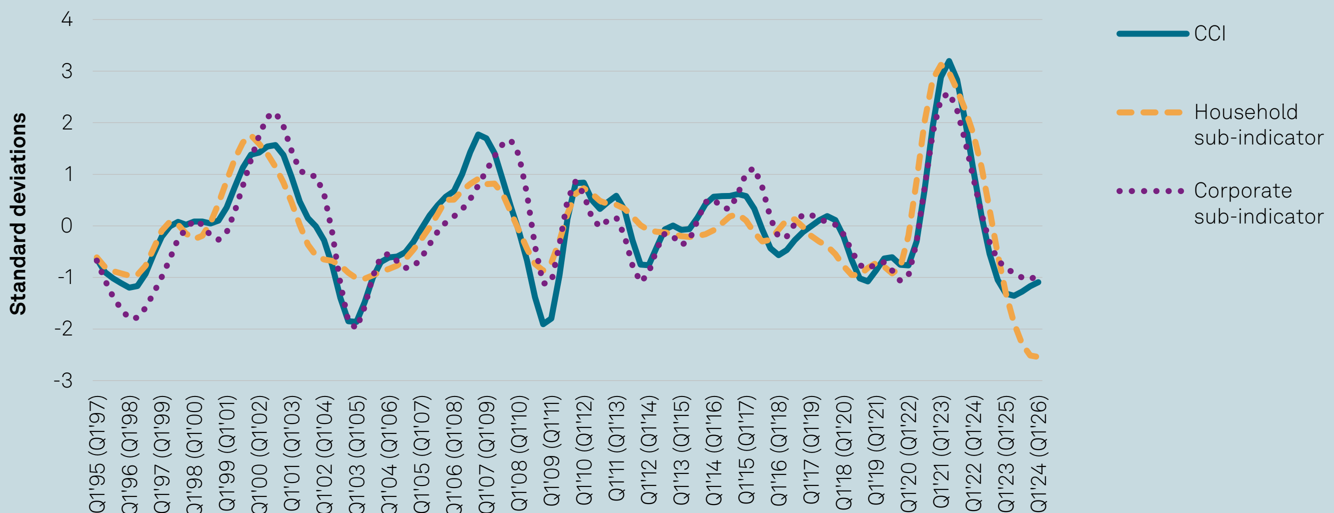
Our eurozone CCI appears to have reached a trough (see chart 11). The leading components of the CCI, namely equity prices and the financial stress index, have moved in a positive direction for several quarters, while the momentum behind the decline in leverage for households and corporates appears to have stalled. Similarly, house prices have proved more resilient than we expected, with the notable exception of Germany. Considering the pick-up in residential mortgage applications, the price outlook has certainly improved, despite central banks only just starting to dial back interest rates.

After the correction, **household debt to GDP** reached 15- to 20-year lows in Italy, Spain, the Netherlands, and the U.K. In contrast, retrenchment has only been back to pre-COVID-19 levels in Germany and France, where household debt to GDP is not particularly high. A similar pattern is evident across major European countries in relation to **corporate debt to GDP.** The corporate debt ratio in Germany is typically stable and relatively low, suggesting that the combination of high inflation, slow real GDP growth, and disrupted supply chains could have increased the pressure on German corporates to maintain debt at the current levels, given the size of their industrial base and working capital needs. The situation in France is different since corporate debt to GDP remains relatively high, similar to early 2019 levels. We note, however, that the Bank for International Settlements' debt figures capture corporates' unconsolidated debt position and that intercompany loans account for a relatively high proportion of French companies' debt.

After three years of retrenchment and barring unexpected systemic shocks, the combination of low unemployment, some economic strength, easing financing conditions, and equity markets close to or at record highs could result in a more typical cyclical recovery over the next quarters, as signaled by the CCI.

Chart 11

### Eurozone 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 higher. Sovereign risk is not included as a formal part of the CCI. CCI--Credit cycle indicator. Q--Quarter. Sources: Bank for International Settlements, Bloomberg, S&P Global Ratings.

# Financial Institutions

- Our outlook for European banks is largely stable, apart from banks in Southern Europe, whose creditworthiness still shows some upside. Banks' profitability will remain solid in 2024, even though declining interest rates will put more pressure on earnings in 2025, forcing banks to increase their focus on fee income and cost control.
- Asset quality remains remarkably resilient. Even though it could deteriorate moderately--particularly in more vulnerable small and midsize enterprise (SME) portfolios, unsecured consumer credit, and CRE--the effect should be contained, with credit costs normalizing from low levels.
- Banks continue benefiting from sound capitalization, which--combined with better valuations--can increase M&A activity.
- Key risks include market turbulence, prolonged weak economic growth, higher risk appetites, and weak operational resilience.

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## Key developments

**Our outlook bias is largely stable.** Positive outlooks are concentrated on Southern European banks and reflect improvements from lower rating levels. Our outlooks on most European banks are stable, meaning positive and negative rating actions will be limited and driven by idiosyncratic features.

