S&P Global Ratings

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European Corporate Credit Mid-Year Outlook:

The sense of an ending

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Key Takeaways

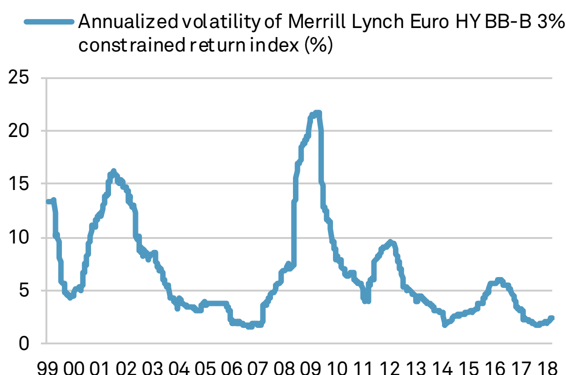
- **When the cycle turns:** With economic growth past the peak, monetary policy normalizing, and risk assets priced for perfection, concerns about a turn in the credit cycle are growing.
- **European exceptionalism:** While Europe's credit impulse is slowing, particularly with the end of QE in December, the region remains arguably nearer mid-cycle than late. Credit fundamentals are strong: cash flow is expanding, EBITDA margins improving, debt metrics easing, and monetary tightening likely to be slow and cautious. In our base case, we expect European non-financial corporate default rates to remain below 3% over the next year.
- **Political fears:** More immediate regional worries are the increasing possibility of a disruptive Brexit and of political ruptures within the Eurozone, particularly in relation to Italy.
- **No immunity:** While U.S. and eurozone yield curves are less closely linked than they were, European asset markets would not be immune from a repricing of U.S. risk assets, nor a broader crisis in emerging markets, especially one close to home in the case of Turkey. Moreover, European autos remain front and center in terms of the risk of a broader escalation of trade tensions between the U.S. and the rest of the world.

Strong market fundamentals are allowing markets to ignore political volatility

European credit markets remain remarkably calm; volatility is still exceptionally low (see chart 1) and spreads are tight and locked in a narrow range (see chart 2). This apparent sangfroid might seem surprising in the face of gathering trade conflicts, uncertainty around Brexit, crises in some emerging markets, and what appear to be profound changes to the multilateral systems and power balances that have held sway in the post-war world. Yet in market terms, the situation is less surprising. The sound and fury of politics may signify something, but it is far from clear what. Meanwhile, market fundamentals – cash flow, interest rates, debt metrics, and availability of financing – are all still healthy as far as European non-financial companies go.

Chart 1

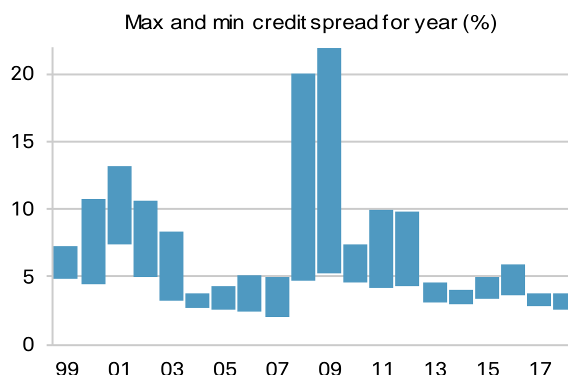
European credit index volatility remains exceptionally low...



Source: Bank of America Merrill Lynch, Thomson Reuters Datastream, S&P Global Ratings

Chart 2

...and credit spreads (BofAML Euro High Yield BB/B constrained) remain tight

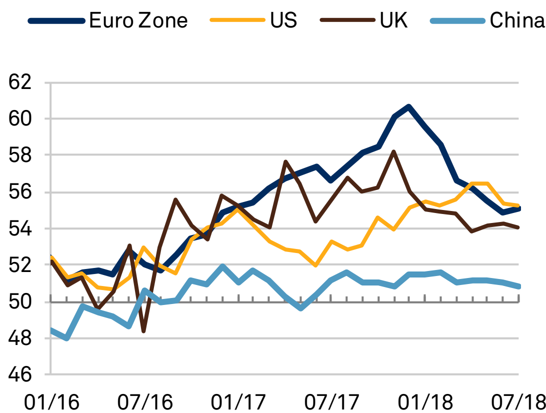


Source: Bank of America Merrill Lynch, Thomson Reuters Datastream, S&P Global Ratings

Economic growth and monetary policy remain strongly supportive, and while both have passed the point of maximum support for markets, S&P Global Ratings does not expect strongly adverse developments in these key drivers for the next year at least. Global manufacturing PMIs are past their peak, but they continue to point to expansion across all regions (see chart 3). We do not expect eurozone interest rates to rise until third-quarter 2019, and while European Central Bank (ECB) net asset purchases will end in December, we expect the central bank to continue to reinvest proceeds from maturing securities until the end of 2020, helping keep yields low. The formal ending of quantitative easing is likely to present a challenge to market sentiment given the importance that it has had for liquidity – directly or indirectly (see chart 4) in credit markets and helping keep risk premiums low. Nevertheless, policy normalization is also an important positive milestone in achieving a return to more normal financial conditions a decade after the last financial crisis.

