S&P Global Ratings

Credit Conditions Europe Q3 2023

The Slow Burn of Rising (Real) Rates

June 27, 2023

This report does not constitute a rating action

Key Takeaways

- **Overall**: Financing conditions are expected to continue to tighten as central banks maintain their laser focus on restoring price stability. As the COVID-19 recovery fades and higher (real) rates start to dampen demand, eurozone economic activity may contract modestly around the turn of the year under our base case.
- **Risks**: Credit risks are linked mainly to the lagged impact of unexpectedly high inflation (especially for consumers), and the historic rise in the cost of servicing debt. The outlook for key segments within European real estate is poor, although only a moderate systemic risk, in our view, given the role and strength of the larger European banks. Geopolitical risk relating to the war in Ukraine is a severe tail risk, as decision-making in Russia is so unpredictable.
- **Ratings**: The European banking sector remains on a stable outlook, as net interest margins support earnings and are expected to cover some increase in credit costs. While corporate earnings' momentum is stalling, strong financial performance has translated into a positive ratings transition, particularly for investment-grade companies. We continue to have concerns over the ratings outlook for more vulnerable speculative-grade issuers.

Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Emerging Markets, North America, and Europe). Discussions center on identifying credit risks and their potential ratings impact in various asset classes, as well as borrowing and lending trends for businesses and consumers. This commentary reflects views discussed in the European committee on June 20, 2023.

European economies, households, and enterprises continue to demonstrate considerable resilience amid the sharpest tightening in financial conditions since the global financial crisis. This is also reflected in recent rating actions in Europe, which have largely been positive given that the March turmoil in the U.S. and Swiss banking sectors was quickly contained. In part, this can be attributed to the success in limiting the severity of the impact of the series of systemic shocks experienced over the past three years--COVID-19, the war in Ukraine, the energy crisis, and inflation. Governments have provided substantial fiscal support, households have built up savings buffers, companies have been able to pass through higher input costs and, in a tight post-COVID labor market, have limited layoffs.

However, this resilience also reflects that much of the real impact of the rise in interest rates has still to percolate through. This, in a nutshell, is the key message from our latest credit conditions deliberations. While official interest rates are now in restrictive territory, and probably

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close to peaking, we expect the Bank of England (BOE) and European Central Bank (ECB) to remain single minded in pursuit of their price stability targets. This will mean trying to prevent second-round effects taking hold--the implications being that interest rates will likely remain restrictive until they are close to restoring price stability (not before 2025 in the eurozone), and that real short-term interest rates are likely to become positive in 2024 for the first time since 2007-2008.

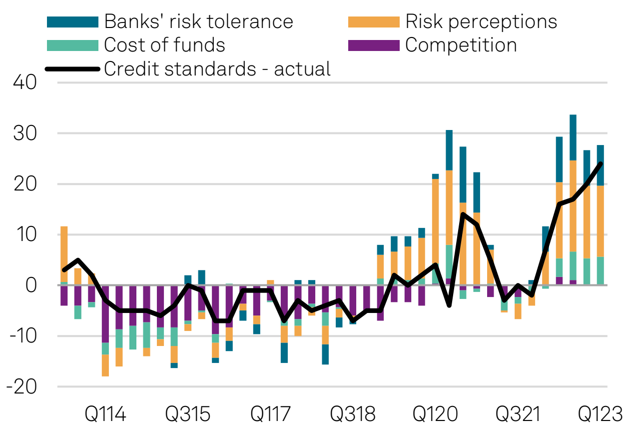
Credit conditions continue to tighten as banks become more risk averse, borrowers' funding costs rise, and the focus on credit quality increases, even as windows of issuance activity have returned in the primary bond markets**.**

- **Banks:** Our stable outlook on the sector reflects improving profitability as the increase in net interest margins continues to outpace the repricing in remuneration of deposits, even factoring in some deterioration in asset quality that, we think, will modestly increase credit costs. Even so, the combination of lower credit demand and tighter underwriting standards--the sharpest tightening in banks' credit standards since the euro sovereign debt crisis in 2011 according to the ECB's Q1 2023 Bank Lending Survey (see charts 1 and 2)--points to a further decline in lending growth through the year.

Chart 1

Banks are tightening credit standards for large enterprises

Net percentage of banks reporting a tightening of credit standards and contributory factors

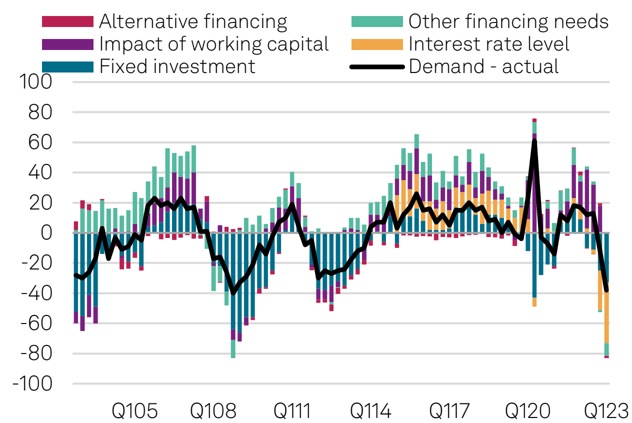


Source: ECB Bank Lending Survey Q1 2023.

Chart 2

Loan demand is weak due to high rates and slow capex

Net percentage of banks reporting an increase in demand from enterprises and contributory factors



Source: ECB Bank Lending Survey Q1 2023.

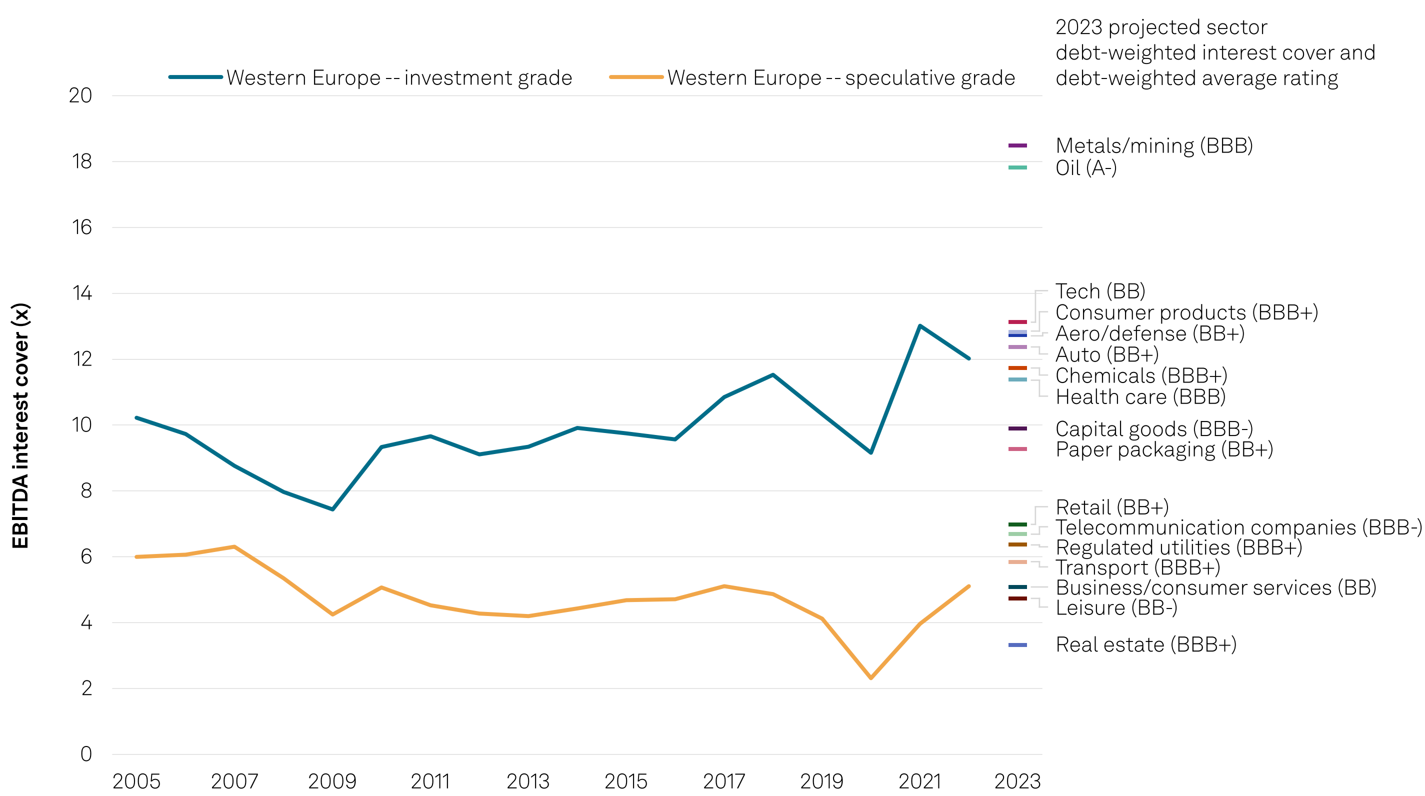
- **Corporates:** We see a growing divergence in ratings performance between investment-grade (IG) and speculative-grade (SG) entities. In the main, perhaps with the notable exception of real estate, against the backdrop of enormous uncertainty created by the war in Ukraine and the energy crisis in Europe, IG companies have proved able to strengthen their existing credit profiles and maintain sufficient financial flexibility to adapt to a slow growth, high inflation, and higher rate environment. Clearly, consumer discretionary sectors remain in the front line. But barring a recession and a substantial increase in unemployment (that we don't anticipate under our base case), we expect negative rating actions in IG territory to be quite limited.

  Instead, our concerns center mostly on speculative grade, especially those highly leveraged entities that may generate little or no free operating cash flow and with upcoming maturities in the next year or two. There are several reasons for this. Most obviously, SG credits are most exposed to higher funding costs either on their floating-rate debt (perhaps when any hedges unwind) or when they refinance. Less obvious, but no less important, is that our expectation of an extended period of high (and positive real) rates, together with lackluster growth, means that r (cost of funding) will exceed g (nominal growth) as inflation slows. This presents a more acute credit risk for companies with more unsustainable capital structures in this credit cycle than we have seen since the global financial crisis.

These concerns are also reflected in the divergence of interest cover ratios between IG and SG. The recent strength of operating performance has boosted coverage ratios strongly over the past two years (see chart 4), particularly for IG that are now 20% higher than the average that prevailed between 2010-2019 (see chart 3). Digging a little deeper into the sector detail, there is, as would be expected, a marked divergence across sectors looking at the projected debt-weighted average coverage ratios for 2023. Capital-intensive IG sectors such as telcos, transportation, and regulated utilities appear relatively weak on this metric, although transportation includes airlines and shipping, the earnings of which have been volatile due to the fallout from COVID. Similarly, some regulated utilities, such as EDF, took a big hit to earnings due to regulatory actions to cap energy prices in 2022, although that should correct as subsidies unwind. Within SG the media, entertainment, leisure and consumer, and business service sectors, have the weakest coverage ratios and will be heavily reliant on continuing to expand earnings to underpin their coverage ratios as refinancing picks up in coming quarters.