**European banks continue benefiting from solid profits and their 2024 results will be similar to those in 2023.** During the first half of this year, net interest income, in particular, proved more resilient than we expected due to the delay in policy rate cuts. Yet pressures from declining interest rates will increase in 2025, even if hedging strategies lessen the effect for many banks. To support profitability, banks will increase their focus on fee income generation and cost control. Given ongoing investments in digital transformation and risk management, however, many banks will struggle to maintain a positive operating jaws. As a result, cost increases will likely exceed revenue growth in 2025. Still, we expect banks' results will remain solid (see charts 12 and 13).

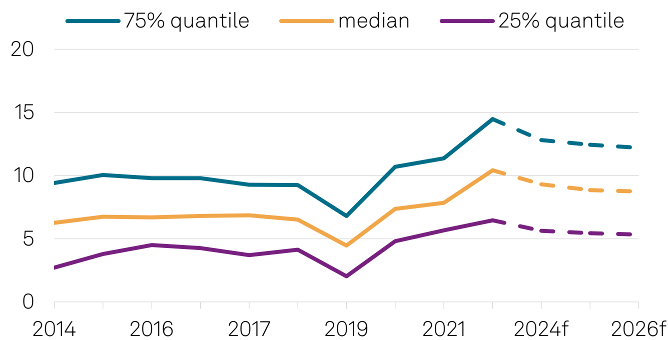
**Asset quality is proving resilient and any potential deterioration will likely be moderate.** Companies have dealt well with the modest rise in financing costs--which increased from low levels over the past couple of years--and the low level of activity, despite some defaults and a general increase in provisions. Equally, the solid performance of the labor market supported the quality of household exposures. Even if a lag effect materialized and some problem loans emerged from highly leveraged SMEs and unsecured lending to low-income individuals, we expect the effects will be manageable. CRE remains a weak spot and a source of additional provisioning but mostly for some German banks, which are significantly exposed to the U.S. CRE market (€52 billion as of end-2023, which represented 18% of their total CRE exposures). These exposures will likely continue to represent a source of credit provisioning for German banks over 2024-2025, given comparatively low coverage ratios. The ECB has criticized some supervised banks' CRE valuations and lack of provisioning overlays in this asset class.

**Banks will maintain attractive shareholder distributions, combining cash dividends and share buybacks.** Solid profitability, comfortable capital headroom, the manageable effect of Basel III amendments on regulatory capital from day one, and the increasing use of significant risk transfer to manage risk and capital (passing on losses to the non-bank financial sector) will enable banks to sustain shareholder distributions, even if profitability declines and business volumes pick up.

Chart 12

We expect lower but still solid profits in our base case

Return on average common equity for European banks (%)

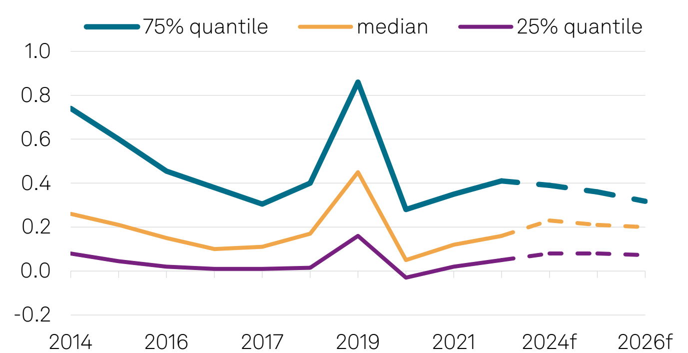



Sample includes rated European banks with a stand-alone credit profile.
f--Forecast. Source: S&P Global Ratings.

Chart 13

Credit losses should remain contained

Evolution of cost of risk for rated European banks (%)




Sample includes rated European banks with a stand-alone credit profile.
f -- Forecast. Source: S&P Global Ratings.

**Dealmaking activity will pick up.** Additionally, banks will deploy excess capital to the business. Following Nationwide's agreement to buy Virgin Money in the U.K., and BBVA's decision to launch a voluntary tender offer to Sabadell's shareholders, BNP Paribas announced in early August exclusive negotiations to buy AXA Investment Managers, while UniCredit bought a 9% stake in Commerzbank in early September. Furthermore, Unicredit has requested authorization to increase their stake to 29.9%, having secured financial instruments that will give it control of an additional 11.5% stake which will materialize if the approval is obtained. This demonstrates that, on the back of solid capital positions and improved valuations, bank managers consider strategic options to strengthen their franchises, support and diversify earnings, and achieve efficiencies. This could increase the number of in-market deals. The improvement in valuations caused governments to resume the divestment of their remaining stakes in the banks they rescued during the global financial crisis. For example, the U.K. government's stake in NatWest has been reduced to just below 18%, while the Dutch government reduced its holdings in ABN-AMRO to 40.5%. The Irish government cut its stake in AIB by 5% in June and the German government just divested a 4.5% interest in Commerzbank--which UniCredit bought--reducing its stake to 12%.

**Market debt issuance is robust.** Banks have taken advantage of supportive market conditions to accelerate debt issuance and fulfill their funding plans well ahead of the end of 2024. This positions them well if investor appetite declines. Should that not be the case, banks could pre-fund some of their 2025 borrowing needs. Increased covered bond issuance, modest business growth, and robust deposit stocks mean that banks' liquidity positions remain very comfortable.

