

Time To Face The Music

Dec. 1, 2022

This report does not constitute a rating action

Key Takeaways

- Credit prospects appear dimmer in 2023 as Europe grapples with a rapidly changing world order as war, energy transition, and supply chain vulnerabilities create a more volatile economic environment, notably with inflation soaring to multi-decade highs.
- Extended rate rises to rein in inflation, even as a shallow recession takes hold in the region, could continue to expose hidden risks as liquidity shrinks, and make refinancing difficult for more stretched households, companies, and even governments.
- Further escalation of the Russia-Ukraine war, energy supply shocks, stubborn inflation, and volatile and illiquid markets all present credit risks that, in various combinations, could trigger a deeper, more prolonged, recession than we currently anticipate.

Editor's Note: S&P Global Ratings' Europe Credit Conditions Committee took place on Nov. 21, 2022.

The credit quality of energy-intensive, consumer discretionary, and leveraged corporate sectors will likely be hit hardest in 2023. Broadening input cost pressures, rising funding costs, and potential contractions in demand will increasingly weigh on earnings, particularly in more competitive sectors lacking pricing power. Vulnerabilities are expected to surface among companies rated 'B-' and lower, either unable to refinance or extend maturities on a timely basis, or overly exposed to variable rates, leading to a moderate increase in the default rate (including distressed exchanges) to 3.25% by autumn next year under our base case. Retail, media and entertainment, capital goods, and consumer products are the sectors most exposed on this basis.

The rating outlook for European banks remains relatively stable. Despite a weakening macro environment, higher interest rates mean improving net interest margins, underpinning earnings. We expect asset quality to deteriorate (unevenly by region and sector), but the resulting rise in credit losses will be manageable and absorbed by earnings. Weak growth and inflation pressures will primarily affect lending to small and midsize enterprises and consumers. Residential mortgage performance will hold up, even if property prices slip, thanks to high employment, low loan-to-value ratios and banks managing risk more proactively by offering some flexibility of terms to borrowers in difficulty. Furthermore, banks face 2023 with solid capital and liquidity. A more severe, spread-out recession in Europe, however, could lead to more negative outlooks emerging.

European sovereigns' ability to bail out the real economy is reaching its limit. The ability of economic authorities to pay for the cost of yet another global economic emergency (the energy price shock from the Russia-Ukraine war) has become restricted by central banks refocusing on their core price-stability mandates. Most European governments' post-pandemic debt is high, implying a withdrawal of fiscal policy commencing in 2023 and accelerating in 2024, with some notable exceptions.

A higher cost of living and increased financing costs will be in the spotlight for structured finance. As European consumers feel the strain of rising living costs, we anticipate deteriorating collateral performance will first appear in asset-backed securities (ABS) backed by loans to non-prime borrowers or unsecured receivables. For residential mortgage-backed securities, borrowers in the nonconforming sector typically have well-seasoned loans with low balances, making rate rises less onerous than for borrowers with higher leverage. The labor market's strength is likely to remain a key credit factor underpinning the collateral performance in consumer-related structured finance sectors. Investment-grade tranches in securitizations are generally well positioned to weather a potential rise in underlying delinquencies or defaults, benefitting from strong built-in protections.

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Top European Risks

Impact of higher financing costs weighs on financial risk profiles

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

Over and above rising energy costs, food prices, supply bottlenecks, and the post-pandemic recovery of demand have contributed to broader price pressures and high core inflation. Against the backdrop of a still tight labor market, monetary authorities remain under pressure to tighten policy significantly. The accompanying risk is that, as growth slows, significantly higher funding costs will increasingly weigh on borrowers' financial risk profiles, mainly where refinancing requirements are material, debt levels are unsustainable, or where exposure to variable rate debt is high. This is particularly pertinent for non-financial corporate weakest links.

Risks of an escalation and broadening out of the Russia-Ukraine conflict

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

In the wake of Russia's recent battlefield losses and an increase in hostilities as winter approaches, we believe the conflict will grind on. While direct NATO military engagement in the conflict is not our base case, the risk is not insignificant, particularly should Russia use unconventional weapons or cause Article 5 to be invoked. The asymmetric nature of these risks only exacerbates existing shocks reverberating through the global economy. More broadly, this deepening geopolitical divide between autocratic and democratic blocs is increasingly undermining decades of economic cooperation and development, with implications for global security, trade, communications, climate, and health.

The war, energy scarcity, persisting inflation, and slow growth in U.S. and China risk an extended recession in Europe

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

High gas storage levels, warm seasonal temperatures, and lower industrial gas demand have eased some short-term pressures in Europe's gas and power market. But a continuation of the war carries potential further supply risks, particularly during winter 2023/2024, should Russia further cut pipeline gas supplies or retaliate against EU sanctions on Russian oil shipments (starting Dec. 5), or should the EU impose an oil price cap. Persisting inflation and higher rates, combined with weak growth prospects in the U.S. and China, risks a deeper and longer recession in Europe.

Sovereign bond investors may be unwilling to fund fiscal policy shifts

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

Sovereigns' ability to meet the cost of another global economic emergency (energy price shock) has run up against a hard constraint: central banks' renewed focus on their core price-stability mandates. Post-pandemic debt is elevated and only the strongest sovereign balance sheets (such as Germany's) are able to implement energy subsidies in excess of 6% GDP for 2023. Essentially, this represents a (reluctant) shift to tighter fiscal policy, since the majority of European governments, including the U.K., are set on withdrawing stimulus, albeit only gradually. Whether they are doing so quickly enough, given central banks' retrenchment from quantitative easing, is a dynamic that will play out throughout 2023, and into 2024 when revised fiscal rules are set to be reactivated in the euro area. Market conditions will depend largely, therefore, on the willingness and ability of investors to make up the gap in market demand left by the end of central banks' net asset purchases. In the end, whether budgets are more or less austere may hinge as much on market appetite as it does on policy or political calculations.

Structural risks

Heightened disruptions linked to physical and transition risks from climate change

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

The political and economic imperative to end Europe's reliance on Russian fossil fuels has created an urgency to accelerate the energy transition, with more ambitious plans. These face implementation challenges, notably regarding slow permitting and supply chain strains for renewables, biomethane, energy efficiency, and heat-pump rollouts, even as the phaseout of carbon-intensive energy sources is delayed to secure supply in the near term. The widening gap, between current emission trajectories and those needed to align to a 1.5 degree Celsius target by 2030, may lead to heightened societal tension as policymakers struggle to balance short-term social and economic priorities with long-term decarbonization ambitions. This may also trigger abrupt policy actions in later years, disrupting industries and business models, notably in the automotive, building, cement, steel, chemicals, transportation, and utilities sectors.

Mounting cyberattacks from geopolitical tensions and increasing digitalization

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

The pace of digitalization in the global economy exposes corporates and countries to mounting cyber risks-- where targets can include anything from utilities to insurers, to government agencies--that weigh on credit quality, result in substantial monetary losses, and undermine confidence in key institutions and infrastructure. In addition to the cyber threat from increasingly sophisticated criminal activity, ongoing geopolitical tensions increase the prospect of major cyberattacks. Russia's use of cyberattacks, while largely limited to Ukraine since the invasion, could become a new front in response to the West's military support for Ukraine, with potential systemic implications.

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 about whether the risk level could increase or decrease over the next 12 months.

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