Chart 3

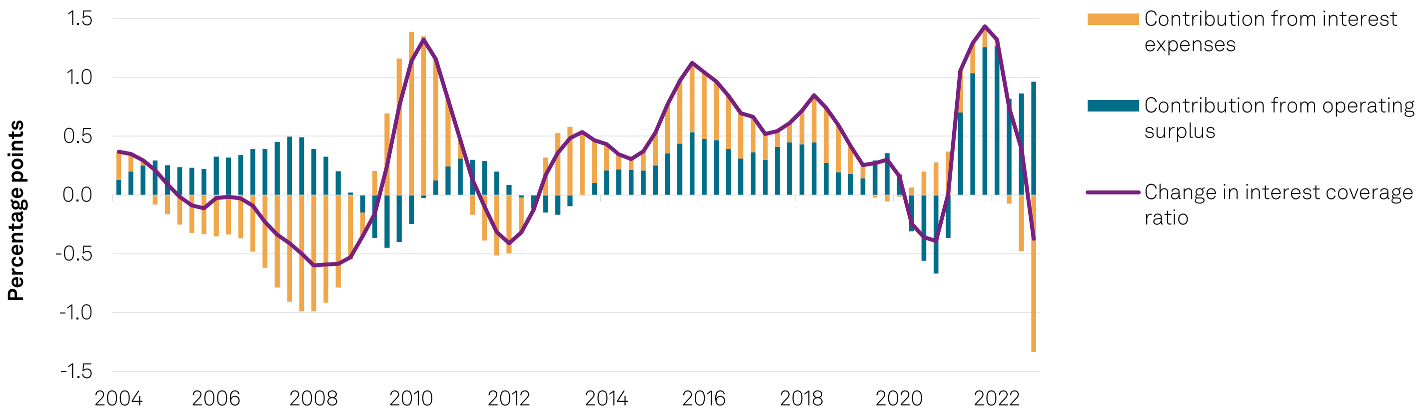
Interest cover ratios for European rated investment-grade and speculative-grade nonfinancial corporates and projected by sector for 2023



Source: S&P Global Ratings.

Chart 4

Interest cover ratios now falling as interest costs rise and earnings momentum stalls



Source: European Central Bank.

Governance issues are arising: After a turn in the credit cycle, especially one as extended as we have experienced over the past decade, it is not uncommon for improprieties and governance issues to surface sporadically. Indeed, in a recent research report ("ESG In Credit Ratings", published June 16, 2023) we noted that over 45% of ESG-related rating actions globally so far this year relate to governance issues. The credit issue here is that weak governance--which can encompass risk management, oversight, transparency, and reporting, among other factors--can often drive a more rapid negative credit transition than we would normally expect. Rated companies in Europe that we view as having very negative governance scores currently include French food retailer Casino Guichard-Perrachon, telecommunications operator Altice France S.A., and Swedish real estate landlord Samhallsbyggnadsbolaget (SBB).

- **Real estate**: Pressured by rising interest rates, a price correction is underway in most European commercial real estate markets, which we think will continue to fall until the end of the year. Offices (particularly non-prime), logistics, and lower yielding assets appear more exposed as yields adjust. For residential, we generally anticipate more pressure in countries with a high share of variable rate mortgages and where the interest rate rise is largest, such as Sweden. Still, we don't expect residential mortgage portfolios to be a major source of credit losses for European banks given the relative strength of household finances and labor markets, as well as prudent underwriting and regulatory standards for mortgage lending. European banks continue to have moderate exposure to real estate in their loan books, although it is higher than average in Sweden and Germany (equating to about one-third of the corporate loan book in Germany, for instance). While we understand banks are likely to continue supporting the property sector, notably with existing clients, they could become more selective. In the current environment of difficult bond markets, commercial real estate investors are also seeking to deleverage by raising liquidity by other means, such as cutting capital expenditure and dividends, raising equity, and disposing of assets where possible.

The war in Ukraine is entering a new and potentially dangerous phase as Ukraine seeks to go on the offensive to regain its territory, while sensitivities in Russia to the progress of the war have edged higher following the recent mutiny of the Wagner group. Given the uncertainty and unpredictable nature of decision-making in Russia, tail risks remain high even if the macro credit impact in Western Europe has, so far, proven much less damaging than was feared last year.

Russia-Ukraine Conflict: S&P Global Ratings' Base-Case Scenario

Although it is evident that Ukraine is ramping up a summer offensive, and some territory is likely to be recovered, it nonetheless seems unlikely that Russia will capitulate, especially as it has extensively prepared its defensive capabilities. This implies that a military stalemate remains the most likely outcome as both sides resign themselves to an extended war.

- We expect the Western alliance will continue providing more advanced military equipment (including longer range missiles and fighter jets), as well as financial and humanitarian support for Ukraine. This includes the extension of full trade liberalization, which originally entered into force on June 4, 2022.
- This will demonstrate the strong political support for Ukraine provided by NATO countries, shore up Ukraine's defense capability, and underpin the economy. At the same time, it is being provided on the understanding that Western equipment will not be used against targets inside the Russian Federation.
- Russia's targeting of key infrastructure in Ukraine, and periodic nuclear threats, are unlikely to undermine the still high levels of public support for the war effort in Ukraine and most NATO countries. We believe Russia wants to avoid direct military engagement with NATO, and China's tacit political support for Russia is believed to be contingent on it not deploying its nuclear arsenal or broadening the conflict into the EU.
- Both sides' strategic objectives are so far apart that the prospect of any negotiated peace plan appears almost non-existent. Consequently, existing Western sanctions are (broadly) expected to continue indefinitely. The focus will center more on enforcement rather than any material extension in the breadth of primary sanctions. We think the Black Sea grain deal will likely lapse in mid-July as Russia seeks to sow discord among farmers in Eastern European countries fearing cheap imports.
- Under the scenario of a military stalemate, a de facto partition of Ukraine could eventually emerge, with the EU responding by deepening investment and trade with central and western Ukraine.

We continue to closely monitor a handful of key potential risks related to the conflict in Ukraine:

- **Direct NATO engagement.** To enhance Ukraine's ability to defend itself and retake its sovereign territory, the Western alliance has committed to providing more sophisticated and longer-range weapons to Ukraine. The risk is that this provokes a hostile Russian response that embroils NATO if, for instance, Russia used unconventional weapons or causes Article 5, which sets out NATO's principle of collective defense, to be invoked.
- **Continued economic commitment.** The durability of the Western alliance's commitment to provide the necessary military and financial support to Ukraine is an issue to watch. This is particularly the case if the war still looks intractable toward year-end, more so if China starts providing material military support to shore up Russia's campaign. Wearing down public support in Europe and the U.S., and fostering division between NATO countries (including by increasing the burden of post-war reconstruction in Ukraine), is a strategic part of Russia's plan.
- **Cyber hostilities.** Cyber space provides opportunities to expand the conflict zone in several dimensions. Ukraine's government, military, and civilian infrastructure is reported to have been under almost constant attack from Russia and associated criminal groups, including in the months prior to the war. In contrast, hostile cyber activities targeting critical infrastructure in the West appear to have been sporadic and below a threshold that could trigger Article 5. Nonetheless, there is a clear and growing risk that the Kremlin and associated criminal groups will intensify cyberattacks on critical infrastructure within NATO member states in response to the growing military support being provided to Ukraine.

Top European Risks

Economic growth fragility, despite recent resilience

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

European economic growth remains fragile, despite the economy withstanding the worst of the energy crisis and receiving an initial boost from the reopening of China's economy. We are particularly wary of risks arising from the impact of rising real interest rates, including the effect on the housing market and consumer demand in late 2023 and into 2024. The return of positive real interest rates is not only a paradigm shift for the European economy, it also comes at a time when the tailwinds of the post-COVID recovery are fading. In combination with a negative credit and fiscal impulse, and higher likelihood of a downturn in the production and investment cycle, European economies could fall into a recession. The severity of any recession would largely depend on the offsetting support provided by the service sector (with the first normal tourist season in three years), the resilience of the labor market, and public investment triggered by the implementation of the NextGen EU plan.

Escalation and broadening of the Russia-Ukraine conflict

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

While our base case remains that a stalemate is the most likely outcome, the war in Ukraine is entering a new and potentially dangerous phase as Ukraine seeks to go on the offensive to regain its territory, while sensitivities in Russia to the progress of the war have edged higher following the recent mutiny of the Wagner group. The provision of more sophisticated Western weapons, provided to defend Ukrainian territory, and more frequent (unattributed) strikes on the Russian mainland, could provoke Russia into launching asymmetric actions against NATO countries or using unconventional weapons against Ukraine. China's provision of lethal weapons to Russia would be a destabilizing development. Any material escalation or broadening of the conflict could reverberate through the global economy and destabilize financial markets.

Higher interest rates and reduced funding availability, weighing on financial risk profiles

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

High nominal rates in restrictive territory and, as (headline) inflation subsides, an extended period of positive real rates could expose financial vulnerabilities for lower rated issuers, which may find access to financing restricted. This could be exacerbated by tightening credit standards for bank lending and the withdrawal of liquidity from fixed-income markets by central banks. More vulnerable categories could include: commercial real estate; corporate business models premised on uncertain growth needed to generate cash flow to cover higher debt service costs; and financial institutions, such as non-bank financial institutions, operating with high leverage, running structural liquidity mismatches, or taking significant asset-quality risk. Near-term refinancing risk is manageable as most borrowers have termed out their debt and/or hedged much of their interest rate exposure. Still, stressed corporate borrowers could still default if they conduct distressed exchanges.

Falling real estate values and rising cost of capital, which undermine confidence and create funding challenges

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

High interest rates and falling valuations create an emerging risk for real estate (residential and commercial) in Europe. For commercial real estate (CRE), secular trends (such as the rise in working from home for the office sector), tighter underwriting standards, and lower valuations creates material refinancing risk even for investment-grade companies. While some deterioration in CRE asset quality is likely for banks, most CRE bank lending in the EU is from larger banks, which tend to have a greater capacity to absorb potential losses. Even so, any surge in distressed sales could undermine sentiment in the market, exposing banks to higher credit losses. For residential property, higher mortgage rates and softening prices feed through both to existing borrowers and new transactions, creating spillovers to the broader economy, including a negative impact on consumer confidence and spending.