## Key risks

- **Financial instability due to market volatility:** As demonstrated in early August, market confidence is fragile and investors react quickly to negative news. Given high geopolitical risk and central banks only just started easing monetary policy, episodes of increased volatility and market turbulence could materialize. These could destabilize financial institutions with weaker funding structures--especially non-bank financial institutions with high refinancing needs--and expose banks to higher counterparty credit risk.
- **Subdued economic growth:** This could undermine the financial health of corporates and households, weaken banks' asset quality and cloud business prospects.
- **Increased risk-taking by some banks:** As interest rates decline and banks face earnings pressure, some may be tempted to undertake undue risks.
- **Insufficient resilience against increasing cyber and IT risks**

# Nonfinancial Corporates

- Negative rating actions, which were concentrated on the lower end of the speculative-grade universe, outpaced positive rating actions in August. The positive rating trend in the investment-grade space remains. The percentage of negative outlooks is less than 9% among investment-grade issuers, compared with close to 15% in speculative-grade.
- Enduring geopolitical tensions do not have a direct credit impact on specific sectors but could put pressure on supply chains.
- We revised our outlooks on several auto suppliers to negative over the past few months. This indicates challenges in the auto sector. Most European OEMs have ratings headroom but could suffer from headwinds.
- Refinancing conditions remain supportive for issuers, with many refinancing well ahead of the maturity date. Defaults--mostly in the form of distressed exchanges-- remain elevated, with some involving companies that do not face any near-term maturities.

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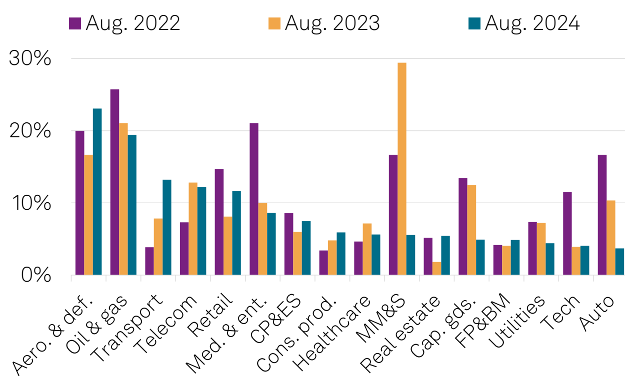
## Key developments

**Rating actions in the investment-grade and speculative grade universe diverged over the past few months.** In July and August 2024, we took 16 negative and eight positive rating actions in the speculative-grade space. Companies with poor operating performances and weak capital structures are finding it increasingly difficult to meet their financial obligations.

**Investment-grade issuers remain resilient.** We lowered the ratings on only two investment-grade issuers in July and August, both of which were in the utility sector. We downgraded Cadent Gas Ltd. to 'BBB/Stable/--' due a significant increase in interest costs following the refinancing of a large portion of its debt stock and EEW Energy from Waste GmbH to 'BBB-/Stable/--' due to a material increase in its planned investments and weaker-than-anticipated margins. The seven recent upgrades occurred across a variety of sectors, including aerospace, pharmaceuticals, auto, oil and gas, and transportation. We expect investment-grade ratings will remain resilient. Potential upgrades could focus on the aerospace and defense sectors, where outlooks are positive on about 20% of the investment-grade portfolio, and on the cyclical transportation sector, where outlooks are positive on more than 30% (see chart 14). However, we note that the weak competitiveness in some European industrial sectors, impacted by the persisting geopolitical tensions, could increase the percentage of negative outlooks in coming quarters.

Chart 14

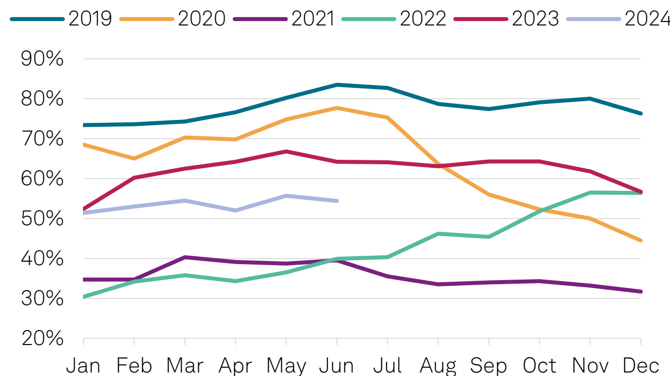
### Positive bias increasing in defense and transportation




CP&ES--Chemicals, packaging, and environmental services. MM&S—Metals, mining and steel. FP&BM--Forest products and building materials. Source: S&P Global Credit Research & Insights.

Chart 15

### Global container schedule reliability decreased in 2024




Source: Sea-Intelligence.

