

Credit Conditions EMEA:

Looking Over The Edge On Trade And Brexit

September 27, 2018

Key Takeaways

- Overall:** Credit conditions remain favorable in the eurozone, but are tightening somewhat in the U.K. ahead of Brexit. Growing concerns about trade tensions and Brexit threaten to undermine business confidence and financial markets if they are not resolved amicably in the fourth quarter.
- **What's changed:** Our top risks continue to deteriorate as the White House ratchets up tensions with U.S. global trading partners, U.S. monetary conditions tighten further, the Brexit deadline nears, and vulnerabilities in emerging economies surface. Unsurprisingly, this is starting to infect business confidence globally, with tangible disruptions to supply chains (autos).
 - **Risks and imbalances:** Our three top risks are escalating trade tensions that threaten to ensnare the European auto industry, external debt refinancing risk for Turkish banks and the increasing risk of a disruptive Brexit in March 2019. While not yet our base case, the latter has now become a more relevant rating consideration for the most exposed entities.
 - **Macroeconomic conditions:** Eurozone GDP growth has peaked and is converging gently toward potential. Core inflation is likely to converge slowly toward target as wage growth accelerates modestly. We expect the euro to remain at its current level until mid-2019 in a context of political uncertainty and rising monetary policy divergence with the U.S.
 - **Financing conditions:** Eurozone private-sector credit conditions remain benign, with credit standards easing, encouraging reasonable loan demand, mainly from investment and acquisition activity. In the U.K., Brexit uncertainties continue to dampen investment and business funding decisions, so we expect borrowing appetite to remain low except for working capital and short-term facilities ahead of Brexit.
 - **Sector themes:**
 - Banks.** European banks' balance sheets remain sound but profitability is generally still subpar. Downside risks are increasing with the potential of a disruptive Brexit and financial markets highly sensitive to increased political uncertainty.
 - Corporates.** While current operating conditions remain satisfactory, the business and rating outlook has started to deteriorate in eight out of the 29 sectors we follow including autos.
 - Insurance.** The end to QE and its impact on asset prices and therefore asset allocations is one of the main risks that insurers face in coming quarters.
 - Public Finance.** Brexit continues to weigh on business conditions for U.K.-based social housing providers, universities, and local governments, with downward pressure on the ratings.
 - Structured Finance.** Credit performance is set to remain benign, although some sectors are exposed to widespread impacts from idiosyncratic events.

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(Editor's Note: S&P Global Ratings' Credit Conditions Committees meet quarterly to review macroeconomic conditions in each of four regions (Asia-Pacific, Latin America, North America, and Europe, the Middle East, and Africa). 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 EMEA committee on Sept. 20, 2018.)

Table 1

Top European Risks

Global Trade

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

The downside risk is growing of a material escalation in trade tensions if the U.S. administration opens a new front against Europe, and the German auto industry in particular, provoking a tit-for-tat response. The concern is that global supply chains would start to unwind, given no obvious path to resolve the underlying issues anytime soon.

Disruptive Brexit

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

The likelihood of a disruptive Brexit in March 2019 is increasing as there is no obvious landing zone for the outline political agreement on the future relationship required as part of the legal withdrawal treaty. The unwillingness of both the U.K. and EU to publicly coordinate their "no deal" safeguarding measures risks exacerbating the inevitable disruption that would arise.

Asset price volatility

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

While European financial markets are showing sensitivity to idiosyncratic risk and monetary conditions are starting to tighten gradually, the main threats to markets continue to be external, relating to growing trade tensions and the potential for contagion to spread among emerging markets.

Weakening European political cohesion

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

Mainstream political parties continue to be challenged from all sides, with Sweden the latest to veer to the right. With their sights set firmly on the European parliamentary elections next May, a sizable vote for nationalist parties could put the brakes on any remaining momentum toward an ever-closer union. This would also make it harder for the European Commission to guide social and economic policies to improve solidarity. Immigration remains one highly divisive issue that may yet undermine the free movement of labor within Schengen.

Top Middle East and Africa Risks

Dependence on external debt

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

This risk is particularly relevant for Turkish and Qatari banks. The risk for Turkish banks is increasing because of the significant depreciation of the Turkish lira and deteriorated relationships with Western allies. For Qatari banks, the risk continued to recede over the past quarters.

Geopolitical risk

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

This risk is materializing through the reinstatement of sanctions on Iran, the boycott of Qatar by a few Arab states, and internal political developments in Saudi Arabia. Our base case excludes any significant escalation for now.

