Fusion Or Fission?

S&P Global Ratings

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This report does not constitute a rating action.

Key Takeaways

- 2025 marks another watershed moment for Europe and the EU. If the region does not rise collectively to the challenges from increasing geopolitical instability and fails to improve economic resilience, fragmentation could increase further.
- Regional wars and their potential effects on energy prices remain the key risk for Europe, at least over the short term. Other elevated risks that we monitor include protectionist trade policies, faltering growth, and tightening financing conditions.

Editor's Note: S&P Global Ratings' European Credit Conditions Committee took place on Nov. 21, 2024.

The macro-credit outlook would be relatively sanguine if geopolitical uncertainty were not that high. Rating actions and outlooks in Europe have largely normalized, following the upheaval caused by the COVID-19 pandemic and the war-induced energy shock. Inflation has returned close to target and the rate cycle has turned. Financing conditions have improved, with M&As and shareholder-friendly payments likely forming a larger part of primary debt issuance in 2025. This cautious optimism is reflected in our forecast, which projects a modest 6.9% increase in median earnings for European rated nonfinancial corporates in 2025.

However, as Mario Draghi stated, the EU faces an existential challenge. It must increase investments to digitalize and decarbonize the economy, beef up its defense capabilities to counter Russian aggression and U.S. ambivalence, and provide necessary support for Ukraine--and all that in light of a possibly damaging trade war with the U.S.

The EU's challenges are most evident in the vehicles and vehicle parts sector that accounted for just above 11% or $56.7 billion of the EU's goods exports to the U.S. in 2023. We have already expected European carmakers' margins to come under pressure due to increasing price competition and lackluster demand. This stems partly from European original equipment manufacturers' (OEMs') ambitious goals to reduce their carbon footprints to meet net zero regulatory targets, but also cut-throat competition from China, where OEMs and suppliers have established market leadership in electric vehicles. Consequently, the large rating headroom built over the past few years will likely erode, as evident in the heightened negative outlook bias of almost 30% in the sector.

Additional U.S. tariffs on Europe and wavering U.S. NATO support could either spur the implementation of Mario Draghi's suggestions after Germany's elections in February 2025 or expose cracks in EU unity. With the important exception of Germany, few major eurozone governments have fiscal space on their national balance sheets to provide the necessary financial support for investment as flagging growth, ageing populations, and fragmented politics are strong headwinds that will keep borrowing and debt levels high--key factors constraining their ratings. Eight out of 27 EU member states have been placed in the excessive deficit procedure since they failed to comply with the 3% GDP deficit target. On the other hand, Germany has remained committed to maintaining its constitutional debt brake for now.

On a positive note, the outlook for European banks remains stable and benefits from solid fundamentals. The decline in most banks' net interest margins due to decreasing interest rates will be partially mitigated by increases in lending and fee earning activity, as well as stable credit costs. Yet German banks could continue to see additional provisioning in commercial real estate. Banks will preserve strong capitalization, which will enable them to maintain shareholder payments and deploy excess capital in M&As.

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Top European Risks

Russia and Israel seek to press home their military advantage

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

Geopolitical risk remains high, with two regional wars ratcheting up in intensity as Russia and Israel press home their military advantage, albeit with Israel now tentatively prepared to scale back hostilities in Lebanon. The risk remains considerable, given potential triggers for a broader conflict and implications for Europe if the U.S. unilaterally reduces its support for NATO or Ukraine. The fallout could trigger risk aversion, a flight to quality, disruption to supply chains--with a severe effect if oil supply was disrupted significantly--and a shift in European governments' spending priorities.

Material trade restrictions extend to Europe

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

The U.S. election has provided a strong mandate to implement aggressive trade protection measures that could affect allies in Europe. The risk, beyond a uniform tariff of at least 10% on all European goods exports, is that specific sectors--such as automotive, pharmaceuticals, chemicals, and metals--could be targeted with higher tariffs. U.S. investigations into European Digital Service Taxes or the proposed EU Carbon Border Adjustment Mechanism would intensify trade tensions. The development of a coherent, unified policy response is among Europe's key political challenges.

European growth falters in an uncertain environment

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

A more hostile and uncertain global environment could further erode Europe's economic security, weigh on consumer confidence, and increase savings at the expense of consumption and growth in Europe. Stagnating growth would be detrimental to corporate credit performance and could weaken sovereign debt ratios further. Even if the political will to tackle Europe's productivity gap existed, few governments have fiscal space for contra-cyclical support, while Germany remains restricted by the debt brake. With national leaders focused on domestic politics, the likelihood of support for EU joint financing of security and energy independence also seems remote for now.

Financing conditions tighten as yield curves steepen in Europe

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

A combination of higher inflation, a recalibration of the U.S. rate path, and a potentially stronger U.S. dollar could slow the pace and extent of rate cuts from the Bank of England and the European Central Bank, compared with our base case. This, together with an increase in bond supply, could also put upward pressure on longer-term benchmark yields in Europe. Tighter financing conditions could increase financial market volatility and affect vulnerable issuers that exhibit weak cash flows, excessive leverage, and face near-term refinancing needs.

Real estate risk to the broader economy remains

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

While real estate issuers' liquidity has benefited from improving financing market conditions and lower interest rates, certain segments, such as non-prime office, remain vulnerable to secular trends, a further economic slowdown, or disruption in financial markets. Distressed sales could reset appraised price levels in local markets, particularly if financial market access became difficult and elevated financing costs persisted. 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 EU's goal to reduce 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 investments in decarbonization in key industries, notably in the automotive, building, cement, steel, chemicals, transportation, and utilities sectors.

Cyber and digital transformation risks are gaining ground

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

The pace of digitalization--including the advance of AI--and heightened geopolitical discord expose corporates and countries to mounting cyber risks, with targets ranging from utilities to insurers and government agencies. Despite advanced cyber defenses, this cyber arms race can still result in business disruption, monetary loss, and reputational damage, weigh on credit quality, and undermine public confidence in critical 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.