

Adapting To New Realities

Nov. 28, 2023

This report does not constitute a rating action.

Key Takeaways

- 2024 looks set to be a year of adaptation to the hangovers from high inflation, high rates, and high debt, against a more uncertain and volatile geopolitical backdrop.
- Geopolitical conflicts spilling over to Europe, a sharp rise in unemployment dragging Europe into recession, and a protracted period of higher rates exposing financial vulnerabilities are the key risks.

Editor's Note: S&P Global Ratings' Europe Credit Conditions Committee took place on Nov. 21, 2023

We expect corporate resilience to gradually erode as slow growth and higher funding costs squeeze earnings and free cash flow. We anticipate higher financing costs will become an increasing burden as 2025 and 2026 maturities are addressed, bringing coverage ratios back into focus and putting financial policies (especially discretionary expenditure including capex) under greater scrutiny. So, for lower rated nonfinancial corporates, generating cash flow, protecting liquidity, and managing down debt levels will be important to underpin debt sustainability and credit quality. Vulnerable segments include commercial real estate (CRE; mainly office), where there is a potential €93 billion funding gap between 2023-2026; and lower rated corporate sectors, particularly consumer products, media and entertainment, chemicals, and capital goods sectors that comprise about 50% of entities rated in the 'CCC/CC' categories. Given the demonstrated resilience of corporates to recent systemic shocks, we characterize the outlook as one of gradual deterioration in credit quality, reflected in the default rate ticking up to 3.75% by September 2024 from 2.9% currently. Credit deterioration among lower-rated corporates would put potential downward rating pressure on CLOs backed by leveraged loans.

Ratings prospects for European banks remain broadly stable, with earnings able to cover a normalization in credit costs comfortably. Strong European labor markets should underpin the performance of the residential mortgage market (albeit with some potential issues around legacy buy-to-let and adverse credit borrowers evident in some RMBS transactions). However, unsecured consumer borrowers will come under greater pressure, similar to corporate borrowers (primarily SMEs), owing to tighter debt and affordability metrics. Restrictive financing conditions are likely to continue to weigh on valuations in the CRE segment and expose banks to losses, all the more so in systems such as Germany, the Netherlands, and the Nordics that have a higher-than-average share of customer loans to CRE. However, EBA stress tests point to potential credit losses being contained at about 2% over a three-year period, even in a very adverse scenario.

Slow growth, higher cost of funding, and weakened public finances will increase pressures to restore greater fiscal discipline. 2024 will see the reimposition of the EU's stability and growth pact in some form. This, together with the higher cost of debt service, slow growth, and slowing inflation, will induce European governments to adopt more restrictive fiscal policies. Further pressure comes from central banks now shrinking their balance sheets significantly, requiring increased gross funding to be raised from public markets. Government interest payments will rise, in general. But the overall increase will be gradual due to the long-dated average maturity of sovereign debt and the relatively low average rate of interest on outstanding debt.

Geopolitics is a key downside risk. The crisis in the Middle East threatens to undermine the strength and cohesion of the Western Alliance that has coalesced in support of Ukraine. And that is even before the U.S. election next year that could see the Republican Party readopting an isolationist policy to the detriment of NATO. This could be unnerving for governments, businesses, and citizens in Europe if security concerns eclipse other priorities.

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Top European Risks

Escalating geopolitical conflicts could spill over to Europe

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

With two wars now being conducted in the region, geopolitical risk is heightened, with touchpoints ranging from potential military escalation in both theaters to protests or outbreaks of violence that could be politically destabilizing across the Middle East and beyond, especially where migration has become a divisive political issue. To varying degrees, this runs the risk of disrupting supply chains and triggering extreme flight to quality/risk aversion, excessive volatility, and the freezing up of some financial markets (at least temporarily).

Recession in Europe remains a downside risk

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

With the region already experiencing a borderline recession, the risk is that a combination of high rates, still elevated energy prices, weaker business and consumer confidence, and a slowing fiscal impulse translates into a more extended downturn, with rising unemployment. Given elevated public debt, few European governments have sufficient fiscal space to launch contra-cyclical support for the economy, should things get worse.

Tighter financing conditions will test financial vulnerabilities

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

High short-term nominal interest rates in restrictive territory and, as headline inflation subsides, an extended period of positive real rates could expose financial vulnerabilities for issuers that are finding access to financing restricted and the cost of debt service prohibitive. Tightening credit standards for bank lending and central banks aiming to shrink their balance sheets could exacerbate the situation. This is a particular credit challenge for companies needing to refinance and generating minimal FOCF where interest coverage ratios are falling below 2x.

Real estate downturn heightens risk of spillovers to the broader economy

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

High interest rates, declining demand in some sectors, and falling valuations continue to pressure credit quality in European real estate. A clear risk is that interest rates and associated financing costs could remain at their current high levels over an extended period. For residential property, higher mortgage rates and softening prices feed through to existing borrowers and new transactions. These pressures could spill over to the broader economy, transmitted through negative effects on consumer confidence, spending, and employment (especially in the construction sector), as well as damaging the asset quality of European banks more than anticipated.

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

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

Further increases in trade tensions and protectionist sentiment, or any unexpectedly sharp economic slowdown in China, would be detrimental to the operating performance of European companies with material country risk exposure to China.

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 tension between the widening stretch goal of reducing net emissions in the EU by 57% by 2030 and the challenges of implementing all aspects of the European Green Deal raises the risk of abrupt, and potentially contradictory, changes in climate policy that could disrupt industries and business models, notably in the automotive, building, cement, steel, chemicals, transportation, and utilities sectors.

Cyber risks may rise

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

The pace of digitalization, including artificial intelligence, in the global economy, and heightened geopolitical discord in EMEA, 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.

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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