U.S. Federal Reserve interest rate increase

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

The risk is moderate for GCC banks due to their limited reliance on external debt and the significant contribution of non-interest-bearing deposits to their funding profile. For Turkey, the increase in interest rates will weigh on the capacity of banks and corporates to refinance their external debt amid more investor risk aversion toward Turkish issuers.

Source: S&P Global Ratings.

* **Risk levels** may be classified as very low, 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.

Regional credit-conditions

What's changed?

After a fairly synchronized strengthening of the global economy that continued into the early part of the year, several adverse developments have led to growth momentum slowing--not least the U.S. administration ratcheting up tensions with global trading partners at a time when U.S. monetary conditions are tightening, Brexit decision time is looming, and some vulnerabilities are materializing in several emerging economies.

As a potential early signal that the global economic temperature is changing, Ifo's World Economic Climate Indicator for third-quarter 2018 has fallen sharply, pointing to declining economic expectations across all major regions including the EU (see chart 1). The proximate cause, according to Ifo, is the potential for a material slowdown of goods trade, particularly between the U.S. and China, with a negative knock-on effect on global investment. This is noteworthy as the last time the Ifo indicator saw such a sharp fall in expectations during a boom phase was in early 2008 in the lead-up to the global financial crisis. With the U.S. administration further ramping up the pressure on China by imposing additional tariffs on \$200 billion of goods, it is to be anticipated that business confidence in the global economy can only fall further. Indicators sensitive to global trading conditions such as shipping company Maersk's share price and the price of copper flag the growing risk of a slowdown in global trade (see chart 2).

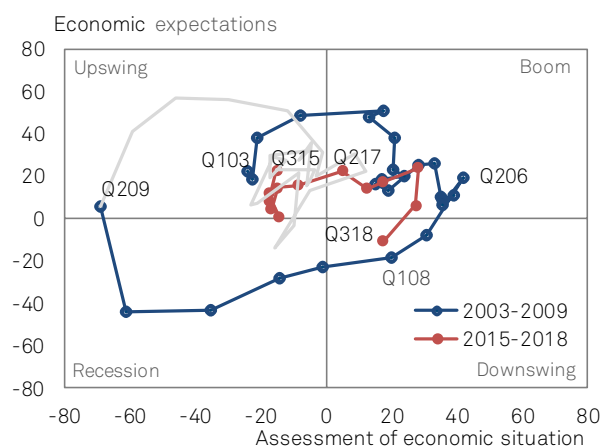
An early signal that the global economic temperature is cooling

Crunch time for Brexit is also approaching. Our base case assumes that politicians will act in the best interests of their citizens and ratify the Withdrawal Agreement, ushering in a 21-month status quo transition, even though there may be only limited detail on how to avoid a "hard border" in Ireland and what the future relationship between the U.K. and EU will look like. However, the political noise generated, primarily in the U.K., and the parliamentary arithmetic mean that business is now rolling out preparations for a disruptive Brexit in March 2019. In our view, business will not be able to protect itself fully from the inevitable bottlenecks that would arise, at least for a while. BMW Mini in Oxford is implementing a robust contingency plan by bringing forward its summer maintenance shutdown to April.

The global environment for emerging-market economies has become more challenging in recent months with rising U.S. interest rates, a strong U.S. dollar (until recently), and global trade tensions being important common factors. Turkey has been, and remains, in the spotlight in the region with refinancing risk for Turkish banks being high given heavy reliance on short-term external debt. Even so, at this stage, we see a limited risk of a broad-based contagion from the events in Turkey and Argentina spreading to other emerging economies and global financial markets.

Chart 1

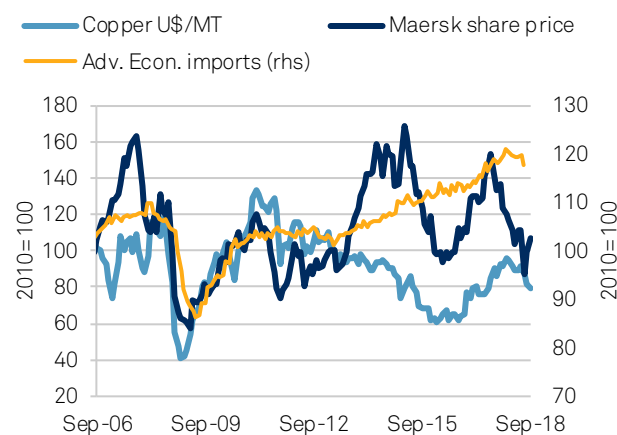
Ifo Business Cycle Clock World Economy



Source: Ifo World Economic Survey (WES) III/2018.