Secular risks

Heightened disruptions linked to climate change and the energy transition

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

The necessary acceleration in Europe's energy transition, following curtailment in Russian fossil fuel supplies, faces significant implementation challenges. The situation has slightly improved with greater preparedness and visibility on the renewables implementation plans. But challenges remain, such as slow permitting and supply-chain strains affecting renewables, hydrogen, biofuels, energy efficiency, and heat-pump rollouts.

The widening gap between current emission trajectories and the ambitious decarbonization targets set by the EU by 2030 may lead to heightened societal tension as policymakers struggle to balance climate goals with other social and economic priorities. Some European leaders are now asking for a pause in new environmental regulations to let stakeholders incorporate all the recent changes and check their efficiency. Even so, the urgent need to meet ambitious decarbonization targets may still trigger abrupt policy action in later years, disrupting industries and business models, notably in the automotive, building, cement, steel, chemicals, transportation, and utilities sectors.

Mounting cyberattacks due to geopolitical tensions and increasing digitalization

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

The pace of digitalization (including AI) in the global economy exposes corporates and countries to mounting cyber risks, with targets ranging from utilities to insurers and government agencies. This can weigh on credit quality, result in substantial monetary losses, and undermine public confidence in key institutions and infrastructure. In addition to the threat from increasingly sophisticated cybercrime, geopolitical tensions have stoked fears of state-sanctioned cyber threats. Russia's recent use of cyberattacks has been largely limited to Ukraine, but could expand in response to the West's military support for Ukraine. Most likely, this would involve (mis)information operations and deepfake hoaxes to subvert Western backing for the war in Ukraine. Less likely, but potentially more systemic, would be a destructive cyber event on vital infrastructure in the West.

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

Macroeconomic Outlook

- A robust labor market, the effects of fiscal measures, and the prospect of further rate rises have led us to amend our baseline GDP forecast for 2023 modestly upward to 0.6%.
- Although disinflation has started, the ECB remains concerned at the level of core inflation and is likely to raise rates once more in July before pausing. We don't expect the central bank to achieve its price stability target before 2025.
- As the COVID-19 recovery fades and higher rates start to dampen demand, eurozone economic activity may contract at around the turn of the year, although a deep recession is not on the cards.

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Eurozone

The medium-term outlook is brighter than the short term. With the eurozone economy in the grip of stagflation at the start of the year, our baseline scenario has largely materialized to date.

However, three recent developments have now prompted us to amend our GDP forecasts slightly upward. First, the labor market is still robust. Unemployment remains on a downward trend in most countries, although we had already expected it to stabilize this spring. Second, fiscal measures in some countries had a stronger impact on GDP than initially thought. Third, the ECB appears to have a more negative view on core inflation than three months ago. It leads us to believe that the ECB will seek to raise rates once again in July, 25 basis points higher than we expected three months ago, before pausing. Compared with our March baseline, we therefore expect GDP growth to be slightly higher in 2023 (revised to 0.6% from 0.3%) and marginally lower in 2024 (revised to 0.9% from 1.0%). Otherwise, our narrative remains unchanged. Disinflation has started and will help the eurozone economy to emerge from the stagflation seen in Q2. At the same time, the tailwinds that emerged from the COVID-19 recovery are fading, and higher interest rates have started to dampen demand. Activity may contract again around the turn to next year, perhaps more sharply and more broadly than during last winter.

That said, even if the economic cycle is weakening, we do not see the eurozone economy sliding into a deep recession that would put a massive strain on balance sheets. On the contrary, we largely confirm our growth forecasts for 2025 and 2026 (at 1.6% for both years) and continue to think that the medium-term economic outlook (2025-2026) is brighter than the short term (2023-2024). Monetary policy should move away from restraining demand within the next two years, and fiscal policy will continue to provide some stimulus through the implementation of NextGen EU until the end of 2026. By allocating more money to the region's less strong economies, NextGen EU also acts as a shield against potential risks of financial fragmentation. What's more, an aging population and progress in labor market flexibility should ensure that the unemployment rate does not rise sharply in response to this cyclical slowdown--or at least that it rises less sharply than in the past.

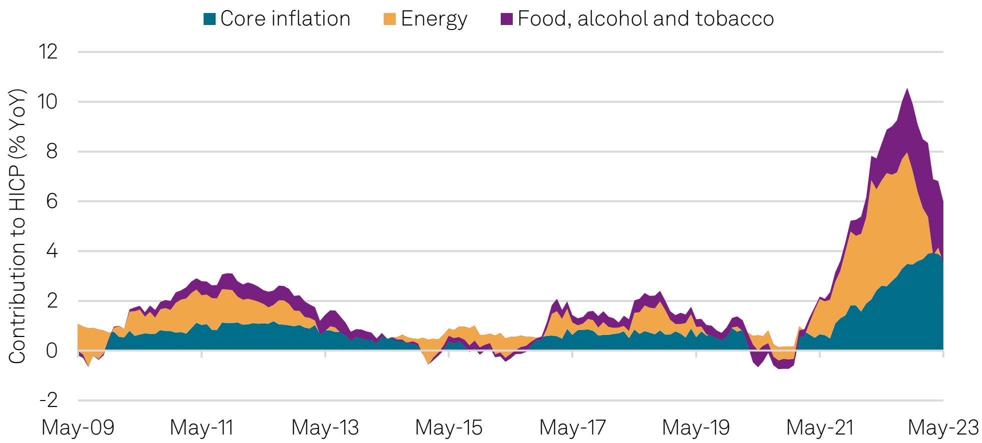
On the price side, actual developments are very much in line with our previous forecasts. Disinflation has begun, but it will progress slowly. Energy prices are falling, but food inflation remains in double digits, while labor costs are progressively on the rise. We expect headline inflation to slow from 8.4% last year to 5.8% this year (5.9% in our March forecasts) now that last year's increases in energy prices are out of the year-on-year comparison, and 2.7% next year. Core inflation is likely to exceed headline inflation from the end of 2023 through to mid-2025.

We expect no talk of a return to central banks' price stability before early 2025.

Chart 5

Core inflation is now the main driver of headline inflation, ahead of food inflation

Contribution to eurozone headline inflation by main components



Source: S&P Global Ratings.

Key assumptions

- The conflict in Ukraine does not spread to other countries and no unconventional weapons are used.
- Rationing of the energy supply to the European economy remains a remote risk for the coming winter.
- The recovery from COVID is largely exhausted in terms of backlogs and inventories.
- The ECB will not raise rates after the summer and will maintain a gradual approach to reducing its balance sheet.

Key risks

- Longer duration and escalation of the conflict in Ukraine, that could further test the resilience of the European economy.
- An unwarranted and disorderly tightening of global financing conditions.
- Over-calibration of the ECB's response to inflation, both in terms of interest rates and balance-sheet reduction.
- Delay in public spending related to the implementation of NextGen EU.

What to look for over the next quarter

- Developments in the conflict between Russia and Ukraine.
- The speed of disinflation and resilience of labor markets.
- The depth of the slowdown in the manufacturing sector.
- The impact of higher interest rates on financing conditions and demand.

U.K.

Core inflation and pay growth have accelerated since our previous forecast, and the economy has shown more resilience to the cost-of-living pressures than anticipated, supported partly by high employment levels and strong pay growth.

Recent data showing core inflation and average pay growth accelerating to above 7% have revived the Bank of England's (BoE) concerns about a self-reinforcing loop between wage and price setting that could translate into inflation remaining stubbornly high for an extended period, causing significant damage to the economy in the medium to longer term. To curb these fundamental, and now predominantly domestic price pressures, the BoE reacted decisively earlier this month and raised the policy rate by 50 basis points to 5%. We expect a terminal rate for this cycle of 5.25%, but rates could go higher if bad news about core price pressures continues to come in.

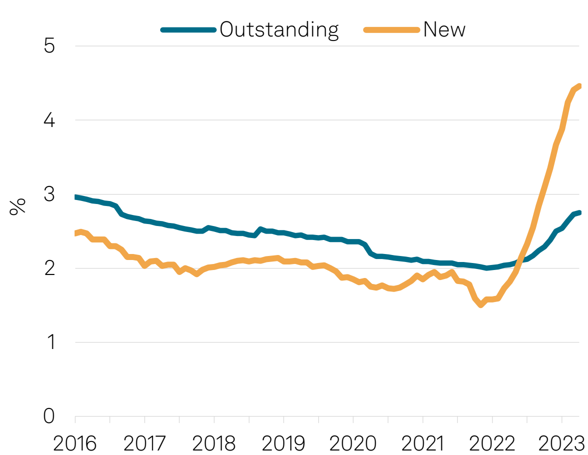
Credit conditions have already tightened and are starting to cool the economy, but still have some way to go. Indeed, monetary policy impacts economic output with a lag, and we estimate it could take until the turn of the year for the interest rate hikes implemented so far to reach peak impact on economic output. For example, the pressure from higher mortgage rates on household budgets has only just started (see chart 6). For the rest of 2023, we see little improvement and expect GDP growth to stagnate. This is still an upward revision from our previous projections to account for the resilience at the beginning of the year. But owing to increasingly restrictive credit conditions, we have revised downward our forecast for 2024 and now expect GDP growth of just 0.9%, compared with 1.5% earlier.

To prevent unduly restricting growth, we think the BoE will not hold rates at the terminal level for long. We think it could start easing again from the second quarter of next year--earlier than markets currently expect. Our key consideration is that real interest rates will have turned positive by then as headline inflation continues to fall because earlier energy price spikes will have reversed, and producer input price inflation, already on a significant downward trend for a few months, will have fed through to consumer prices. Borrowers will no longer enjoy the inflation premium generated from servicing debt below the cost of inflation. This important factor will reinforce the transmission of tighter monetary policy and could warrant some earlier relaxation of monetary policy without sacrificing inflation control.

Chart 6

Higher borrowing costs have yet to hit the majority of mortgage holders

Effective rates across all types of mortgages

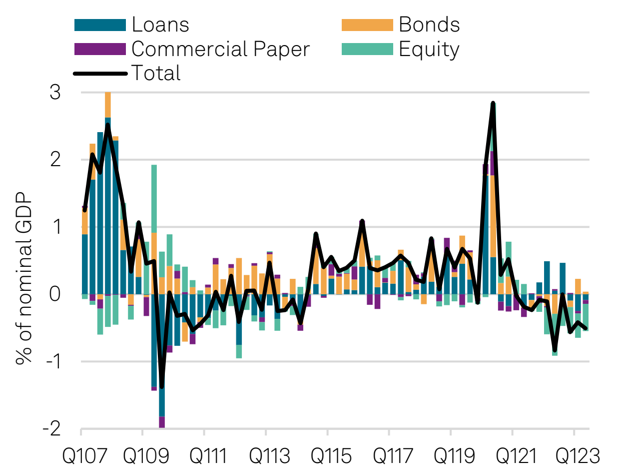


Source: Bank of England, S&P Global Ratings.