Chart 3

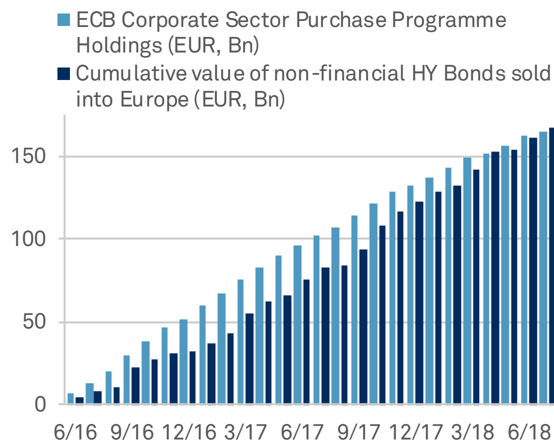
Global Manufacturing PMIs past the peak but still pointing to expansion



Source: Markit, Thomson Reuters Datastream

Chart 4

Cumulative ECB Corporate Sector Purchases and HY non-financial bond issuance into Europe since June 2016

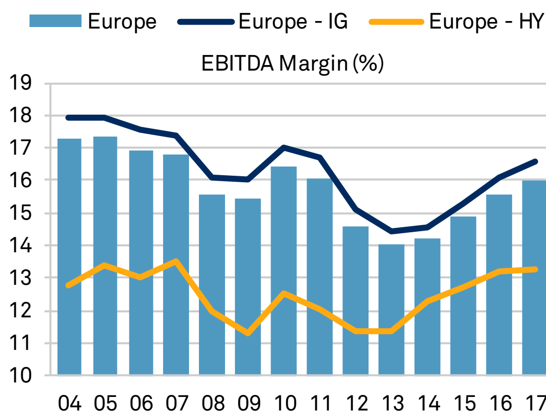


Source: LCD, an offering of S&P Global Market Intelligence, European Central Bank, S&P Global Ratings

Positive economic momentum has been reflected in corporate results, with European non-financial companies delivering positive EBITDA growth, EBITDA margins recovering (see chart 5), and consequently debt-to-EBITDA multiples declining (see chart 6).

Chart 5

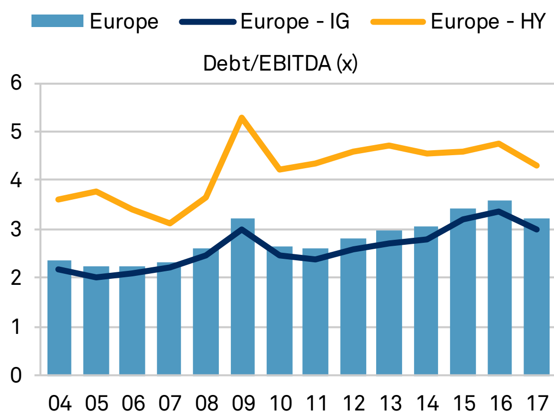
European EBITDA margins continue to improve...



Source: S&P Global Ratings

Chart 6

...helping reduce Debt/EBITDA multiples



Source: S&P Global Ratings

The impact of a globally synchronized economic upswing has also been felt in ratings trends, with the net outlook bias for Western Europe (the percentage of ratings with positive outlooks less the percentage of ratings with negative outlooks) at -3.5% at the end of the first-half, close to the top of

its historical range. In sector terms, most cyclically-sensitive industries have seen improving outlook biases (see table 1). Areas under ratings pressure reflect particular industry pressures and disruption – the extreme pressures on retailers brought about by internet shopping, online delivery, and price competition, for example – rather than broader cyclical challenges.