Chart 2

Global Trade Growth in The Spotlight



Source: CPB World Trade Monitor, Thomson Reuters Datastream

Assessment of key risks in Europe

Global trade - High, worsening

The downside risk is growing of a material escalation in trade tension if the U.S. administration opens a new front against Europe, and the German auto industry in particular, provoking a tit-for-tat response. The concern is that global supply chains would start to be unwound, given no clear path to resolve the underlying U.S. trade concerns anytime soon.

The risk is growing of a material escalation in trade tension if the U.S. opens a new front against Europe

Disruptive Brexit - High, worsening

Although not our base case, the likelihood of a disruptive Brexit in March 2019 has increased. There is no obvious landing zone for the outline political agreement on the future relationship required as part of the legal withdrawal treaty that will need to be ratified in both the EU and U.K. before the end of March 2019. The unwillingness of both the U.K. and EU to publicly announce and coordinate their "no deal" safeguarding measures risks exacerbating the inevitable disruption that would arise.

The likelihood of a disruptive Brexit in March 2019 has increased

Asset price volatility - Elevated, unchanged

While European financial markets are showing sensitivity to idiosyncratic risk, and monetary conditions are starting to tighten gradually, the main threats to markets continues to be external, relating to growing trade tension and the potential for contagion spreading among emerging markets. Adverse regional developments around Brexit and the policy program of the coalition government in Italy have the ability to cause market volatility in coming months. None have materially spooked markets in the region so far.

Weakening European political cohesion - Elevated, worsening

Mainstream political parties continue to be challenged from all sides, with Sweden the latest to veer to the right. With their sights set firmly on European Parliamentary elections next May, a sizable vote for nationalist parties could put the brakes on any remaining momentum toward an ever-closer union. This would also make it harder for the European Commission to guide social and economic policies to improve solidarity. Immigration remains one highly divisive issue that may yet undermine the free movement of labor within the Schengen area.

The Italian coalition government's policy program is a potential flashpoint. However, we anticipate the government will reduce its fiscal ambitions for the 2019 budget, limiting the deficit to around 2.0% of GDP. The Northern League appears to be prioritizing the immigration issue and seems to be seeking to create a right-wing grouping in the European Parliament as another pathway to challenge EU institutions in support its populist agenda. M5S, in contrast, is treading a fine line, needing to deliver some of the economic benefits it promised to core voters while not unsettling the markets.

Assessment of key risks in the Middle East and Africa

Dependence on external debt – Very high, worsening

We consider that refinancing risk remains very high for Turkish banks, which rely heavily on short-term external debt. At June 30, 2018, the total external debt of Turkish banks stood at \$107.9 billion (\$126.2 billion including nonbank financial institutions), including \$44.5 billion (\$51.7 billion including nonbank financial institutions) coming to maturity in the next 12 months. While these risks have been kept in check previously, with strong rollover rates, we believe investors are becoming more averse to Turkish risk and more demanding in terms of remuneration. Banks' access to global capital markets is constrained by investor sentiment, global liquidity tightening, and U.S. sanctions, as well as a U.S. investigation into a large Turkish state-owned bank. For example, interest rates on Eurobonds have reportedly doubled and Turkish banks' access to this market is now constrained. Banks are also exposed to the risk that their foreign currency swaps will not be rolled over. While Turkish banks defaulting on external debt is not currently our base case, this kind of risk, while still relatively low, is starting to emerge. We believe that even with rollover rates on wholesale debt becoming temporarily restrained, the system has enough liquidity buffers to meet its obligations over the next six-12 months. Furthermore, customer deposits have remained relatively stable so far.

The reversal of the outflows of external funds from Qatar that started in the first quarter was confirmed during the second quarter as they dropped to around \$5 billion compared with \$22.1 billion at year-end 2017. Nevertheless, the new inflows of funds came primarily from interbank funding, which can prove volatile in case of any escalation of geopolitical risks. However, we have observed an increase in core customer deposits, particularly in July 2018. The government's injection of funds stabilized at \$32.9 billion at July 31, 2018.

Mounting geopolitical risk in the GCC – Elevated, unchanged

Despite the reinstatement of sanctions against Iran, we still consider the trend for geopolitical risk as stable in the region. The sanctions have already caused significant upward volatility in oil prices, which is beneficial for the Gulf Cooperation Council (GCC) countries. At this stage, we do not foresee any direct impact of Iranian sanctions on geopolitical stability in the GCC. The main risk continues to be the boycott of Qatar and any potential escalation, which is not part of our base case scenario.