Chart 7

New funding of businesses is approaching historic lows

Net quarterly funding flows to nonfinancial businesses by source



Source: S&P Global Ratings.

Financing Conditions

- A combination of high rates for longer and disinflation setting in leads us to expect real rates to turn positive in 2024.
- Credit pricing, which has demonstrated remarkable resilience, is likely to come under rising pressure due to the increasing impact of higher-for-longer interest rates upon credit markets.
- Current divergence in rating performance trends between investment and speculative grade is likely to be mirrored in primary markets, as we anticipate that access to, and cost of speculative-grade issuance will become more challenging as refinancing activity picks up toward the end of the year.

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Real interest rates remain negative, but for how long? Despite 350 basis points (bps) of rate hikes, real rates remain negative. However, as recent economic data points to steady and continued disinflation coinciding with expectations that interest rates are likely to stay higher for longer, real rates are already rising sharply from a deeply negative position. Continuation of this trend is likely to see real rates turn positive in 2024, which will negatively affect financing costs--and may, in the short term, lead to increased primary issuance as some higher rated issuers elect to complete refinancings in anticipation of more costly conditions ahead.

Credit appetite is still constructive, despite rising risks. Notwithstanding mixed economic data, the commencement of a new phase in the war In Ukraine, and the anticipated impact of monetary policy lags, markets seem quite sanguine, with the VSTOXX index down to around 15--one of the lowest levels since the onset of the COVID pandemic. Credit pricing is exhibiting remarkable stability, with banking senior and sub CDS indices having recovered much of the widening they experienced in March, while nonfinancial corporates have tightened back close to opening 2023 levels. European investment-grade (IG) and speculative-grade (SG) credit default swap indices are around 78 bps and 418 bps, respectively, (as of June 23). They have tightened by nearly 27 bps and 100 bps since March peaks and remain substantially below the peaks of about 200 bps and 670 bps seen in July 2022. Rising credit pressure at the lower end of the credit spectrum, alongside the increasing impact of higher-for-longer interest rates--now at 21-year highs--suggest credit pricing may increasingly come under widening pressure, particularly at the lower end.

Issuance trends are solid. Corporate issuance year to date exceeds 2022 levels, fueled primarily by strong IG issuance (+12%), which accounts for about 90% of all issuance. However, SG issuance (+35%) is also up, admittedly from a very low year-to-date base in 2022.

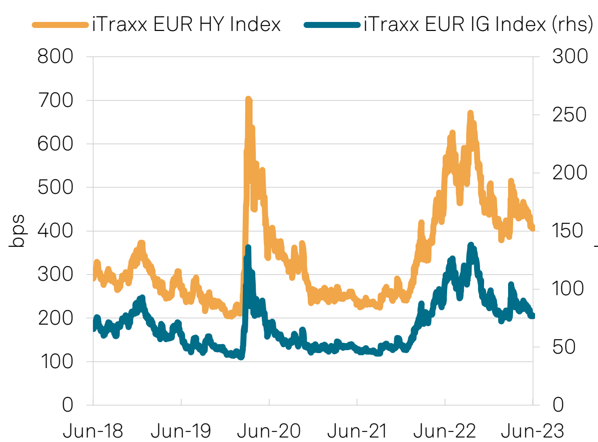
But increasing divergence, which we are already detecting in rating performance trends, is likely to become more pronounced. IG rating trends remain stable, while the number of weakest links ('B-' and below) are at their highest point in over two years. Indeed, we expect the European trailing-12-month SG corporate default rate to reach 3.6% by March 2024, from 2.8% in March 2023. We can therefore expect access to, and cost of SG issuance to become more problematic as we edge closer to 2024. Furthermore, despite the relative stability of current market conditions, around 67% of SG issuance year to date has been by higher rated 'BB' issuers, implying that weaker issuers are already finding it more difficult to access markets.

Refinancing risk tests are only beginning. Near-term refinancing risk remains manageable because, based on January 2023 data, only 10% of corporate debt maturities in 2023 were SG, the majority of which were higher rated 'BB' issuers. However, SG refinancing risk is only starting to build, jumping to 14% in 2024, 20% in 2025, and peaking at 26% in 2026. As issuers generally seek to refinance at least 12-24 months in advance of maturities, refinancing risk will be rising precisely as the impact of higher rates is becoming more acute. We have already seen a number of SG borrowers refinance 2025 maturities this year, and we can expect more higher rated SG issuers to attempt to do likewise as conditions remain constructive. Floating-rate borrowers will be hit from both sides--dealing with operating pressures while also facing the more immediate rise in financing costs. About 44% of SG-rated debt maturing through 2024 is floating rate, primarily in the 'B' rating category. And while 2023 risk is limited, floating-rate refinancing risk ramps up materially to close to €50 billion in 2024, and reaches almost €90 billion in 2025.

It is difficult to assess the health of alternatives to market funding. While market access may become more restrictive, and certainly more expensive, European banks have traditionally played a material role in financing European nonfinancial corporates. However, the most recently published ECB lending survey indicated that lending standards tightened in the first quarter at the highest pace since the sovereign debt crisis in 2011. More restrictive markets and bank appetite could create further opportunities for the burgeoning private debt markets with a much larger pool of private credit now available. However, private debt lenders are not immune from the economic slowdown, rising credit risk, and the need to generate appropriate risk-adjusted returns. They therefore might provide an alternative, but not a universal answer to lower liquidity.

Chart 8

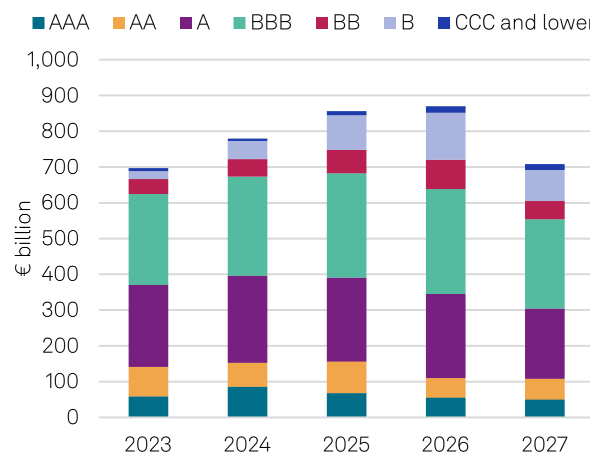
CDS spreads have tightened since Q1 2023



Data as of June 13, 2023. Source: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence.

Chart 9

European corporate maturities by rating category



Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings from financial and nonfinancial corporate issuers. Data as of Jan. 1, 2023. Source: S&P Global Ratings Credit Research & Insights

Credit Cycle Indicator

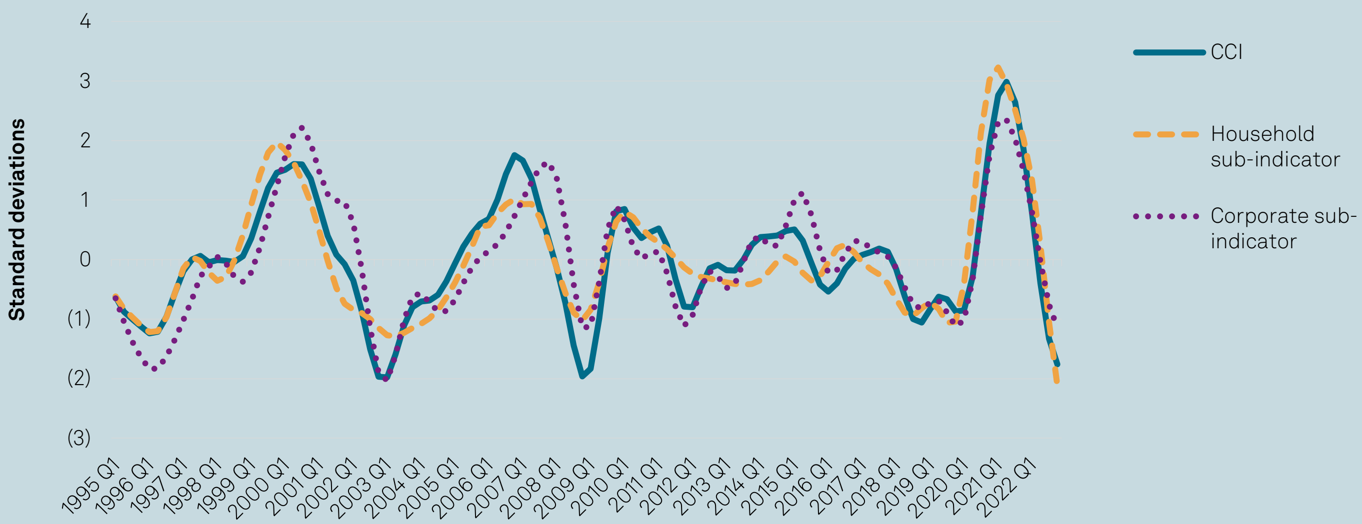
Economic resilience and inflation have eased debt burdens for now

Over the five quarters from Q1 2020, as the COVID-19 pandemic took hold, the eurozone Credit Cycle Indicator (CCI) trended upward, reaching a peak of 3.0 standard deviations in Q2 2021 (see chart 10). Based on statistical precedent, this pointed to potential heightened credit stress six to 10 quarters later, in the period covering late 2022 and into 2023. To date, material credit stress has been relatively limited in Europe, as the economy has proved remarkably resilient, and inflation has helped to ease corporate and household debt burdens in real terms. Indeed, the recovery in the CCI over the past six quarters has been unprecedented in the relatively short history of this series. Nonetheless, we remain cautious because the impact of higher rates--expected to turn positive in real terms in the coming quarters--is still to play out.

For more details about our proprietary CCI, see "White Paper: Introducing Our Credit Cycle Indicator," published on June 27, 2022.

Chart 10

High interest rates are likely to become positive in real terms, pointing to credit stress deferred, not avoided



CCI--Credit Cycle Indicator. Peaks in the CCI tend to lead credit stresses by six to 10 quarters. When the CCI's upward trend is prolonged or the CCI nears upper thresholds, the associated credit stress tends to be greater. Sovereign risk is not included as a formal part of the CCI. Source: Bank for International Settlements, Bloomberg, S&P Global Ratings. Data as of Q4 2022.

Corporates. Since peaking in the first quarter of 2021, the eurozone corporate sub-indicator has descended rapidly from a height of 2.4 standard deviations (Q1 2021) to minus 1.1 in late 2022. The economic and inflationary rebound from the pandemic has spurred nominal growth across the eurozone, helping push down the corporate credit-to-GDP ratio to 105% In Q4 2022, according to the Bank for International Settlements (BIS), from 110% a year earlier. Yet, even with this moderation, debt in the corporate sector remains at pre-pandemic highs in terms of GDP. And although a declining CCI reading signals moderating stress, higher rates, tougher financing conditions, and a stagnating economy may expose financial vulnerabilities within segments of the corporate sector.