**Geopolitical tensions put pressure on global supply chains.** Global sea and air freight are facing increasing operational challenges, mainly due to geopolitical tensions and industrial actions that threaten global supply chains. So far, most transportation-dependent sectors managed the resulting disruptions well. Sectors such as shipping, air freight, and logistics even benefited from elevated freight rates, as well as connectivity and reliability issues. That said, we are closely monitoring the rapidly changing environment. Freight rates remain elevated due to the Red Sea crisis--which necessitates the rerouting of cargo ships and extends the transit time by 30%--higher-than-expected cargo volumes, an early-peak season, inventory restocking, clear signs of container shortages, and looming industrial actions in different regions, including the U.S. East and Gulf Coast ports. While shippers can easily absorb the increase in shipping costs, which account, on average, for 1%-2% of total sales for most industries, timely cargo arrivals remain uncertain, particularly ahead of the Christmas peak season. According to Sea-Intelligence, the global schedule reliability in container shipping is already below the historical average (see chart 15). The emerging shortage of containers poses another risk, considering that the lack of containers contributed significantly to the prolonged global supply chain bottlenecks during the pandemic. Container shortages and maritime port congestions in some crucial hubs, such as the ports of Shanghai and Los Angeles, only complicate the situation further. What's more, switching to air freight is difficult due to air cargo capacity constraints and much higher costs. As many sectors rely heavily on well-functioning global logistics networks, supply chains, and cargo flows for sourcing and supplying goods and services, any upcoming disruptions will likely have negative implications, which are difficult to quantify at this stage.

**We do not expect that the headwinds the auto sector is facing will dissipate soon.** This has caused us to revise several outlooks on European auto suppliers to negative from stable. Although both automakers and suppliers are exposed to increasing headwinds, the ratings on OEMs currently have more financial headroom. Car production in Europe is structurally lower than it was before the pandemic, and we do not expect that it will return to pre-pandemic levels any time soon. Moreover, the expected growth in demand for EVs will not materialize over the short term and force automakers to reduce prices significantly to boost sales. The situation is exacerbated by increasing competition from Chinese electric cars as Chinese carmakers face overcapacity in their local market and are turning to export sales to Europe and other markets to alleviate pressure from tough domestic competition.

**We expect the decision to increase European tariffs on Chinese EVs will only provide a temporary relief.** The increase in tariffs narrows, but does not close, the gap in competitiveness, given the substantial cost advantages of Chinese production. Several Chinese battery EVs are about 50% cheaper in China compared to Europe for the same vehicle. Additionally, the effect of the tariff increase will diminish over the medium term because Chinese automakers plan to open plants in Europe or shift production to lower-cost markets where EU tariffs do not apply. This situation explains Volkswagen's recent decision to rationalize its footprint in Europe by potentially closing two plants in Germany and one in Belgium. We expect other European OEMs will follow suit as cost management will be crucial to navigate these challenges.

**The default rate remains elevated at 4.4% at the end of August 2024 and is expected to decline** to about 4.25% by June 2025. Companies without near-term refinancing needs but high interest rate burdens could opt for restructuring due to unsustainable capital structures. We increasingly focus on identifying companies at the lower end of the rating spectrum with operational difficulties and likely to generate very low or negative cash flows in 2024 and beyond.

## Key risks

- **Escalation of geopolitical tensions:** Significant tariff increases on non-European countries and potential retaliations can impair sectors that are very export-oriented.

# Sovereigns

- Weak European growth will continue and requires European governments to shift priorities.
- Government borrowing shows no signs of abating, with several eurozone countries entering an excessive deficit procedure.
- Sovereign ratings on G7 members are lower than they were 20 years ago. The ratings on all G7 members are currently below 'AAA'.

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## Key developments

**Weak European growth becomes a major problem.** In his report "The future of European competitiveness," Mario Draghi warns that Europe's weak economic growth versus the U.S. is no longer a mere inconvenience but an "existential crisis." In his view, Europe can no longer rely on burgeoning global trade--not least due to an increase in U.S. protectionism--or the U.S. Security Umbrella because the willingness of the U.S. to cover the EU's defense bill could waver, depending on the outcome of the presidential election. Draghi's conclusion is that European governments must prioritize public investments in digitalization, defense, climate mitigation, energy connectivity, and IT infrastructure. In his view, this should be financed by a common EU asset that can compete with U.S. treasuries and increase the attractiveness of the euro as a rival to the U.S. dollar. Immediately after the publication of the report, however, German finance minister Christian Lindner rejected the idea of issuing joint EU debt to finance critical investments in the energy grid and R&D. He stressed that such financing was the responsibility of the private sector and each individual EU member state.

**We expect Europe's weak growth and productivity performance, compared with the U.S., will continue.** This, and eurozone sovereign debt markets' continuous fragmentation, will weigh on fiscal outcomes and market dynamics. The political landscapes in Europe's two largest economies, France and Germany, remain inward-looking. In the absence of another global crisis, appetite for major EU initiatives ahead of Germany's federal elections in September 2025 is low.

**Government borrowing remains high across the eurozone.** The European Commission has placed eight out of 30 EU member states--including Belgium, France, and Italy--in the excessive deficit procedure for failing to comply with the 3% GDP deficit target. Flagging growth, ageing populations, and fragmented politics have made it more challenging for Europe's largest governments to reduce their debt to GDP.

**Sovereign ratings have weakened.** We downgraded all members of the G7--including France, the U.S., and the U.K.--over the past 20 years, with none of them rated at 'AAA' anymore. G7 ratings are currently 1.5 notches below their 2006 levels on a GDP-weighted basis.