Impact of Fed rate increase – Moderate, unchanged

For the GCC countries, we think any Fed rate increases will be mirrored by local authorities to preserve their currency peg (except for Kuwait), but we do not expect a significant economic impact. Banks' reliance on external funding is limited and they benefit from a significant contribution of non-interest-bearing deposits in their funding profile.

For Turkey, the Fed rate increase will weigh on the capacity of corporates and banks to refinance their external debt. Following the recent restructuring by a few large corporates, we do not rule out that other corporates or nonbank financial institutions will follow as the refinancing of external debt becomes more difficult and expensive.

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While Turkish banks defaulting on external debt is not currently our base case, this kind of risk, while still relatively low, is starting to emerge.

Financing conditions

U.K.: Tighter financing conditions are dampening consumer credit and business lending

Following the Bank of England's (BOE) decision to raise interest rates by 25 basis points to 0.75% in August, financing conditions have continued to tighten for unsecured consumer credit and for businesses. Net new unsecured consumer borrowing fell to £0.8 billion in July, driven by a weakening in both credit card and other unsecured lending. Given tightening financing conditions, we expect both the availability and demand of unsecured credit growth to continue to slow. We do not factor in any further increase in the policy rate in 2018, with tighter underwriting continuing to reduce the supply of consumer credit.

Competition in the mortgage market means that spreads remain relatively narrow. Residential mortgage growth remains stable, with total gross advances increasing by 6.4% in the second quarter 2018 compared with the same period in 2017. The value of new commitments increased by 19.8% in second-quarter 2018 from first-quarter 2018, to £73.2 billion. The volume of remortgaging has continued to rise on a nominal basis (£20.5 billion), but has declined as a proportion of new lending to 30.8%.

Total outstanding business borrowing increased by £2 billion in July. Net bank lending to nonfinancial corporates increased to £2.7 billion in July, driven by increased borrowings by large businesses (£3.1 billion net), while small and midsize enterprises saw a net reduction of £0.4 billion. With Brexit uncertainties continuing to affect investment and funding decisions, we expect borrowing appetite to remain low. However, there may be some precautionary borrowing ahead of Brexit to tide companies over what could be a volatile period in the first half of 2019 as the U.K. leaves the EU.

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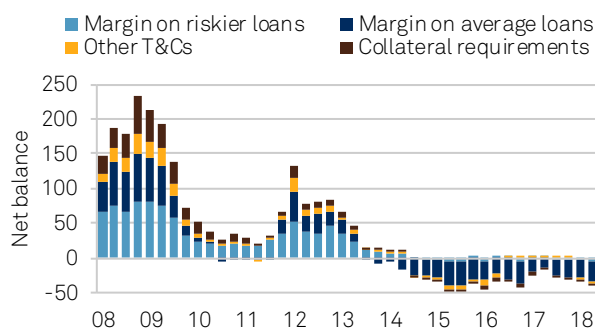
With Brexit uncertainties continuing to affect investment and funding decisions, we expect U.K. borrowing appetite to remain low

Eurozone: Easy credit continues to fuel pockets of risk

Private-sector credit conditions remain borrower-friendly in the eurozone, with credit standards remaining lax for loans to households and enterprises (see chart 3). Loan demand has continued to increase across all loan categories, with investment and acquisition activity driving corporate demand (see chart 4). This is particularly evident in the leveraged finance market where large jumbo debt-funded M&A transactions across the region are somewhat reminiscent of activity seen in the run-up to the financial crisis in 2006-2008. The leveraged loan market appears to be the market of choice as yields for new speculative-grade issuance have risen about 1% while collateralized loan obligation (CLO) origination continues to grow strongly – up 65% to €19.2 billion in the year to end-August according to Leveraged Commentary and Data an offering of S&P Global Market Intelligence.