Table 1

European Non-Financial Corporate Net Outlook Bias by Industry

	No. of Entities	Q4 12	Q4 13	Q4 14	Q4 15	Q4 16	Q4 17	Q1 18	Q2 18
Aerospace & Defense	9	+20.0	+16.7	-16.7	+0.0	-33.3	-37.5	-33.3	-22.2
Building Materials	25	-9.1	-15.4	+26.7	+6.3	+5.6	-28.6	-28.6	-20.0
Retailing	67	-13.0	-4.0	-3.0	-10.0	-2.1	-4.7	-6.3	-17.9
Business & Consumer Services	90	+10.5	+10.0	-2.5	-5.8	-3.2	-10.0	-4.7	-13.3
Media	45	+0.0	+5.0	+0.0	-6.7	+2.8	-10.3	-7.3	-11.1
Healthcare	65	+0.0	+4.3	-3.2	-2.3	-3.8	-16.9	-19.7	-10.8
Engineering & Construction	11	-33.3	-20.0	+12.5	-25.0	-22.2	-45.5	-45.5	-9.1
Consumer Products	72	-3.2	-7.5	-9.3	-6.7	+1.8	+4.6	+0.0	-5.6
Utilities	93	-24.2	-17.4	-5.6	+0.0	-8.0	-10.0	-9.9	-4.3
Hotels Restaurants & Leisure	39	-30.0	-7.1	+16.7	-8.3	+3.3	+0.0	+2.8	-2.6
Telecommunication Services	57	-3.3	-11.4	-12.8	+2.2	+8.5	+2.0	+0.0	-1.8
Capital Goods	67	+4.0	-2.9	-5.0	-15.9	-28.3	-5.2	-4.7	+0.0
Chemicals	48	+0.0	-4.0	-6.7	-19.4	-11.8	-6.7	-6.5	+0.0
Oil & Gas	31	-20.0	+0.0	-28.0	-56.0	-48.1	-13.8	+0.0	+0.0
Technology	47	-10.0	-9.1	+5.9	+8.7	+10.0	+7.1	+6.8	+4.3
Paper & Packaging	30	+0.0	+0.0	+0.0	+0.0	+28.6	+17.4	+16.0	+6.7
Metals & Mining	26	-58.8	-55.6	-20.0	-47.4	+0.0	+8.3	+3.8	+7.7
Real Estate	49	-6.3	+9.1	+4.0	-10.0	+6.1	+8.7	+4.3	+10.2
Autos	32	+15.8	+10.0	+4.2	-8.0	+7.4	+20.7	+13.3	+12.5
Transportation	25	-7.7	-15.4	-5.6	+5.3	-19.0	+0.0	+0.0	+20.0
Western Europe	**928**	**-10.9**	**-7.1**	**-4.0**	**-8.7**	**-4.4**	**-4.2**	**-4.3**	**-3.5**

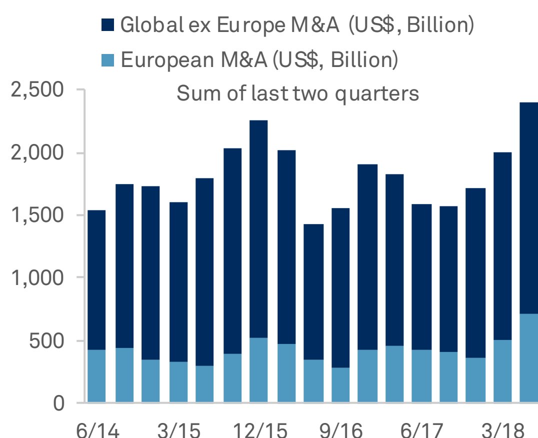
Source: S&P Global Ratings

M&A booms, but poses risks to ratings

Market sentiment has also been buoyed by a global surge in M&A activity (see chart 7), in which European companies have played a full part (see chart 8). This will present ratings risk over the next few years, given that high valuations currently create the risk of overpaying, perennial execution risk in terms of delivering assumed savings and synergies and the fact that much M&A activity is coming as a response to challenges to the operating environment and business models. It is telling, for example, that 24% of European M&A activity over the past six months has been in the consumer sector (see chart 9).

Chart 7

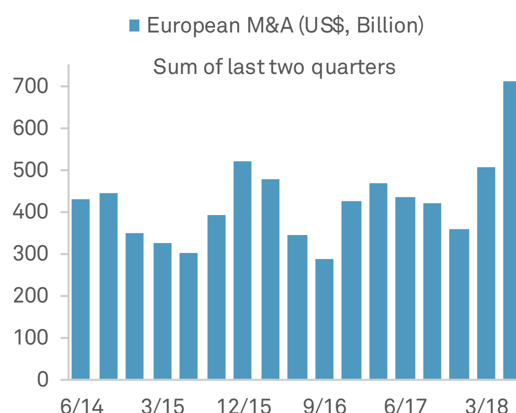
Global M&A by transaction value



Source: S&P Global Market Intelligence

Chart 8

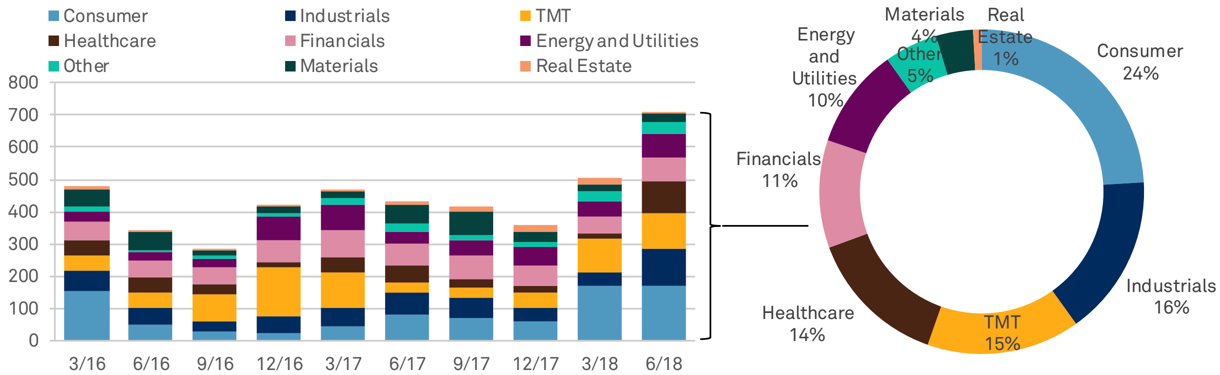
European M&A by transaction value



Source: S&P Global Market Intelligence

Chart 9

European M&A by sector and sector share of H1 2018 total (US$ Billion, 6 month rolling sum of transaction value)