**Rising debt is not only a European problem.** We do not expect that any G7 member's debt to GDP will return to pre-pandemic levels by 2027. We project average general government deficits of 3.2% of GDP in the eurozone over 2025-2027, compared with about 6% in the U.S. While U.S. fiscal imbalances are arguably higher than those in Europe, weak European growth and the absence of significant intra-European fiscal transfers mean eurozone public finances and debt markets are more susceptible to market shocks than they are in the U.S. The dominance of the U.S. dollar as a global reserve currency underpins the depth of U.S. capital markets.

**European bond markets lack a single pan-European asset and a single yield curve.** This raises European borrowing costs. In the absence of an equally liquid alternative to U.S. capital markets, the world's largest net external creditors--including Germany, China, and Japan--largely recycle their excess savings into the U.S., for example via U.S. treasuries.

# Structured Finance

- Stresses in the retail and office real estate sectors have been feeding through to European CMBS, where ratings are deteriorating.
- The credit performance of loans backing residential mortgage-backed securities (RMBS) is diverging between sectors, with U.K. nonconforming and legacy BTL seeing rising arrears.
- We lowered 2% of our European structured finance ratings over the past 12 months, while we raised 8%.

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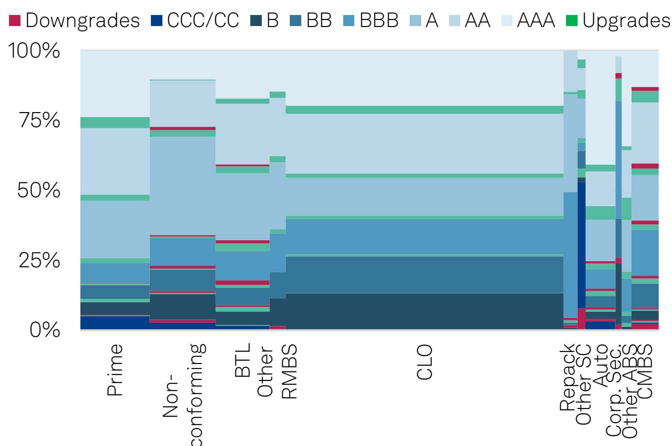
## Key developments

**On average, European structured finance ratings continued to rise over the past 12 months.** Yet this trend has slowed as higher interest rates put pressure on the underlying borrowers. We lowered 2% of our securitization ratings in the 12 months to Aug. 31, 2024, while we raised 8% (see chart 16).

Chart 16

### Upgrades prevailed, despite some downgrades in CMBS

European structured finance ratings heatmap

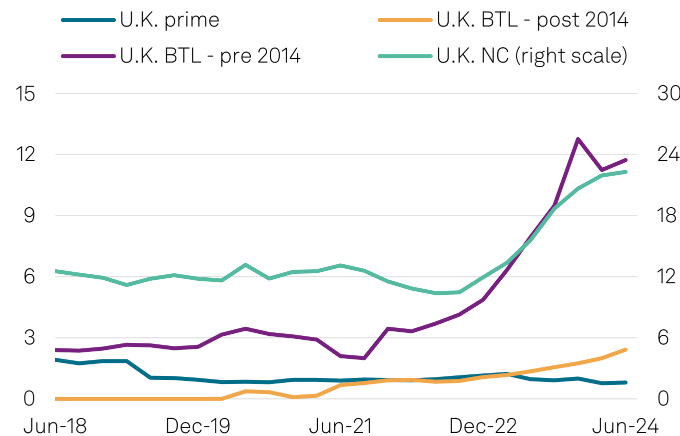



Based on rating transitions over the 12 months to Aug. 31, 2024. ABS--Asset-backed security. BTL--Buy-to-let. CMBS--Commercial mortgage-backed security. CLO--Collateralized loan obligation. SC--Structured credit. Source: S&P Global Ratings.

Chart 17

### Mortgage arrears are diverging between sectors

U.K. RMBS average arrears rate, by subsector (%)




RMBS--Residential mortgage-backed securities. BTL--Buy-to-let. NC--Nonconforming. Source: S&P Global Ratings.

**CMBS have been most affected by downgrades.** Although the sector constitutes a small portion of our outstanding ratings, it is the principal area in the securitization space where CRE stresses--brought on by higher interest rates, e-commerce, and the rise in remote working--have manifested. According to some indices of European office and retail properties, market value declines over the past few years have been substantially greater than during the global financial crisis, while CMBS transactions have seen a corresponding rise in credit risk. Given this deterioration in underlying CRE markets, we have since lowered 47 (25%) of the 187 European CMBS ratings that were outstanding at the beginning of 2020. Of these, six tranches (3% of the total outstanding) have defaulted, in some cases suffering a principal loss. The refinancing of commercial mortgage loans remains challenging, with potential repercussions for CMBS ratings. That said, only one of the loans backing European CMBS that we rate is currently in special servicing. Many borrowers have still been able to refinance at loan maturity, which has led to some CMBS upgrades over the past 12 months where transaction structures have delevered.