Chart 3

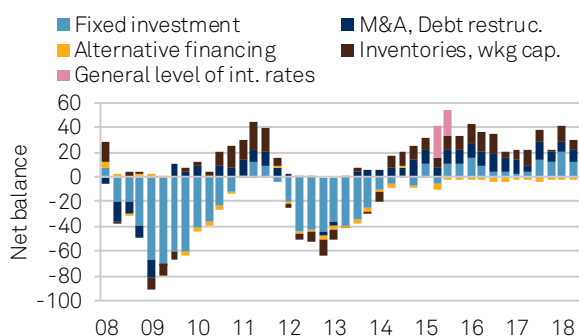
Competition is keeping downward pressure on loan margins



Source: ECB Bank Lending Survey, Thomson Reuters Datastream

Chart 4

Investment and M&A is driving company loan demand



Source: ECB Bank Lending Survey, Thomson Reuters Datastream

Macroeconomic developments and assumptions

- Eurozone growth has come down from its 2017 heights on the back of weaker external demand. Nonetheless, robust domestic demand will keep the economy running above trend growth in the next few years, translating into rising wages that should put upward pressure on inflation.
- We expect policy uncertainties and rising monetary policy divergence with the U.S. until mid-2019 to keep a lid on the euro-dollar exchange rate, but the euro should appreciate from there on as the focus shifts back to macroeconomic fundamentals like the U.S. twin deficit and the eurozone's current account surplus.
- Our base case forecast for the U.K. is still underpinned by the assumption of a U.K.-EU Brexit deal later this year and a status quo transition phase that lasts until the end of 2020.
- Risks lie to the downside with business confidence increasingly sensitive to adverse developments on trade, risk of a disruptive Brexit, and turmoil in emerging markets.

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Eurozone

What's changed?

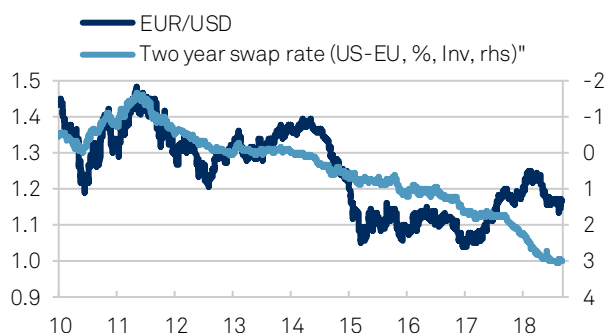
GDP growth stabilized at a quarterly 0.4% in second-quarter 2018 due to a temporary rebound in exports that offset slower but still rising private consumption. Consumer confidence retreated further from peak as higher energy prices - headline inflation jumped to a 2% high - and an unexpected halt in the decline of unemployment bit into real disposable income.

With more uncertainties surrounding external demand, we scaled back our growth prospects to 2.0% for the remaining year and kept them unchanged at 1.7% for 2019. Disappointing growth and inflation figures, a widening interest rate differential with the U.S. and mounting European political risks weakened the euro-dollar exchange rate over the second quarter (see chart 5). With political key issues still on the agenda--the Italian budget, Brexit negotiations, and the start of the campaign for the EU Parliament elections--we now expect euro appreciation to kick in later and not before the second half of next year.

Low core inflation should, however, not prevent the European Central Bank (ECB) from ending its bonds purchase program in December and heading for a first rate hike in third-quarter 2019 as scheduled. That's because when the Fed tightens U.S. monetary policy, it typically opens a window of opportunity for the ECB to do the same. Consequently, we now expect a faster pace of monetary normalization over the longer term, so that the refinancing rate should reach near 1.25% by 2021.

Chart 5

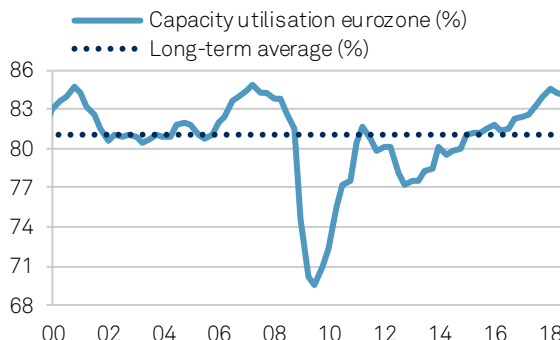
Rising monetary policy divergence will continue to weigh on EUR/USD in the short term



Source: Bloomberg, S&P Global Ratings

Chart 6

Capacity utilization well above LT average suggests the output gap has closed



Source: European Commission Survey, S&P Global Ratings

Key assumptions

- GDP growth has peaked and is converging gently toward potential. Statistical evidence suggests activity is far from overheating but slack has diminished considerably. For instance, capacity utilization is above long-term average (see chart 6), with labor and capital scarcities as factors limiting production.
- Risks to growth lie on the downside. In particular, exports should suffer from emerging-market turmoil, bearing in mind that Turkey – for which we expect a recession next year – makes 1.6% of eurozone exports and even 2% of Spanish and Italian exports.
- The inflation regime should remain benign, that is, in line with the central bank's objective of price stability. Core inflation is likely to converge slowly toward headline inflation on the back of modestly accelerating wage growth and slightly decelerating energy prices.