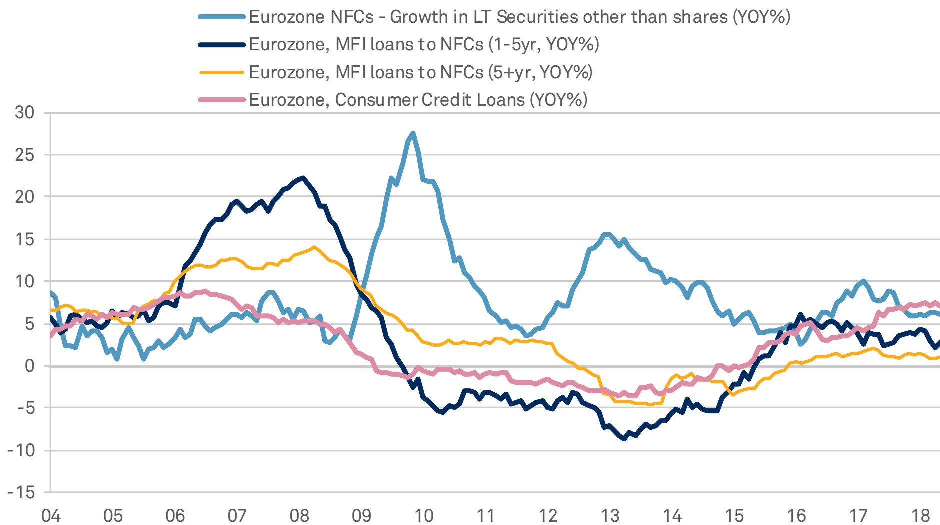
Source: S&P Global Market Intelligence, S&P Global Ratings calculations

Europe's credit cycle may not be ending, but the credit impulse will weaken

With economic growth past the peak, monetary policy on the road to normalization, and market valuations high – often uncomfortably so – thoughts inevitably shift to the turn in the credit cycle, both when it will happen and what it will mean. Within a purely European context, such concerns can seem a little premature. Debt levels have risen but not excessively so compared with the previous peak, and low interest rates and debt refinancing mean interest-based credit metrics are very comfortable in aggregate. Annual rates of bond issuance and loan growth are back in positive territory but expanding steadily and at rates far below prior surges (see chart 10). It is probably more accurate to say that – within a regional context – the credit impulse is slowing rather than the credit cycle ending.

Chart 10

Eurozone credit and loan growth rates remain relatively constrained



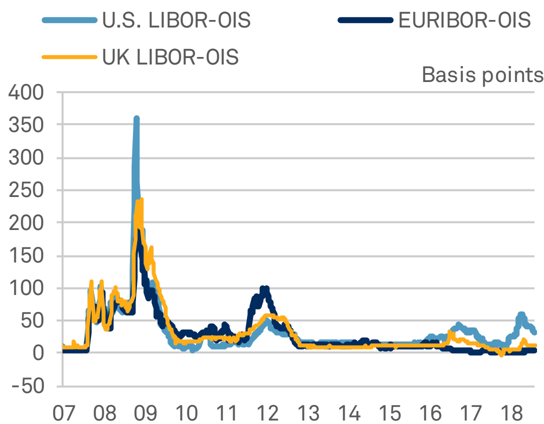
Source: European Central Bank, Thomson Reuters Datastream, S&P Global Ratings

Market contagion from the U.S. or emerging markets a key concern

Even if European economies remain nearer to mid- than late-cycle, there is little chance that regional markets will be able to avoid volatility triggered elsewhere, be it from a late-cycle U.S. or an emerging markets crisis of some kind. Amongst developed economies badly affected by the financial crisis, the U.S. is furthest down the road to normalization with strong growth, tightening labor markets, and the Federal Reserve seven hikes into a rate-tightening cycle that began in December 2015. S&P Global Ratings anticipates two more rate hikes this year and three more in 2019, as interest rates move towards a long-term neutral rate. Tightening U.S. financial conditions are already causing an uptick in banking sector risk as measured by the LIBOR-OIS spread (see chart 11) and, along with trade tensions, are arguably the main cause of the pressure afflicting a number of emerging market economies (see charts 12 and 13). The emerging markets now under the most pressure are those with expanding current account deficits, large external funding needs, and who have taken on significant U.S. dollar-denominated liabilities in recent years. Moreover, tightening monetary conditions come at a time when U. S. equity market valuations are exceptionally stretched (see chart 14) and vulnerable to any loss of the growth momentum underpinning them.