## Key risks

- **Underlying arrears in U.K. nonconforming and legacy BTL RMBS have increased substantially since 2022 (see chart 17).** These subsectors include a significant number of loans originated before the global financial crisis. The borrowers, who typically pay a floating rate at present, could be unable to qualify for more favorable rates on new loan products. Additionally, almost all securitized BTL mortgage loans make payments on an interest-only basis, meaning any rate rise affecting the loans has had a directly proportional effect on borrowers' monthly instalments. Current interest rates do not exceed those that the borrowers backing legacy U.K. BTL RMBS were paying when their loans were originated, and rents have also increased substantially over the same period. However, servicers are reporting that the smaller BTL investors, who are more prevalent in legacy pools, have been relying on rental returns as a significant portion of their personal income and may have prioritized using this to service other debts over staying current on their BTL mortgage payments.
- **Some covered bonds are exposed to the correction in CRE valuations, with a few issuers experiencing tighter funding conditions.** Covered bond programs' CRE exposures vary significantly between and within countries. German issuers have the highest exposure to office and retail assets. While CRE loans only represent on average 11% of total lending for large EU banks, the concentration is higher in some covered bond pools. That said, available overcollateralization in the programs continues to shield investors from credit deterioration, in our view.

# International Public Finance

- Many European local and regional governments' (LRGs') budgetary performance remains resilient, despite the economic slowdown and rising spending pressures. Restored national deficit and debt restrictions require expenditure cuts, notably on capital investments, or a shift of the burden to lower tiers of government.
- European social housing providers' credit quality diverges, depending on risk appetite amid rising maintenance costs. Some providers opt to increase borrowings, while others sell assets to finance development programs.
- U.K. universities may need to adjust strategies as the expected decline in the number of international students will weaken their revenue growth and financial performance.

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## Key developments

**Low economic growth continues to strain LRGs' budgets.** Inflation-driven increases in wages and utility bills, demographic changes, and high interest rates continue to boost operating spending, while tax revenues and state grants are expected to grow slowly. As a result, many governments may need to cut infrastructure investments in real terms to meet national deficit and debt restrictions (see chart 18). Exceptions include Italy, Spain, and Central and Eastern Europe, where LRGs will increasingly use EU capital grants.

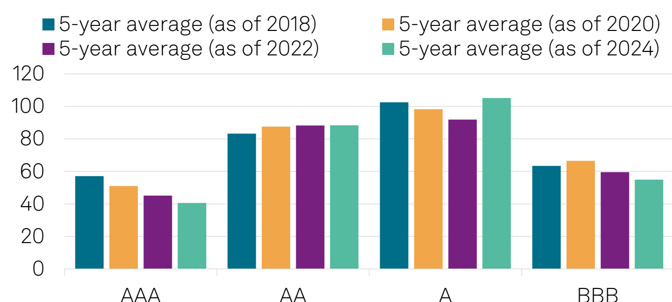
**The new U.K. government appears willing to allow revenues generated by social housing and universities to rise ahead of the inflation rate.** This could improve long-term visibility on their spending plans. U.K. social housing providers' credit quality diverges, partly due to variations in relatively large providers' business combinations (see chart 19).

**U.K. universities' high reliance on international students is becoming increasingly risky.** Heightened geopolitical uncertainty and changing immigration policies could discourage international students from studying in the U.K. and reduce universities' tuition fee income.

Chart 18

### Investment-grade housing providers' debt burden remains stable

Median tax-supported debt (% operating revenues)

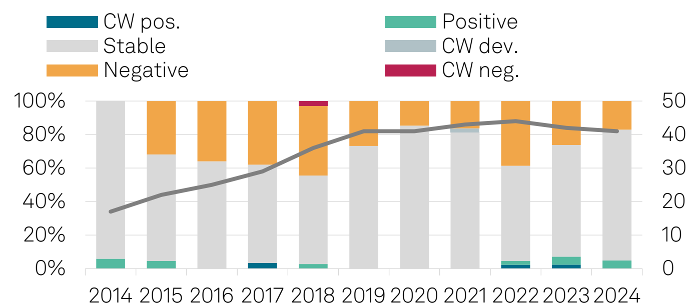



Five-year averages cover two historical years, the current year, and two future years. For example for 2024, averages cover 2022-2026. Data refer to actuals, then estimates or base cases whenever available. Source: S&P Global Ratings.

Chart 19

### Negative outlook bias for U.K. social housing reached a 10-year low

Outlook distribution




*As of Sept. 4, 2024. Source: S&P Global Ratings.

## Key risks

- **Deterioration in public services:** Declining capital investments could impair the quality of public services, while demand keeps rising due to increasing and ageing populations.
- **Escalation of geopolitical risks:** Higher demand for defense spending and still elevated price levels could put further pressure on public finances.

# Insurance

- Non-life insurers continue ramping up premium rates in response to still elevated claims inflation.
- Year to date, non-life insurers recorded a material natural catastrophe load. Similar to 2023, global reinsurers and global multiline insurers face relatively high natural catastrophe related-claims, mainly due to thunderstorms in the U.S.
- Reinsurers' earnings prospects are sound for 2024-2025, after strong operating results in 2023 and the first half of 2024. Profit margins are at their highest level since 2009, amid favorable pricing in short-tail lines and healthy investment income.
- We expect ratings will remain strong, mirroring robust capitalization, diversified insurance exposures, and muted investment risk appetite. Our ratings on most European insurers are in the 'A' category, with predominantly stable outlooks (see charts 20 and 21).