Key risks

Political and external factors pose the main risks to the eurozone outlook. These notably include the budget exercise by the new Italian government and the approaching deadline for a deal between the U.K. and the EU, which may induce some elevated market volatility over the second half of the year.

Regarding external factors, our assessment is that trade war rhetoric has not abated. It still weighs on confidence and has the potential to become more of a drag on growth if the situation escalates (with, for example, U.S. car import tariffs). Furthermore, since the dollar is expected to remain strong, emerging-market turmoil could last, triggering even lower external demand addressed to the eurozone.

What to look for over the next quarter

- We will pay attention to the first budget exercise by the new Italian government, which has to balance EU rules and electoral promises regarding basic income, tax cuts, and a rollback of pension reform.
- It will be interesting to follow whether there is an increasing effect on long-term interest rates from the phasing out of the ECB bond purchasing program. The eurozone economy could prove to be sensitive to higher borrowing costs, as deleveraging has been rather modest and asymmetric since the financial crisis.

U.K.

What's changed?

Recent data releases, such as for GDP growth, Inflation, and the unemployment rate, were in line with our earlier expectations. As a result, our forecast has not changed much, and the economy looks on track to achieve growth of 1.3% this year, and not much stronger growth thereafter.

As expected, the Bank of England (BoE) raised its policy rate from 0.25% to 0.5% in August. There was no compelling reason to do so given that wage growth, albeit picking up, remains below expectation in view of a record low unemployment rate. Inflation was also coming down quicker than the BoE had expected. At the same time, there was no compelling economic reason not to raise rates, not least because markets overwhelmingly expect the Fed to raise US rates at the September Federal Open Market Committee. What the hike did, however, was to allow the BOE to restore some credibility after failing to tighten on several occasions despite strong signaling. It also created more leeway to loosen policy again if required, for example in the event of a disruptive Brexit.

Finally, since our last report, U.K. Prime Minister Theresa May and her cabinet also published a long-awaited white paper – the so-called Chequers plan – that sets out the U.K.'s negotiation position regarding its future relationship with the EU. Elements of this plan have been rejected by the EU, most recently at the September summit in Salzburg. The rejection centers on the U.K.'s proposal of close alignment with the EU single market only on goods trade and the feasibility of the U.K.'s customs facilitation plan.

Key risks

Our forecast is still underpinned by the assumption of a U.K.-EU Brexit deal later this year and a status quo transition phase that lasts until the end of 2020. Risks to this forecast are heavily skewed to the downside. The most important risk would materialize if the U.K. and the EU cannot agree on a withdrawal agreement, or if this agreement fails to be ratified in the U.K. parliament and, as a consequence, the UK leaves the EU abruptly in March 2019, and trade with the EU reverts to World Trade Organization rules. Such a disruptive Brexit would constitute a major negative short-term shock to the economy and likely affect it markedly in the longer run as well.

EMEA Emerging Markets

What's changed?

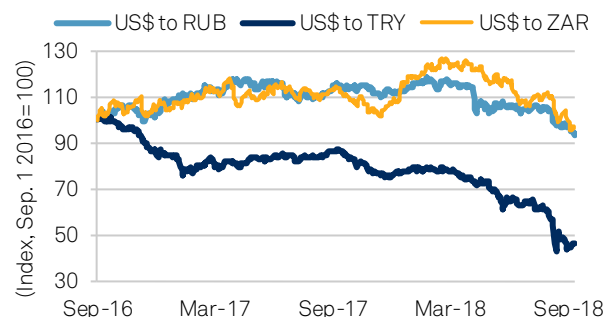
The Turkish and Argentine currencies tumbled sharply in August, sending shockwaves through emerging markets worldwide. The Turkish lira and Argentine peso lost 26% of their values each during August, while other emerging-market currencies also suffered losses, albeit on a smaller scale. The Russian ruble depreciated by 7% and the South African rand by 11% (see chart 7).

At this point, we see a limited risk of a broad-based contagion from the events in Turkey and Argentina to other emerging economies and global financial markets. In our view, country-specific issues are largely responsible for the financial market stress in both economies. At the same time, these events also reflect the more challenging global environment for emerging-market economies, with rising interest rates in the U.S., a strong U.S. dollar, and global trade tensions being common factors weighing on investors' sentiment toward emerging markets. In August, foreign portfolio investors pulled \$US5 billion out of emerging-market debt, according to preliminary Institute of International Finance data. Equity flows to emerging markets (excluding China) showed tentative signs of a revival in July-August after several months of outflows, but remained weak (see chart 9).