Households. The household sub-indicator follows a similar trend to that of corporates: a sharp peak followed by a large decline across 2021 and through to end-2022. Over that period, total credit to eurozone households as a percentage of GDP decreased to 57.4% by Q4 2022, down from 59.9% a year earlier. To some extent, this moderation reflects the ongoing strength in the labor market and the lags involved in higher rates feeding through to end users. In the context of ongoing cost of living pressures and delayed impact of rate rises--for instance on household mortgages--those consumers with minimal savings could find themselves badly squeezed and resorting to expensive consumer credit in the event of an economic downturn and rising unemployment.

Financial Institutions

- We took positive rating actions on selected banks during the first half of the year, mainly reflecting progress in asset quality, profitability, or restructuring. But our outlooks remain largely stable.
- The nonbank segment concentrates the largest share of negative outlooks, reflecting refinancing risks and business model challenges in a higher rate, more risk-averse environment.
- Banks' earnings will continue improving in 2023 as balance-sheet repricing to higher rates continues, which will help them preserve a solid capitalization.
- Business volumes will remain subdued due to the combination of lower demand for credit and banks' tighter underwriting.
- Signs of asset quality deterioration are so far limited, but we expect to see some problems emerging in the second half of the year and in 2024. Nevertheless, we expect the impact to be manageable.

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Key Developments

European banks are facing lower credit demand and are also tightening their lending standards. Lending growth is thus set to decelerate further as the year goes by (see chart 11). Higher rates and continued macroeconomic uncertainties are the main reasons behind these trends. The ECB's latest lending survey reported that in Q1 2023 the pace of net tightening of banks' credit standards for companies was the highest since the euro area sovereign debt crisis in 2011. The decline of companies' net demand for loans was also the highest since the fourth quarter of 2008, while the share of rejected applications also rose. Interestingly, in the household segment, while mortgage demand and approvals are also under pressure, this is less the case for consumer-lending facilities. There are also differences among key European countries. In Italy and Spain the private sector is actually deleveraging, with households using excess savings to prepay mortgages and several companies reimbursing some of the government-guaranteed loans received during the pandemic. At the other end of the spectrum, lending growth in France in Q1 2023 remained solid, up 4.4% annually for households and 6.5% for companies, while lending growth in the U.K. and Germany are in the middle ground.

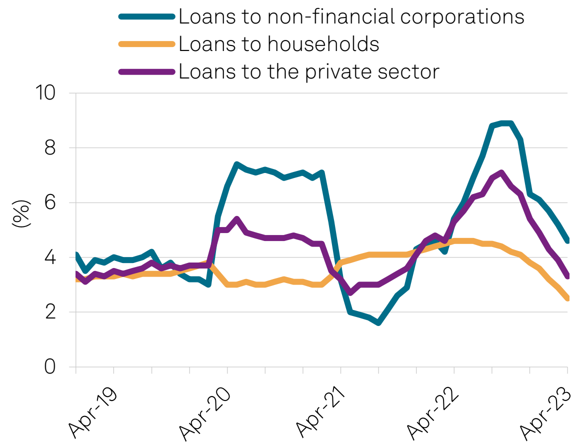
Banks' net interest margins continue to improve as assets reprice at higher rates and remuneration of deposits remains contained. The repricing will continue over the rest of the year, which means that many banks will this year outperform their previous results guidance, even taking into account a more normalized cost of credit and higher operating expenses due to inflation. Performance will vary from country to country, however. The benefit of higher interest rate hikes will be more clearly seen in banks with largely floating balance sheets and cheap deposit funding, while the improvement will be fairly limited for those banks that, like the French, have a large share of fixed-rate assets on their balance sheets, a regulated savings product remunerated at close-to-market rates, and structurally higher operating costs.

Unlike some regional U.S. banks, European banks were not confronted with a confidence crisis. One reason for this is the stability of banks' deposits, which currently account for about 60% of banks' total funding. Deposits are largely provided by households and are to a high degree insured. Another reason Is the manageable size of banks' unrealized losses on securities portfolios carried at amortized cost (and thus not recognized already in the profit-and-loss account or regulatory capital). Additionally, we believe that banks' ample liquidity, largely in the form of cash, positions them well to deal with potential deposit outflows, should they materialize (see chart 12).

Chart 11

European banks' lending growth is clearly decelerating

Annual growth rates of adjusted loans to residents provided by European banks

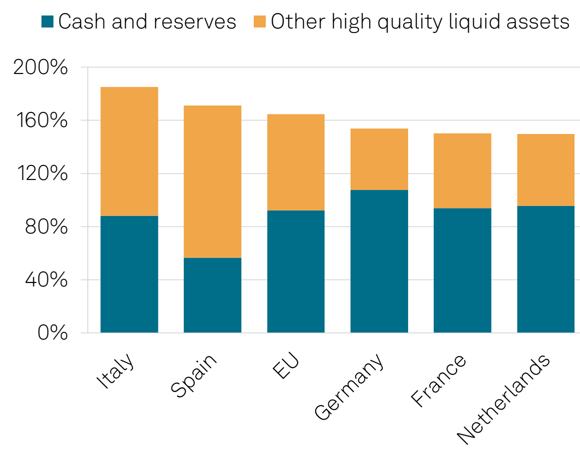


Source: ECB.

Chart 12

High liquidity buffers support the resilience of European banks to potential funding shocks

Composition of liquidity coverage ratio for large EU banks



Data as of Dec. 2022. Source: ECB, S&P Global Ratings.

Banks have anticipated the repayment of €1 trillion of TLTRO borrowings. But their funding and liquidity profiles remain comfortable. Between September 2022 and April 2023, banks repaid just over €1 trillion to the ECB, reducing their borrowings to €1.1 trillion, half the balance outstanding in September 2022. Interestingly, liquidity deposited at the ECB declined to a lesser extent (€612 million), leaving the outstanding at an ample €3.9 trillion. The latter, coupled with limited business growth prospects ahead and banks' broad compliance with MREL requirements, suggest that, other than to replace maturing instruments, additional net debt issuance this year will remain modest. Covered bonds will probably continue gaining ground in the mix of debt instruments.

Asset quality remains resilient, although some problem loans could emerge in the second half of the year and through 2024, most likely in SMEs and unsecured consumer lending portfolios. So far, both corporates and households are dealing well with the challenges posed by inflation and higher financing costs. Most companies have been able to pass their higher costs to customers and even improve their returns, while households are benefiting from accumulated savings and resilient employment. But there are pockets of vulnerability among highly leveraged companies and low-income individuals facing the full impact of higher financing costs and slowdown in activity. Indeed, in some countries corporate bankruptcies are rising, although from low levels. We therefore forecast some deterioration in asset quality, but we expect it to be manageable and to result only in a modest increase of credit costs.

A price correction is underway in several European property markets, affecting both residential and commercial real estate. But it is the commercial real estate segment that could result in higher problem loans for banks. Valuations are under pressure due to higher rates and economic uncertainty. Structural changes in the industry are weakening demand for office and retail space in particular. Real estate companies are facing difficulties refinancing their debts in the capital markets and are turning to banks instead. While large European banks' exposure to commercial real estate represents only 10% of total loans, it is much higher for German and Swedish banks, at around 18%-19%. And, indeed, for a number of banks in those systems, exposure exceeds their CET1 capital by at least 2x.

Banks will maintain their remuneration to shareholders. The dividend payout, including both cash dividends and share buybacks, will likely remain at around 50% of net profits, given that business volume growth ahead will be limited, banks' capital positions are solid and earnings are set to rise.

M&A activity will stay limited. Banks' better earnings prospects reduce pressures from stakeholders to look for strategic moves, while higher rates could also mean higher negative valuation adjustments and higher capital needs to complete deals. This is what happened recently to the agreed sale of HSBC's French retail operations to My Money Bank. Both parties had to negotiate amendments to the original deal to receive regulatory approval to go ahead.

Nonbanks are more vulnerable to refinancing risks and business model challenges. Access to the market for noninvestment grade issuers remains difficult and costly, which explains some of the negative outlooks we have on a number of nonbanks. Additionally, the higher funding costs are posing business model challenges for some of them too.

Key Risks

- **Weaker growth prospects amid tightening monetary and fiscal policies.** This would undermine the financial health of the private sector, thus negatively impacting banks' asset quality and business prospects.
- **More restrictive financing conditions.** Difficulties in accessing the market for financing, and extremely high funding costs, would put pressure on weaker corporates and non-banks, leading to higher credit losses for banks.
- **Banks' failure to deliver commercially and operationally resilient business models.** This could happen if banks do not tackle inefficiencies, do not properly digitalize the business, and do not improve their resilience to cyberattacks.

Nonfinancial Corporates

- With substantially higher borrowing costs and sluggish market liquidity prominent among risks to creditworthiness, there is a noticeable divergence in rating actions between investment-grade (IG) and speculative-grade (SG) entities.
- Within IG we observe a highly positive trend, largely driven by the favorable impact of the COVID-19 recovery on sectors such as travel and leisure, and the positive impact from energy transition and sustainability trends. In the SG space, some positive rating actions emanate from the same factors, but the gradual impact of higher financing costs is becoming evident.
- We expect IG companies to be relatively resilient to weakening economic conditions toward year-end, while the lower SG spectrum is likely to face increasing pressure.
- A negative outlook bias is prevalent across various sectors, particularly among SG issuers. Consumer goods, real estate, and chemicals are exhibiting the highest negative bias.

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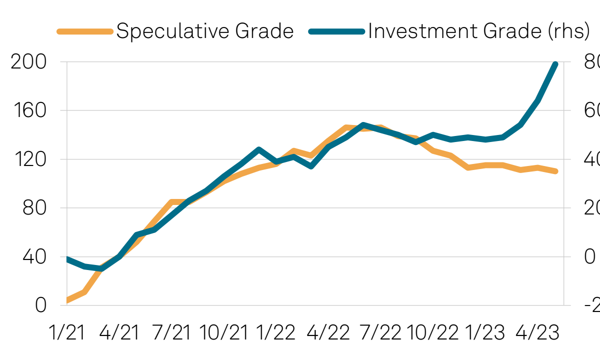
Key Developments

Rating dynamics in the corporate sector are diverging between IG and SG entities. We have witnessed 4x more upgrades than downgrades among IG companies since the beginning of the year as inflation and rising interest costs have very different impacts on IG and SG entities (see chart 13). For SG issuers, although interest rates have risen, the impact on debt servicing costs has not yet fully materialized for most companies. Only a small portion of issuers have had to refinance their debt at rates above pre-COVID levels so far. However, given they have a higher share of floating rate debt, they feel rising debt servicing costs more acutely (see chart 14).