Chart 11

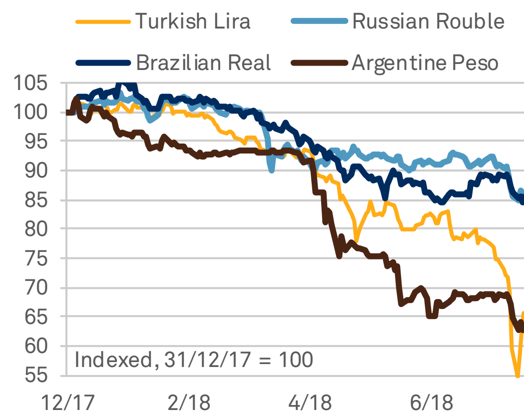
Measures of banking sector risk



Source: Thomson Reuters Datastream / Fathom Consulting.
OIS refers to Overnight Indexed Swaps

Chart 12

Many EM currencies have slumped this year relative to the U.S. Dollar



Source: Thomson Reuters Datastream, S&P Global Ratings
Shows U.S. dollars to local currency, indexed to rate at 31/12/17

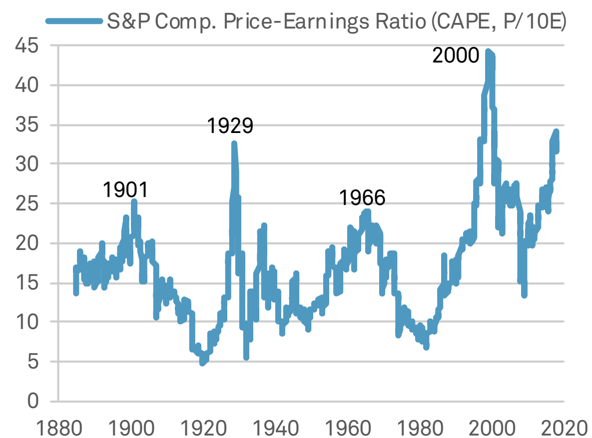
Chart 13

Chinese equities back in bear-market territory; contagion to copper prices

Source: Thomson Reuters Datastream, S&P Global Ratings

Chart 14

Cyclically-adjusted price to 10-year earnings ratio for U.S. equities (S&P Composite Index)



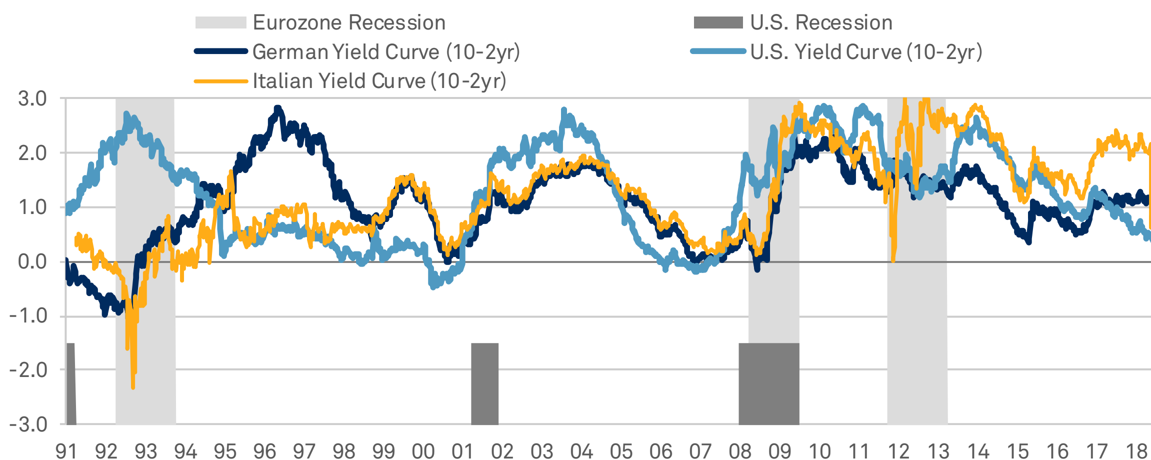
Source: Professor Robert Shiller, www.econ.yale.edu

It seems unlikely that European markets could avoid financial market volatility in the U.S. or, indeed, a more generalized problem in emerging markets given high levels of correlations between markets (especially in downturns) and how important the latter have become for capital flows and as end-markets. Whether Europe could avoid following the U.S. into a recession is a more uncertain proposition. Although yield curve trends became more synchronized from the late 1990s onwards, the 2008-2009 financial crisis is the only instance of a simultaneous recession in the eurozone and the U.S. since 1991 (see chart 15). The eurozone avoided recession after the tech crash in the early 2000s (which might be a relevant comparison should the tech-led U.S. equity bull-market end badly) and the eurozone recession of 2012-2013 was a local affair. It need not necessarily follow that a U.S. recession in the next few years – which is not S&P Global Ratings's base case - would necessarily automatically trigger the same in Europe, given that the latter remains nearer mid than late-cycle.