We anticipate financial conditions in key emerging economies in Europe, the Middle East, and African (EMEA) will become tighter and more volatile, compared with our previous expectations. In Turkey, 10-year local currency bond yields soared by almost 300 basis points (bps) in August, to above 20%, before easing in September (see chart 8). Since end-June, 10-year local currency bond yields have risen by 100 bps in Russia and 25 bps in South Africa. Weaker currencies partially offset the impact of tighter credit conditions. At the same time, inflation risks have risen, although the situation differs across the countries. Russia's inflation has picked up from historically low levels, but annual price growth is still below the central bank target of 4%. By contrast, headline inflation in Turkey soared to close to 18% in August.

Chart 7

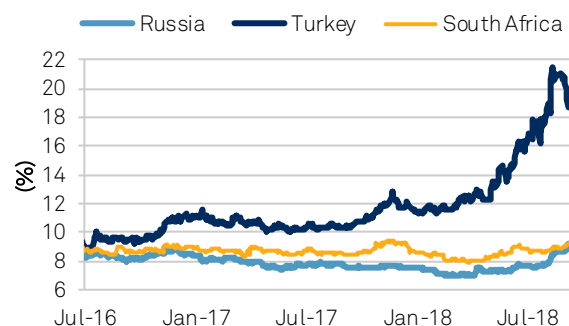
U.S. Dollar Foreign Exchange Rates



Source: Thomson Reuters Datastream, S&P Global Ratings

Chart 8

Ten-Year Government Bond Yields (Local Currency)



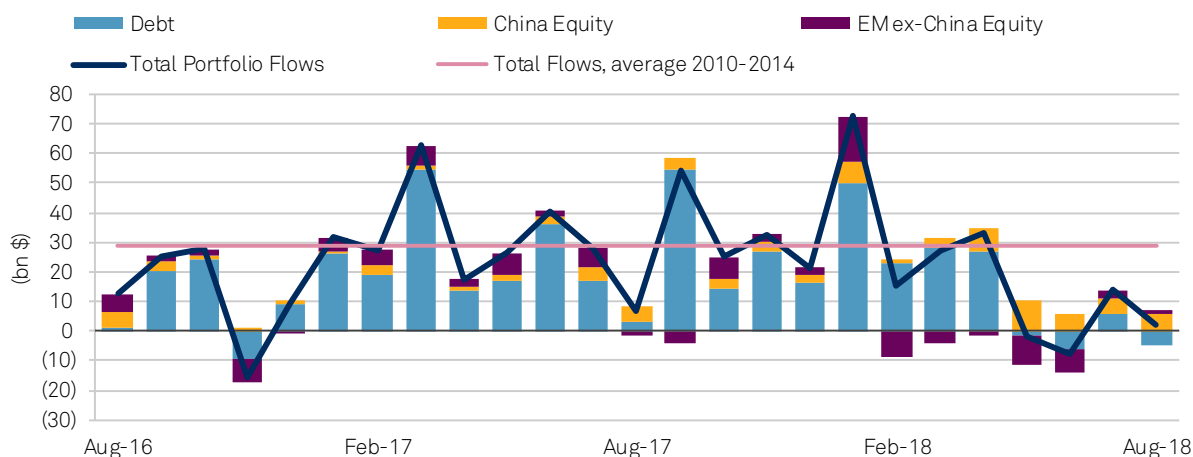
Source: Bloomberg, S&P Global Ratings

Monetary policies have switched to a tightening mode. The Turkish central bank hiked the one-week repo rate to 24% from 17.75% at its September meeting. The Central Bank of Russia (CBR)

raised the key rate by 25 bps to 7.5% in September, in a first hike since 2014, reversing its easing cycle before reaching the neutral rate level which it sees in a 6%-7% range.

Chart 9

Net Non-Resident Portfolio Flows to Emerging Markets



Source: IIF, S&P Global Ratings calculations

Turkey

We reviewed our macroeconomic forecast for Turkey in August and now expect a "hard landing" for the Turkish economy, after a prolonged period of overheating and widening macroeconomic imbalances, with output falling by 0.5% in 2019¹.