More positively, higher rates and high inflation create stronger incentives for companies generating free cash flow to recalibrate their capital structures to protect credit quality. Absent a significant deceleration in economic activity, this is likely to create wider divergence between companies able to deleverage and others that may struggle to refinance and need to pursue asset disposals, or even debt restructuring as a last resort.

Chart 13

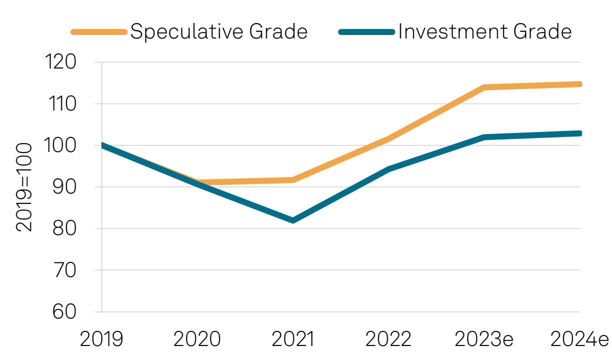
Cumulative European nonfinancial corporate rating actions since Jan 2021



Data as of May 31, 2023. Source: S&P Global Ratings.

Chart 14

Effective interest rate (indexed)



For reference: 2019 effective rates - 3.1% (IG), 5.3% (SG). Data as of May 31, 2023. Source: S&P Global Ratings.

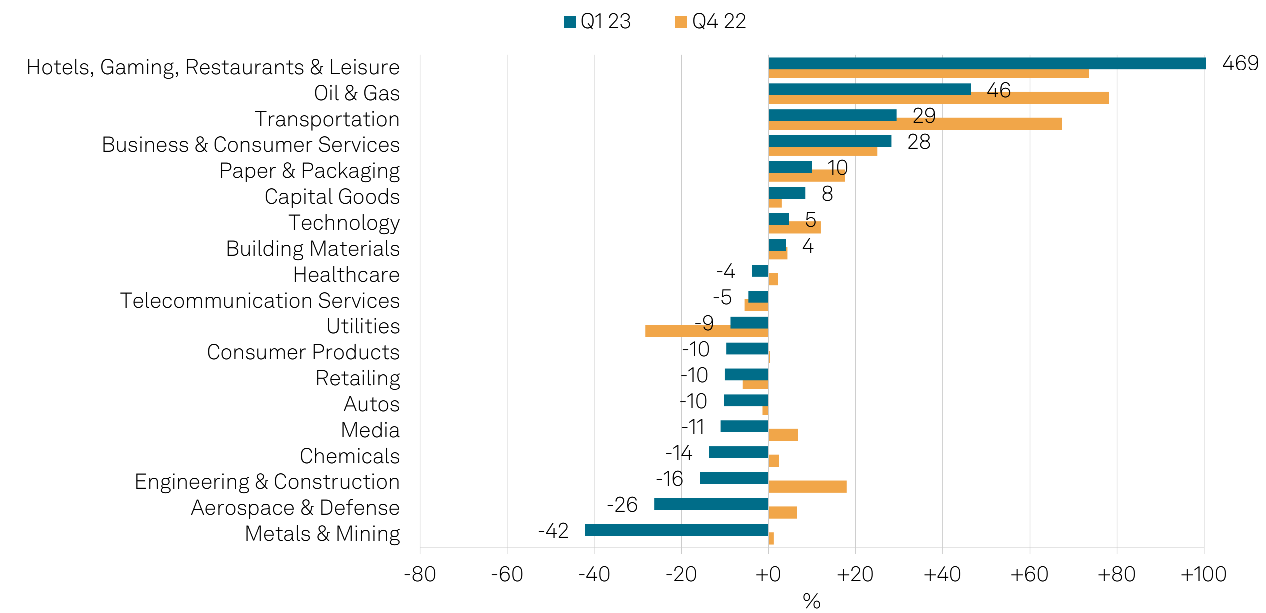
The positive rating action trend in investment grade gained momentum in Q2 2023. In the past three months, there were 23 IG upgrades, including five rising stars. Some upgrades were linked to the energy transition or sustainability megatrends, particularly among capital goods, chemicals, and building materials companies. Other companies reported healthy credit metrics as they succeeded in expanding margins through aggressive price increases. In other sectors, such as auto OEMs, issuers benefitted from repositioning to higher value-added products enhanced by new technologies. Some IG companies communicated a reduction in their financial risk tolerance--also a supporting factor for some upgrades.

Over the coming months, we expect that the effects of the economic slowdown and restrictive measures adopted by the ECB and the BoE will dampen demand and companies' earnings, especially in sectors most exposed to the change in consumer disposable incomes, such as leisure, retail, and consumer goods. However, given many issuers have headroom in credit metrics, and those with lower headroom have the possibility to scale back shareholder remuneration, we do not envisage a significant increase in negative IG rating actions.

Chart 15

EBITDA growth momentum is fading apart from in the leisure sector (for now)

Trailing 4-quarter, year over year



Measured in U.S. dollars, at historic rates. Only includes companies reporting quarterly. Latest quarter only includes companies that have reported Q1 2023 results. Source: S&P Capital IQ, S&P Global Ratings. Data to June 20, 2023.

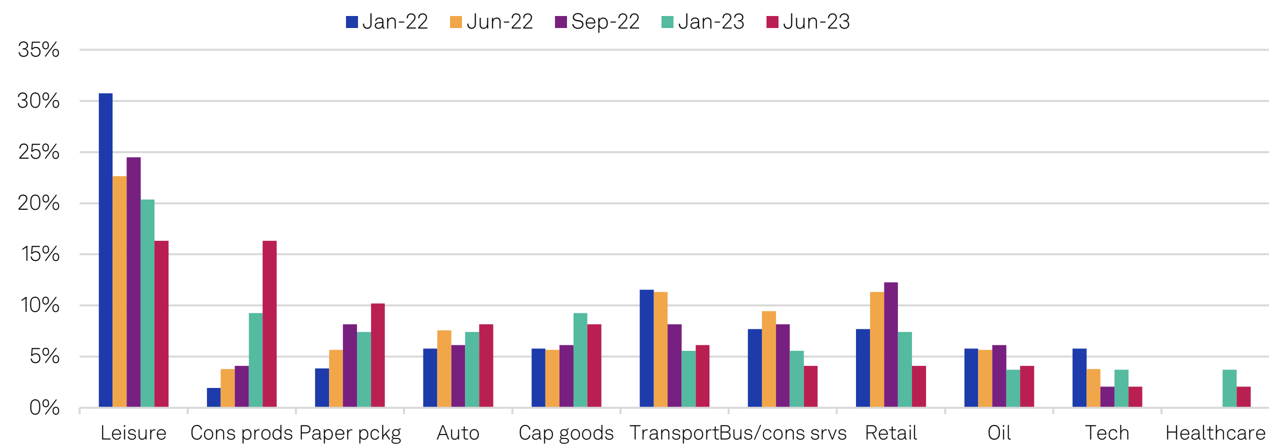
Leisure, travel, and entertainment are still benefitting from the post COVID tailwind effect, but we expect this to fade over the next few months (see chart 15). Demand for products and services related to leisure and entertainment has maintained good momentum in 2023, and the summer season is expected to be very positive. This has triggered upgrades for many companies, with airlines the highest-profile examples. Most issuers have been upgraded recently, including Ryanair Holdings PLC (BBB+/Stable/--), easyJet PLC (BBB/Stable/--), International Consolidated Airlines Group S.A. (BB+/Stable/--), British Airways PLC (BB+/Stable/--), and Deutsche Lufthansa AG (BB+/Positive/B), now a potential rising star. Still, only the Ryanair rating has returned to its pre-pandemic level. While we assume demand for leisure and travel will soften later in the year, the airline sector may hold up quite well, as air passenger traffic is still below pre-pandemic levels; airfares have increased a lot; and passengers' disposable incomes tend to be higher than the average of the broader consumer universe.

The corporate sector is entering an EBITDA recession, according to latest quarterly results (see "Corporate Results Roundup Q1 2023," May 24, 2023), with growth slowing rapidly in performing sectors, such as oil & gas, leisure, and transportation. This can be attributed to cyclical factors, including the waning impact of rising commodity prices and recovery of sectors deeply affected by the pandemic. These significant drivers of EBITDA growth in recent years are gradually losing their potency, leaving us uncertain about the next sources of expansion.

An absence of clear catalysts raises concerns about the sustainability of EBITDA growth, although those related to energy transition, sustainability, and energy saving are expected to persist. Already, we are observing a gradual erosion of margins, which we anticipate will intensify as spending slows, supply-demand imbalances normalize, and inflationary pressures abate. We also see a significant risk of sliding into a recession in the eurozone around the turn of the year. Nevertheless, the extraordinary challenges experienced in recent years, including the far-reaching impact of the COVID-19 pandemic, escalating geopolitical tensions, and the surge in interest rates have instilled a sense of prudence, properly reflecting the risks ahead while providing a cushion to support ratings' stability in the event of further economic disruption.

Chart 16

Changing trends in sector distribution within CCC/CC ratings categories 2022-2023



Source: S&P Global Ratings.

Recent rating activity has altered the composition of the 'CCC' and lower rated portfolio (see chart 16). In the past 18 months, the percentage of companies rated 'CCC', 'CC', and 'C' in the EMEA nonfinancial corporate rated portfolio has been stable at around 5% of all rated entities but the composition has evolved. In January 2022, media, leisure, and entertainment represented about one-third of this category. Many companies suffered the effects of lockdowns and limitations to mobility, and the post-COVID recovery was slow to arrive. Even before the pandemic, the rating distribution in this sector was skewed toward SG, and ability to withstand adverse conditions was limited. Today, this sector makes up only about 15% of entities rated 'CCC' and below. In contrast, the consumer goods sector, that was almost completely unrepresented in January 2022, now accounts for around 8%. Many were rated previously in the 'B' category and came under ratings pressure as they were unable to fully pass cost increases through to their customers, especially those with limited product offerings compared to larger competitors. In general, we expect more vulnerable companies will struggle with higher financing costs and lower funding availability.

Key Risks

Financial market turbulence that restricted lower rated entities from accessing financing could trigger liquidity squeezes and push debt financing costs to unsustainable levels.

Weaker-than-expected economic conditions. Slower demand could hit volume, revenues, and operating margins, putting pressure on credit ratios and ratings, especially lower rated entities.

Sovereigns

- Most developed sovereigns are relying on inflation and modest growth to lower net debt to GDP.
- Somewhat accommodative fiscal policy leaves little room to address another fiscal shock.