The greater challenge for European markets remain its internal political and economic dynamics, both relating to Brexit as well as the challenges posed by the unfinished architecture of the eurozone. While there is much focus on the flattening U.S. yield curve, what is equally interesting within a eurozone context is the difference between the German and Italian curves. The close correlation between the two, established in the late-1990s run up to the foundation of the euro, started to fray in the aftermath of the 2008-2009 financial crisis. Indeed it was Italy's yield curve – not Germany's – that anticipated the 2012-2013 recession. With that in mind, the tensions between Italy's new government and the EU regarding fiscal policy in particular and the broader disagreement between western European and central and eastern European members around matters such as immigration, are extremely important and loom over regional credit conditions. Moreover, as the cycle progresses, the tensions between the need for tighter monetary policy in Germany and for looser policy elsewhere in the eurozone are likely to re-emerge.

Chart 15

Eurozone and U.S. yield curves and recessions



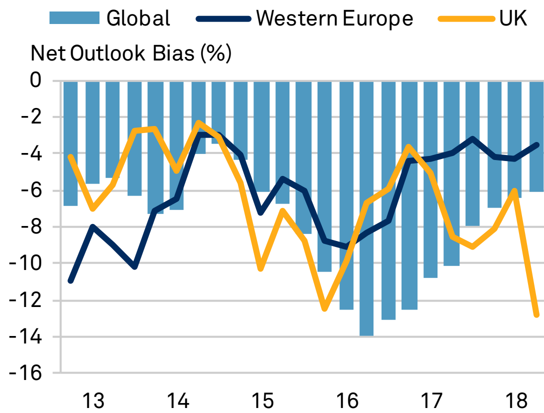
Source: Thomson Reuters Datastream, National Bureau of Economic Research (NBER), Centre for Economic Policy Research (CEPR), S&P Global Ratings. Shaded areas denote recessions for the eurozone (light gray) as determined by the CEPR and for the U.S. (dark gray) as determined by the NBER. Yield curves calculated as 10-year minus 2-year yields for Thomson Reuters government bond indices.

Crunch time for Brexit and trade risks haven't gone away

The next few months will also see the fraught negotiations around the U.K.'s exit from the EU come to a head. The effects of uncertainty and subdued confidence are already apparent in terms of relative corporate ratings trends, with the U.K. corporate net outlook bias deteriorating sharply in the second quarter (see chart 16). The possibility of the U.K. leaving without signing a withdrawal treaty and an agreed transition phase has risen in recent months, as reflected in weakening sterling since April (see chart 17). Our base case remains that a deal will be struck and that the transition phase will go ahead. If it does not, market volatility would likely follow as companies and investors attempt to gauge what this will mean and what degree of disruption is likely.

Chart 16

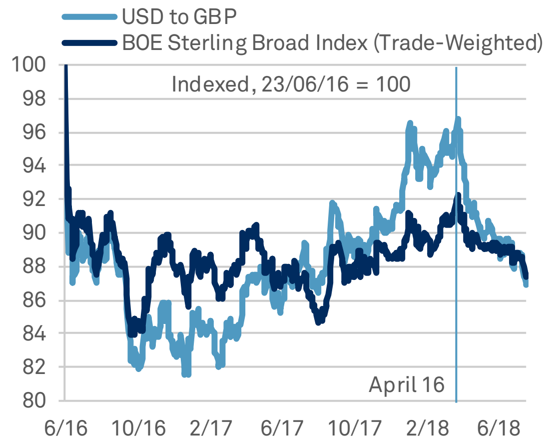
S&P Global Ratings net-outlook bias trend for non-financial corporate ratings



Source: S&P Global Ratings
Net outlook bias shows the percentage of positive outlooks for the rated universe less the percentage of negative outlooks. Shown quarterly to end-June 2018.

Chart 17

Indexed change in trade-weighted Sterling and USD to GBP since the UK's referendum on EU membership



Source: S&P Global Ratings
Indexed, so that 100 equals the value of the currency as of market close on June 23, 2016, the date of the U.K. referendum on EU membership.

The ongoing trade disputes between the U.S. and the rest of the world also remains a source of concern which could, especially if escalation occurs, weaken cash flows and necessitate costly remedial measures like moving production centers. The EU's large trade surplus with the U.S. (dominated by Germany and its car industry) is one of the main bugbears of the Trump administration and imposition of additional tariffs on European cars on national security grounds could easily trigger rounds of retaliatory tariffs as already seen with China. The stakes are high on both sides. The U.S. is a key market for many European corporate issuers (see charts 18 and 19).