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## Key developments

**Seasonal natural catastrophe events impair insurers.** Heavy rain, hail, and flood events are becoming increasingly common in the European summer. While they often lead to high-frequency/low-severity losses, for example in the form of damaged cars, the total severity per single event has been material in recent years. Given the general increase in primary insurers' retention ratios over the past few years, we expect primary insurers, as opposed to reinsurers, will bear a higher share of these insured claims.

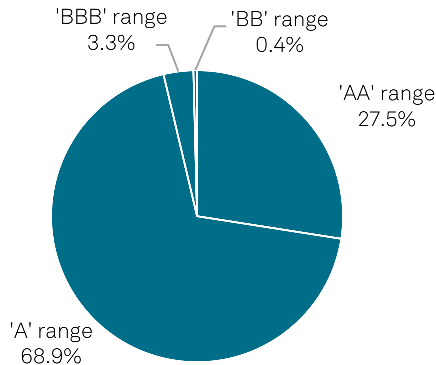
**Reinsurers still benefit from sound business conditions.** Despite signs of a moderation in property pricing, overall conditions are still favorable for reinsurers. This is due to structural changes in the reinsurance market in 2023 and strategic actions taken during renewals. These actions include:

- Increasing the threshold at which an insurance policy provides coverage for a loss;
- Scaling down limits offered to insurance companies that cede risks to reinsurers;
- Reducing exposure to frequent natural disasters;
- Tightening contractual terms and conditions;
- Reducing aggregate cover offerings; and
- Repricing risk.

**The onus is on primary insurers to achieve adequate premium rate increases.** While some global multiline insurers and some industrial and commercial lines insurers noted sustainably strong profit margins, evidenced by combined (claims and expense) ratios of 90%-95% (a ratio below 100% indicates an insurance profit), many regional primary insurers lag claims trends, with current premiums not adequately reflecting the risks. For example, the German motor market reported a combined ratio above 100% in 2023, and we expect it will continue to do so in 2024. In the U.K., pricing outpaced inflation, which is already declining. We expect the U.K. insurance market will post a combined ratio of close to 100%.

Chart 20

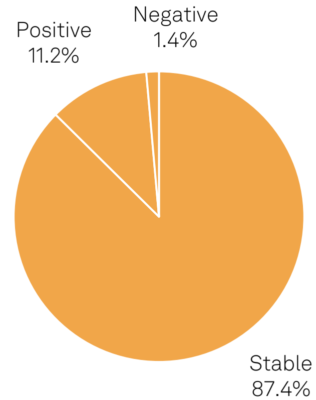
Ratings on European insurers are mainly in the 'A' category




Data as of Sept. 13, 2024. Source: S&P Global Ratings.

Chart 21

Our ratings outlooks on most European insurers are stable




Data as of Sept. 13, 2024. Source: S&P Global Ratings.

## Key risks

- **Balance sheet impairments:** Capital market volatility due to geopolitical risks could impede insurers' investments. European insurers have material exposure to equity and bond markets, with about €11 trillion for EU insurers alone. Any prolonged capital market downturn could impair insurers' balance sheet strength.
- **Losses on life insurers' illiquid investments:** European life insurers increased their exposure to illiquid assets in search for yield when interest rates were low. While their exposure is relatively limited, they could still suffer from potential asset value declines in private equity, private debt, and real estate. We already witnessed revaluations, for example, in the Dutch real estate market in the first half of 2024.
- **Lapse risk:** Small undiversified life insurers specialized in savings products to affluent and high-net-worth individuals in markets such as France, Luxembourg, or Italy continue to face competition from high-yielding bank term accounts and the lack of significant penalties in case of exit (except for a major fiscal penalty in France prior to an eight-year maturity). That said, in the wider life insurance sector, lapse rates are very low in most regions.

# Related Research

- Credit Conditions Asia-Pacific Q4 2024 Mixed Signals: Growth And Rates, Sept. 25, 2024
- Credit Conditions North America Q4 2024: Steady Improvement - With Eyes On The Election, Sept. 25, 2024
- Credit Conditions Emerging Markets Q4 2024: Risks Loom Amid A Fragile Stability, Sept. 25, 2024
- Economic Outlook Eurozone Q4 2024: Consumer Spending To The Rescue, Sept. 24, 2024
- U.K. Economic Outlook Q4 2024: Disinflation And Rate Cuts Will Stimulate Growth, Sept. 23, 2024
- Economic Outlook U.S. Q4 2024: Growth And Rates Start Shifting To Neutral, Sept. 24, 2024
- Economic Outlook Asia-Pacific Q4 2024: Central Banks To Remain Cautious Despite U.S. Rate Relief, Sept. 23, 2024
- The Energy Transition, Geopolitics, And Cannibalization Are Shaping Europe's Power Prices, Sept. 12, 2024
- Corporate Results Roundup, Q2 2024, Sept. 11, 2024
- The future of European competitiveness, published by the European Commission on Sept. 9, 2024
- Europe Must Avoid The Middle Technology Trap To Continue Reaping Free Trade's Rewards, Sept. 5, 2024
- European Banks Continue To Reap The Benefits Of Benign Credit Conditions, Sept. 3, 2024
- EMEA Structured Finance Chart Book, Sept. 2024
- Sovereign Debt In Large Advanced Economies: Up, Up, And Away, July 2, 2024