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Key Developments

With the exception of Canada, South Korea, and Switzerland, no major developed government is set to operate an underlying fiscal surplus this year (see chart 17). The largest global sovereign issuers are likely to rely on the only very gradually fading tailwinds of high inflation and modest growth to reduce their net debt-to-GDP ratios. To its credit, Italy is the one large highly indebted sovereign in Europe likely to operate close to a balanced underlying primary (i.e., the fiscal position excluding interest payments) budget during 2023. However, notably in Italy's case, by 2026 the "snowball effect", which measures the impact on the national debt due to the difference between nominal GDP growth and the average cost of debt, is projected to be negative (see chart 18). This means Italy's debt dynamics will require it to operate underlying budgetary surpluses to continue to reduce its debt-to-GDP burden.

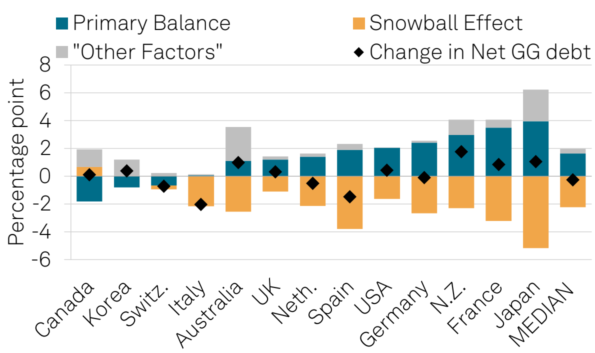
Other highly indebted larger eurozone sovereigns--particularly France--are taking a more relaxed approach to fiscal consolidation, relying upon still high inflation, better than expected economic growth, and the delayed pass-through of higher market interest rates into their average cost of debt (thanks to long-dated debt profiles) to argue in favor of gradual back-loaded fiscal consolidation. Given very strong tax receipts in the first part of 2023 across VAT, personal and corporate taxes in line or higher-than-core inflation, most European governments remain confident that they will outperform their budgetary targets for 2023.

The worry is that few governments today have sufficient fiscal space to deal with yet another fiscal shock. An additional concern is that underlying fiscal policy remains somewhat accommodative, potentially forcing the ECB to do more monetary tightening than it might prefer.

What is likely to break through this fiscal complacency across much of Europe? In 2024, the EU will re-apply a version of the Stability and Growth Pact budgetary rules, even though it appears increasingly possible there will be no final agreement on a new set of permanent rules along the lines of the European Commission's (EC) recent proposals. Nevertheless, some parameters seem clear. The Treaty reference values remain in place: 3% of GDP for public deficit and 60% of GDP for public debt. For those EU members that do not comply with these targets (a majority), the EC will require fiscal plans that aim to require a minimum fiscal adjustment of 0.5% of GDP per year.

Chart 17

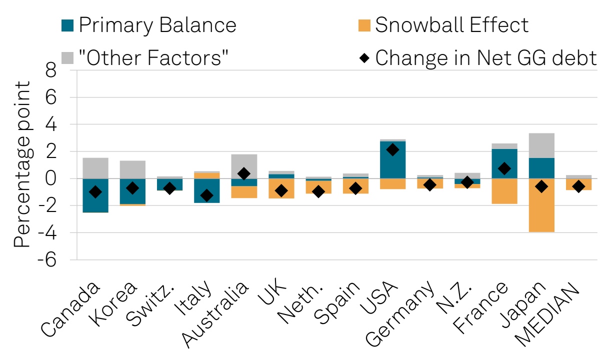
2023 - Contributions to change in net GG debt



Data as of May 31, 2023. Source: S&P Global Ratings.

Chart 18

2026 - Contributions to change in net GG debt



Source: S&P Global Ratings.

Structured Finance

- Severe delinquencies for mortgage pools backing prime and owner-occupied RMBS that we rate have not yet increased significantly, despite rises in the cost of living and interest rates.
- Across all the European CLOs that we rate, the median 'CCC' exposure has increased from a trough of 3.2% in September 2022 to 4.8% by the end of May 2023.
- We lowered only 1.4% of our European structured finance ratings over the past 12 months, while we raised 7.9%.

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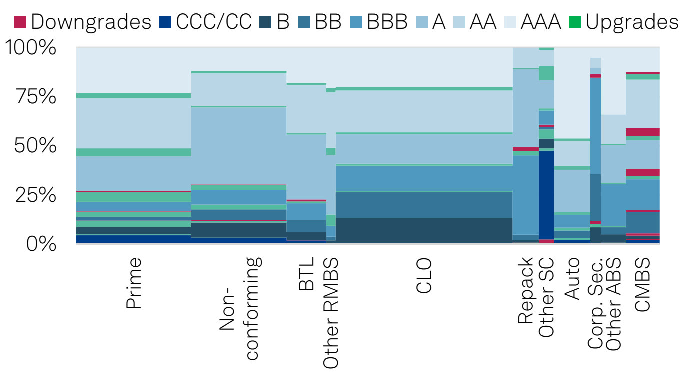
Key Developments

Across European structured finance, most recent rating actions have been upgrades, and we lowered only 1.4% of our ratings in the sector in the 12 months to end-May 2023 (see chart 19). Weakness has largely been confined to commercial mortgage-backed securities (CMBS), with most downgrades in transactions backed by U.K. shopping malls. Over the same period, there have been very few negative rating actions in the major consumer-backed sectors, such as residential mortgage-backed securities (RMBS), although the cost-of-living squeeze and rising interest rates are putting some borrowers under pressure. European leveraged loan collateralized loan obligations (CLOs) have also seen few rating actions in the past year.

Chart 19

Most recent rating actions have been upgrades

European structured finance ratings heatmap

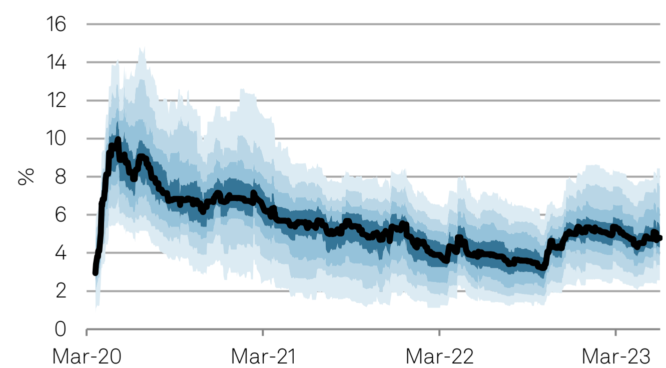


Based on cumulative count of rating actions between June 1, 2022 and May 31, 2023. BTL--Buy-to-let. SC--Structured credit. Source: S&P Global Ratings.

Chart 20

CLO pool credit quality has deteriorated marginally

European CLO exposure to 'CCC'-rated corporates



Solid line is the median, with each band representing a decile, from 10th to 90th percentiles. Estimates based on portfolios from latest available trustee reports, with ratings updated. Source: S&P Global Ratings.

European investor-placed securitization issuance has begun to pick up after a subdued start to the year, although weak activity in the leveraged loan CLO sector means that aggregate volumes for the first five months of 2023 were still down by 20%, at €36 billion. By contrast, benchmark covered bond issuance remains very strong, reaching nearly €107 billion by the end of May--up more than 25% on the equivalent period in 2022. Normalizing monetary policy has supported covered bond supply as some issuers seek to replace funding they drew down under central bank schemes, such as the ECB's TLTROs. Similarly, while securitization volumes are muted in absolute terms, bank-originated issuance is a potential bright spot, after a decade of stagnation. This type of supply represents 27% of Issuance volumes so far in 2023, compared with only 14% in the first five months of 2022.

Key Risks

The leveraged loan CLO sector is the largest European securitization asset class backed by corporate credit, and emerging corporate risks could hypothetically hurt CLO performance. We are monitoring for any knock-on effects to CLO ratings from a deteriorating credit profile among the underlying corporate obligors. One closely watched metric in the CLO sector is the proportion of obligors in transactions' collateral pools that are rated in the 'CCC' category or below. Across all the European CLOs that we rate, the median 'CCC' exposure has increased from a trough of 3.2% in September 2022 to 4.8% by the end of May, with some transactions seeing a figure of more than 9% (see chart 20). However, this is still far from the peak median of 10%, reached early during the onset of the COVID-19 pandemic in May 2020.

Looking at the trend in the 12-month default rate for European speculative-grade corporates, this has been rising, recently crossing above the 15-year average of 2.6%. We expect this default rate to continue heading higher, to about 3.6% by early 2024, although this would still be close to the steady-state level of the pre-pandemic era. That said, while CLO portfolio credit quality is gradually deteriorating, the transactions benefit from significant obligor and sector diversification in the underlying loan portfolios, and initial portfolio selection and ongoing active portfolio management also allow some risk mitigation. During the COVID-19 pandemic, spikes in both corporate default rates and CLOs' exposures to 'CCC' credits were not sufficient to cause material CLO downgrades.

Market interest rate benchmarks remain elevated, putting further pressure on some household borrowers whose loans back European structured finance transactions. In general, severe delinquencies reported for the mortgage pools backing prime and owner-occupied RMBS that we rate have not yet increased significantly, despite rises in the cost of living and interest rates. Even if they did, the ratings on senior RMBS tranches are likely well-protected by structural features. For example, we simulated the impact of increased 90+ day arrears and house price declines on a sample of 60 RMBS that we rate in the major continental European markets. Even under increased stress, 'AAA'-rated tranches demonstrate significant stability, with no more than 15% of ratings lowered—and only by one or two notches—in even the most stressful scenario of an eight-percentage-point rise in 90+ day arrears. Full details of the scenario analysis are available through our interactive dashboard, by clicking here.

In the CMBS sector, some underlying real estate markets are suffering from longer-term secular trends in addition to the higher rate environment. For example, European and U.K. office occupational demand has been dwindling as hybrid and working from home becomes the new way of work. Office values are also feeling the pressure from rising interest and cap rates. We conducted a scenario analysis which shows that 'AAA' and 'AA' rated office CMBS tranches could withstand increasing vacancy rates with relatively minimal downgrades, although lower-rated tranches are more vulnerable to stress. For example, if vacancy rates were to increase by 10%, the office CMBS tranches that we rate 'AAA' would see an average 0.7-notch downgrade, compared with more than two notches for 'BBB' rated tranches.

International Public Finance

- European local and regional governments (LRG) face difficult economic times, but from a position of financial strength.
- They are largely sticking to tight financial policies amid the economic slowdown and rising interest rates, which might result in lower infrastructure investments.
- U.K. social housing providers are responding to elevated interest rates and low rent increases by trimming their development programs. Management's ability to respond to financial challenges in a timely manner has become one of the main factors differentiating credit quality in the sector.