Chart 18

Estimated U.S. revenue as proportion of total revenues for European nonfinancial corporates rated investment grade by S&P Global Ratings

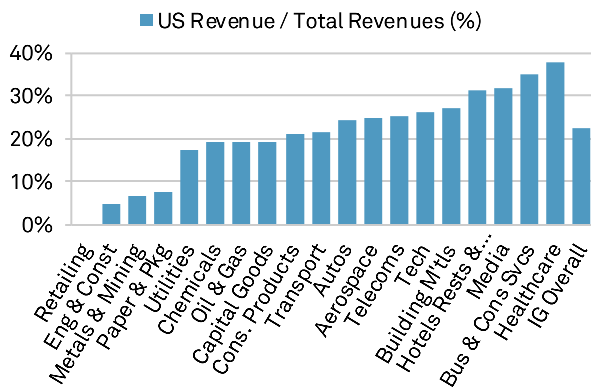
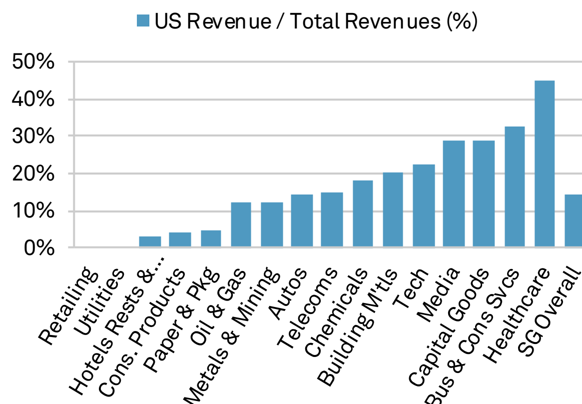


Chart 19

Estimated U.S. revenue as proportion of total revenues for European nonfinancial corporates rated speculative grade by S&P Global Ratings



Source: S&P Global Market Intelligence, S&P Global Ratings
Note that values are estimates based on publicly available geographic segment data and private estimates by S&P Global Ratings. Figures only reflect the data for those entities with available or estimated data. Not all companies disclose the relevant data.

Conclusion

In fundamental terms, the European corporate credit outlook still appears benign, with 12-month trailing default rates around 2% and, in S&P Global Ratings' view, unlikely to rise beyond 3% over the next 12 months. The benefits of a strong pickup in global economic growth are feeding through into cash flows, and financing conditions are set to remain supportive given still-modest inflationary pressures and central banks' desire to take a very gradualist approach to policy normalization. Stronger 'animal spirits' are reflected in a powerful boom in global and European M&A. Although this may pose some credit risks in the medium term as the success or otherwise of these deals becomes apparent, the rise in issuance is not proving difficult to absorb, particularly given still ongoing asset purchases by the ECB. While there have been some bond issuance that has not materialized in recent months, reflecting some pushback on pricing, spreads remain tight and locked in a range, and credit market price volatility is still exceptionally low. Political risk – especially in relation to trade and tariffs- has been greater and more troubling than expected at the start of the year, but this has not yet translated into a broader repricing of risk assets.

Even so, this may be a period of calm before the storm. Given the long duration of the U.S. economic cycle in particular, thoughts are turning to when the credit cycle will end and what it will mean. Within a European context, the credit impulse is slowing in the sense that growth has passed its peak, net asset purchases by the ECB's quantitative program are set to end in December, and interest rates have risen in the U.K. and are likely to rise in the eurozone next year. But the credit cycle is not at a point of excess: bond issuance and loan growth annual rates are relatively modest, corporate cash remains plentiful, profit margins improving, and debt levels are high but easing as EBITDA improves.

However, the U.S. credit cycle is more advanced, with the rate tightening cycle well underway. While U.S. growth and cash generation are also strong, equity and credit valuations are priced for perfection and the potential for risk-asset repricing is high. It is unlikely that European credit markets would be immune from this, even allowing for relative positions in the cycle. Higher U.S. interest rates are also pivotal to the strains apparent in a number of emerging markets and sparking bond and currency volatility. This is not yet a broader crisis, but has the potential to become one. The growing conflicts over world trade and a broader tussle between the U.S. and China, ostensibly in relation to intellectual property rights and trade abuses, add a further dimension to this risk.

Within Europe, the greatest risks are political: Brexit negotiations remain fraught and the risk of a disruptive outcome has risen in recent months; meanwhile Italy's new government is symptomatic of the continuing tensions around issues such as fiscal policy and immigration in the eurozone. Fiscal policy disputes have the potential to lead to a stand-off that unnerves the markets. Europe could yet become the locus of a market crisis, but for the moment the greater worries are elsewhere.