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# Appendix: Q4 2024 Economic Data And Forecast Summaries

Table 1

## Real GDP (%)

| | Eurozone | Germany | France | Italy | Spain | Netherlands | Belgium | Switzerland | U.K. |
|---|---|---|---|---|---|---|---|---|---|
| 2022 | 3.4 | 1.4 | 2.6 | 4.1 | 5.8 | 5.0 | 3.0 | 3.1 | 4.3 |
| 2023 | 0.5 | -0.1 | 1.1 | 1.0 | 2.5 | 0.1 | 1.4 | 0.7 | 0.1 |
| 2024f | 0.8 | 0.2 | 1.1 | 0.9 | 2.7 | 0.6 | 1.2 | 1.3 | 1.0 |
| 2025f | 1.3 | 1.1 | 1.2 | 1.1 | 2.1 | 1.5 | 1.3 | 1.5 | 1.3 |
| 2026f | 1.4 | 1.3 | 1.4 | 1.1 | 2.0 | 1.4 | 1.4 | 1.4 | 1.6 |
| 2027f | 1.3 | 1.1 | 1.3 | 1.0 | 2.0 | 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 | 2.8 | 9.1 |
| 2023 | 5.4 | 6.0 | 5.7 | 5.9 | 3.4 | 4.1 | 2.3 | 2.1 | 7.3 |
| 2024f | 2.5 | 2.7 | 2.5 | 1.4 | 3.0 | 3.0 | 4.0 | 1.3 | 2.6 |
| 2025f | 2.1 | 2.2 | 1.9 | 1.9 | 2.1 | 2.6 | 2.2 | 1.1 | 2.3 |
| 2026f | 1.9 | 1.9 | 1.8 | 1.7 | 2.0 | 2.0 | 2.0 | 1.1 | 2.0 |
| 2027f | 1.8 | 1.9 | 1.7 | 1.7 | 1.8 | 2.0 | 1.9 | 1.0 | 2.0 |

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 | 13.0 | 3.5 | 5.6 | 4.4 | 3.9 |
| 2023 | 6.5 | 3.0 | 7.4 | 7.7 | 12.2 | 3.6 | 5.5 | 4.1 | 4.0 |
| 2024f | 6.5 | 3.4 | 7.5 | 7.0 | 11.6 | 3.7 | 5.6 | 4.2 | 4.3 |
| 2025f | 6.5 | 3.3 | 7.6 | 7.4 | 11.4 | 3.9 | 5.5 | 4.3 | 4.4 |
| 2026f | 6.3 | 3.1 | 7.5 | 7.3 | 11.3 | 3.9 | 5.5 | 4.1 | 4.4 |
| 2027f | 6.2 | 3.1 | 7.4 | 7.3 | 11.2 | 3.8 | 5.4 | 4.0 | 4.4 |

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 | 2.0 | 1.2 | 1.5 | 3.2 | 2.2 | 1.4 | 1.7 | 0.8 | 2.3 |
| 2023 | 3.3 | 2.5 | 2.9 | 4.3 | 3.5 | 2.8 | 3.1 | 1.1 | 3.9 |
| 2024f | 3.0 | 2.4 | 2.9 | 3.8 | 3.2 | 2.7 | 2.9 | 0.6 | 3.9 |
| 2025f | 3.0 | 2.3 | 2.8 | 3.9 | 3.1 | 2.6 | 2.8 | 0.8 | 3.6 |
| 2026f | 3.0 | 2.4 | 2.8 | 4.0 | 3.1 | 2.7 | 2.9 | 1.0 | 3.5 |
| 2027f | 3.1 | 2.4 | 2.9 | 4.0 | 3.2 | 2.7 | 3.0 | 1.0 | 3.5 |

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 | 0.95 | 1.00 |
| 2023 | 1.08 | 0.92 | 1.24 | 1.15 | 0.90 | 0.97 |
| 2024f | 1.09 | 0.91 | 1.29 | 1.18 | 0.89 | 0.97 |
| 2025f | 1.14 | 0.88 | 1.33 | 1.16 | 0.90 | 1.03 |
| 2026f | 1.17 | 0.86 | 1.29 | 1.10 | 0.91 | 1.06 |
| 2027f | 1.17 | 0.85 | 1.28 | 1.09 | 0.91 | 1.07 |

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

Table 6

## Policy interest rates (%, year-end)

| | ----Eurozone (ECB)---- | | U.K. (BoE) | Switzerland (SNB) |
|---|---|---|---|---|
| Policy rates | Refinancing rate | Deposit rate | Bank rate | Policy rate |
| 2022 | 2.50 | 2.00 | 3.25 | 1.00 |
| 2023 | 4.50 | 4.00 | 5.25 | 1.75 |
| 2024f | 3.40 | 3.25 | 4.71 | 0.75 |
| 2025f | 2.65 | 2.50 | 3.33 | 0.75 |
| 2026f | 2.65 | 2.50 | 3.00 | 0.75 |
| 2027f | 2.65 | 2.50 | 3.00 | 0.75 |

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

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