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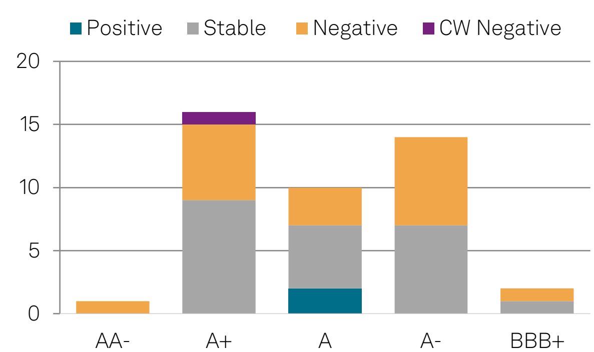
Key Developments

The ability to adequately respond to a tougher economic environment is differentiating the credit quality of the U.K. social housing providers. On the one side, tighter cost control and a severe moderation of development plans have resulted in a few positive outlooks for 'A' rated entities. Conversely, the number of ratings in the 'BBB' category has been growing, reflecting challenges in timely adjustment to higher inflation and interest rates (see chart 21).

In our view, European LRGs remain resilient to the ongoing economic challenges. Many governments entered 2023 exhibiting a strong budgetary performance boosted by economic recovery and high inflation. As a result, they have created financial buffers that would allow them to absorb additional spending and slower revenue growth without material weakening of their credit profiles. Most LRG ratings have stable outlooks and the number of positive outlooks equals that of negative outlooks for the second year in a row (see chart 22).

Chart 21

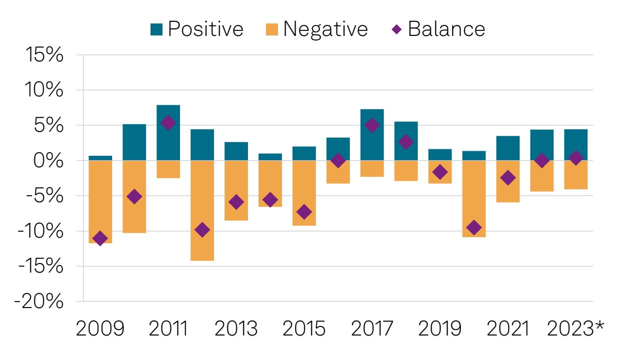
Ratings on U.K. social housing providers are diverging



Source: S&P Global Ratings.

Chart 22

Most EMEA LRG ratings have stable outlooks



*--YTD- year-to-date. Data for all rated LRGs, including confidential ratings.
Source: S&P Global Ratings.

LRGs, especially those in large metropolitan areas, are exposed to potential volatility in the real estate sector. However, the impact on budget revenues may only materialize over time. In most cases, governments' collection of property taxes is not linked directly to market prices.

Key Risks

- **Higher-for-longer interest rates could further constrain investments of LRGs and public sector enterprises.** Lower public investments might complicate the task of spurring economic growth and improving efficiency, including carbon footprints, in public transport and housing.
- **Constraints on public-sector enterprises to raise fees.** The cost-of-living crisis could limit the ability to cover rising costs by increasing fees in line with inflation.

Insurance

- Quarterly financial updates confirmed robust results from primary and reinsurers across Europe. Despite a few outliers, profitability is holding up well.
- Few 2022 unrealized losses have been reversed but, conversely, we also observed very limited impairments. Our concerns around illiquid investments in private credit, private equity, and real estate, however, are more long term into 2024/2025.
- Ratings are robust, as indicated by mostly stable outlooks, with a few exceptions.

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Key Developments

European primary insurers reported robust quarterly results, with stable or slightly lower insurance margins in non-life, and muted growth for life insurers without any materially increased investment impairments. Major European economies are expected to show muted growth, including the risks of a shallow recession. This is dampening European insurers' top lines, despite non-life insurers still raising premium rates to offset claims inflation, while the pace might be slower than before. We note that claims inflation in many regions is in excess of CPI, e.g., where automobile parts saw disproportionate price increases. While we expect some impairments to come from life insurers' illiquid investments in real estate, private credit, and private equity, this might not materialize until 2024/2025. Our current expectation is that those investment impairments might be limited and offset by higher reinvestment rates given higher interest rates.

Reinsurers continued renewals in a hard market, raising premium rates materially across lines and regions. The sector trend remains negative, as return on capital barely exceeds the cost of capital, although the hard market might have a positive impact over time. We will therefore closely track upcoming renewal rounds and operating performance in quarterly financial reports.

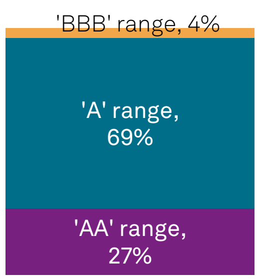
Insurers reporting under IFRS transitioned to IFRS 17, and IFRS 9. European insurers have been late with communication around IFRS 17, providing some high-level insights as late as year-end 2022. First-quarter results showed that some used transitional options to tweak their earlier indications to align somewhat to developing market standards. We note that the level of complexity, and some inconsistencies in legacy metrics being reported, e.g., premiums and combined ratio, is a challenge to users of insurers' financial reporting. However, IFRS 17 might provide more economic insight compared to retired IFRS 4.

Key Risks

- Impairment of illiquid investments in real estate, private credit, and private equity.
- Ongoing high inflation causing non-life insurers to increase long-tail lines reserves

Chart 23

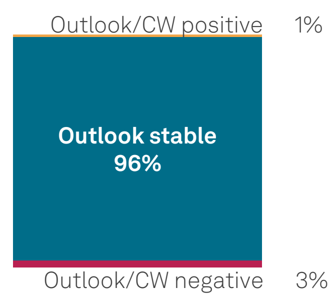
EMEA insurers' rating distribution



Data as of June 15, 2023. Source: S&P Global Ratings.

Chart 24

EMEA insurers' outlook distribution



CW--CreditWatch. Data as of June 15, 2023. Source: S&P Global Ratings.

Related Research

- Credit Conditions North America Q3 2023: Risks vs. Resilience, June 27, 2023
- Credit Conditions Asia-Pacific Q3 2023: China Grapples With An Uneven Recovery, June 27, 2023
- Credit Conditions EM Q3 2023: Inflation Peaked, Risks Remain, June 27, 2023
- Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer, June 26, 2023
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- Economic Outlook U.K. Q3 2023: Higher Rates Start To Bite, June 26, 2023
- Economic Outlook Asia-Pacific Q3 2023: Domestic Demand, Inflation Relief Support Asia's Outlook, June 26, 2023
- EMEA Real Estate Companies--Strongest To Weakest, June 14, 2023
- European Structured Finance Weathers All The Storms, June 12, 2023
- Global Nonfinancial Corporates: Interest-Rate Costs Start To Bite, June 1, 2023
- Corporate Results Roundup Q1 2023: Beating Expectations, But EBITDA In Recession, May 24, 2023
- EMEA Financial Institutions Monitor 2Q2023: Steering Through Volatility, May 24, 2023

Appendix 1: Q3 2023 Economic Data and Forecast Summaries

Table 1

Real GDP (%)

	Eurozone.	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Switz.	U.K.
2021	5.3	2.6	6.4	7.0	5.5	4.9	6.3	4.2	7.6
2022	3.6	1.9	2.5	3.8	5.5	4.5	3.2	2.1	4.1
2023f	0.6	-0.1	0.7	1.0	1.6	0.7	0.8	0.8	0.0
2024f	0.9	0.8	0.9	0.6	1.3	1.1	1.0	1.3	0.9
2025f	1.6	1.6	1.5	1.3	2.3	1.7	1.9	1.4	1.6
2026f	1.6	1.7	1.4	1.3	2.2	1.7	1.4	1.5	1.7

Table 2

CPI inflation (%)

	Eurozone.	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Switz.	U.K.
2021	2.6	3.2	2.1	1.9	3.0	2.8	3.2	0.6	2.6
2022	8.4	8.7	5.9	8.7	8.3	11.6	10.3	2.8	9.1
2023f	5.8	6.5	5.6	6.5	4.1	4.8	3.8	2.5	7.0
2024f	2.7	2.9	2.4	2.3	3.0	3.3	2.6	1.6	2.4
2025f	2.0	2.0	2.0	2.1	1.9	2.3	1.9	1.5	1.6
2026f	1.8	1.6	1.9	2.0	1.9	2.3	1.9	1.4	1.8

Table 3

Unemployment rate (%)

	Eurozone.	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Switz.	U.K.
2021	7.7	3.6	7.8	9.5	14.8	4.2	6.3	5.1	4.5
2022	6.7	3.1	7.3	8.1	12.9	3.5	5.6	4.3	3.7
2023f	6.7	3.1	7.2	7.8	12.6	3.5	5.7	4.1	4.2
2024f	6.9	3.2	7.5	8.0	12.8	3.7	5.8	4.2	4.6
2025f	6.7	3.2	7.5	8.0	12.7	3.6	5.7	3.9	4.3
2026f	6.6	3.0	7.2	7.9	12.7	3.6	5.6	3.9	4.2

Table 4

10y Government Bond Yields (% annual average)

	Eurozone.	Ger.	Fra.	Ita.	Spa.	Neth.	Belg.	Switz.	U.K.
2021	0.2	-0.3	-0.1	0.8	0.4	-0.2	0.0	-0.3	0.7
2022	2.0	1.2	1.5	3.2	2.2	1.4	1.7	0.8	2.3
2023f	3.4	2.6	3.1	4.3	3.7	2.9	3.1	1.3	4.1
2024f	3.7	2.9	3.4	4.7	4.3	3.2	3.4	1.6	3.9
2025f	3.6	2.7	3.2	4.6	4.1	3.0	3.2	1.5	3.3
2026f	3.4	2.6	3.0	4.6	3.9	2.9	3.0	1.6	3.2

f--S&P Global Ratings forecast, annual averages. Source: S&P Global Ratings Research.

Table 5

Exchange rates (annual average)

	---- Eurozone ----		---- U.K.----		---- Switzerland ----	
	US$/€	€/US$	US$/£	€/£	SFr/US$	SFr/€
2021	1.18	0.85	1.38	1.16	0.91	1.08
2022	1.05	0.95	1.23	1.17	0.96	1.00
2023f	1.08	0.93	1.24	1.15	0.92	0.99
2024f	1.11	0.9	1.30	1.17	0.92	1.02
2025f	1.16	0.86	1.37	1.18	0.94	1.08
2026f	1.17	0.85	1.38	1.18	0.95	1.11

f--S&P Global Ratings forecast, annual averages. Source: S&P Global Ratings Research.

Table 6

Policy Interest Rates (% end-of-year)

	----Eurozone (ECB)----		U.K. (BoE)	Switzerland (SNB)
Policy Rates	**Refi Rate**	**Deposit Rate**	**Bank Rate**	**Policy Rate**
2021	0.00	-0.50	0.25	-0.75
2022	2.50	2.00	3.50	1.00
2023f	4.25	3.75	5.25	1.75
2024f	3.50	3.00	4.25	1.00
2025f	2.50	2.00	2.50	1.00
2026f	2.50	2.00	2.50	1.00

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