Related Research

- Credit Conditions EMEA: Any Cure For The Trade And Brexit Blues? June 28, 2018
- Economic Research: Monetary Policy Normalization In The Eurozone: Will One Size Fit All? June 26, 2018
- Economic Research: Eurozone Corporates' Move To Market-Based Financing Is Here To Stay, June 18, 2018
- Recent Market Transactions Weigh On The Average Credit Quality Of The European Leveraged Finance Market, May 2, 2018
- In the firing line: Trump, trade and EU corporate credit, May 1, 2018
- Credit Conditions EMEA: Trade And Market Volatility Threaten To Overshadow Brexit, March 28, 2018
- European Corporate Credit Outlook 2018, December 13, 2017

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Appendix

Table 2

European Corporate Credit Conditions Survey – June 2018

Sector / Question	1. Current Business Conditions	2. Business Outlook Over Next 12 Months	3. Free Operating Cash Flow Over Next 12 Months	4. Capital Expenditure Over Next 12 Months	5. Sector Outlook Over Next 12 Months
Consumer Goods	Satisfactory	No change	No Change	No Change	Stable to Negative
Media	Satisfactory	No change	No Change	No Change	Stable to Negative
Packaging	Satisfactory	Moderately weaker	No Change	No Change	Stable to Negative
Pharma & Healthcare	Satisfactory	Moderately stronger	No Change	No Change	Stable to Negative
Retail	Weak	Weaker	Decrease	Increase	Stable to Negative
Aerospace & Defense	Satisfactory	No change	No Change	No Change	Stable
Autos – Manufacturers	Satisfactory	No change	No Change	No Change	Stable
Autos – Suppliers	Satisfactory	No change	No Change	No Change	Stable
Building Materials	Satisfactory	No change	No Change	No Change	Stable
Capital Goods	Satisfactory	No change	No Change	No Change	Stable
Chemicals	Satisfactory	No change	Increase	Decrease	Stable
Leisure	Satisfactory	No change	No Change	No Change	Stable
Oil & Gas - Downstream	Satisfactory	No change	No Change	No Change	Stable
Real Estate	Satisfactory	No change	No Change	No Change	Stable
Service Companies	Satisfactory	Moderately stronger	No Change	No Change	Stable
Technology	Satisfactory	No change	No Change	No Change	Stable
Telecoms – HY	Satisfactory	No change	No Change	No Change	Stable
Telecoms – IG	Satisfactory	No change	No Change	No Change	Stable
Transp. Infra. – Airports	Satisfactory	No change	No Change	No Change	Stable
Transp. Infra. - Rail	Satisfactory	No change	No Change	No Change	Stable
Transp. Infra. - Toll Roads	Satisfactory	No change	No Change	No Change	Stable
Transportation – Airlines	Satisfactory	No change	No Change	No Change	Stable
Transportation – Shipping	Satisfactory	No change	No Change	No Change	Stable
Utilities - Regulated	Satisfactory	Moderately weaker	No Change	No Change	Stable
Mining	Strong	No change	No Change	No Change	Positive to Stable
Oil & Gas - Upstream	Strong	Moderately stronger	Increase	No Change	Positive to Stable
Steel	Strong	No change	No Change	No Change	Positive to Stable
Utilities - Unreg. Power & Gas	Satisfactory	Moderately stronger	No Change	No Change	Positive to Stable
Forest Products	Satisfactory	No change	Increase	Decrease	Positive

S&P Ratings Services - European Corporate Credit Conditions Survey Questions

Change indicators

Weaker since March 2018

Stronger since March 2018

Question	Definitions
1. Current Business Conditions	Very strong/very weak = sharply above/below conditions unusual; Strong/weak = above/below average conditions
2. Business Outlook Over Next 12 Months	Stronger/weaker = more than 5% improvement/deterioration; Moderately stronger/weaker = up to 5% improvement/deterioration
3. Free Operating Cash Flow Over Next 12 Months	Substantial increase/decrease unusual for the industry historically; Increase/decrease
4. Capital Expenditure Over Next 12 Months	Substantial increase/decrease unusual for the industry historically; Increase/decrease
5. Sector Outlook Over Next 12 Months	Positive/negative = material number of potential upgrades/downgrades; Positive to stable /negative to stable = modest number of potential rating and outlook changes

Source: S&P Global Ratings
S&P Ratings Services' corporate analysts are surveyed quarterly as part of the S&P Credit Conditions Committee process

Table 3

GDP growth and unemployment forecasts for selected European countries

	Real GDP Baseline forecast			Unemployment Baseline forecast		
(%)	2018f	2019f	2020f	2018f	2019f	2020f
France	1.7	1.6	1.7	9.0	8.5	8.2
Germany	2.0	1.8	1.5	3.4	3.0	2.9
Italy	1.3	1.2	1.0	10.9	10.6	10.2
Netherlands	2.7	2.3	1.8	3.9	3.7	3.5
Spain	2.8	2.3	2.1	15.6	14.5	13.9
Eurozone	**2.1**	**1.7**	**1.6**	**8.4**	**7.9**	**7.7**
Switzerland	2.2	1.7	1.5	2.9	2.7	2.7
U.K.	1.2	1.4	1.6	4.3	4.4	4.5
Europe	**2.3**	**2.1**	**2.0**	**7.3**	**7.0**	**6.9**

Source: S&P Global Economics

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