We forecast domestic demand to fall by 3% in 2019, with both private consumption and investment shrinking next year amid a surge in inflation, a significant tightening of financial conditions, and a hit to confidence. Foreign trade should contribute positively to growth next year, with sharp depreciation of the real exchange rate boosting exports and leading to import compression. This market-induced rebalancing of the economy should result in a narrowing of the current account deficit to 2.6% next year, from close to 8% in the first quarter of 2018.

After the sharp hike, we expect the Turkish central bank to keep the key rate at the current level well into 2019, and to start gradual easing afterward, assuming inflation pressures subside.

South Africa

We have lowered our GDP growth forecast for South Africa to 0.8 % this year, from 2% previously, reflecting the impact of a second-quarter contraction in output that put the economy in the technical recession and weaker sentiment amid external headwinds. We also lowered the 2019 GDP forecast to 1.8% from 2.1%.

Russia

Russia's economic growth should be relatively resilient to the deterioration in external conditions, but its pace will remain modest, reflecting numerous structural constraints and restrictive macroeconomic policies. The unusual combination of higher oil prices and a weaker ruble has led to strengthening fiscal and external accounts and the return of "twin surpluses." We expect GDP growth to average 1.8% this year, and to slow to 1.6% next year, on the back of tighter credit conditions, the VAT hike, and softer oil prices.

We expect the CBR to resume rate cuts in 2019 because Russia's real interest rates are still in restrictive territory. The CBR will proceed cautiously, given the uncertain external environment, and

¹ "Turkey Long-Term Foreign Currency Rating Lowered To 'B+' On Implications Of Extreme Lira Volatility; Outlook Stable," Aug. 17, 2018

we do not exclude another hike in the short term if external pressures resurface. We see the key rate at 6.5% by the end of 2020.

Key risks

- External downside risks are related to a steeper rise in U.S. rates and a stronger U.S. dollar, as well as escalating trade tensions. Further U.S. dollar appreciation would be of a particular concern for emerging markets reliant on U.S. dollar financing. Indeed, two previous periods of relative U.S. dollar strength (the 1980s and the late 1990s) have seen major crises in several emerging markets.
- Turkey remains highly exposed to the risks of further deterioration in external financing conditions. While the forced external adjustment should result in a meaningful narrowing of the current account deficit, Turkey's external financing needs will remain significant, given the high level of external indebtedness among its banks and corporates. Indeed, our baseline forecast of a mild recession assumes that Turkey's indebted banks and corporates will be able to roll over their existing stock of foreign debt. Should rollover rates drop below 100%, this would almost certainly result in a much more pronounced economic adjustment and output volatility than we currently project.
- By contrast, Russia is not particularly vulnerable to the tightening of global liquidity, due to its continuous – and widening – current account surpluses and strong external balance sheets. However, the risk of significant tightening of international sanctions has risen, following new proposals by the U.S. Congress over the summer.
- For South Africa, key domestic risks are the potential fallout from the land reform debate, and a waning reform momentum. Conversely, faster implementation of key reform initiatives would boost confidence, investment, and growth.

What to look for over the next quarter

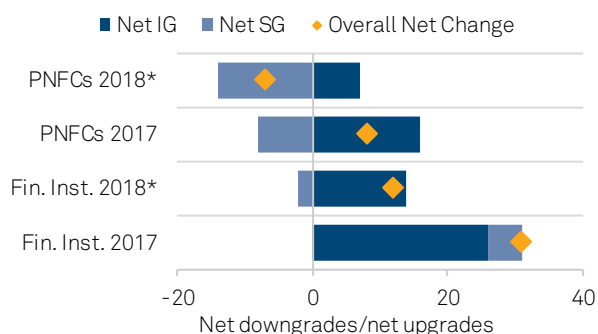
- We are likely to receive more information about U.S. sanctions on Russia in the next quarter.
- We will monitor incoming macroeconomic data about Turkey to assess the magnitude of the slowdown in economic activity and the speed of external adjustment. The rollover ratios of external debt will be a key indicator to watch.
- We will continue to follow progress regarding the government reform agenda in South Africa. The Medium Term Budget Policy Statement unveiled in October will likely contain more details about the recently announced fiscal package aimed to stimulate growth by reprioritizing government spending within the existing fiscal framework.

Sector Themes

- **Rating trends:** The tailwind of the global economic upswing is reflected in rating trends, with ratings on West European financial institutions and investment-grade nonfinancial corporates (NFCs) benefitting from improving credit quality (see chart 10). Downgrades dominate in the speculative-grade segment led (mainly) by leveraged buyouts in retail, consumer goods, health care and business services.
- Overall, the net outlook bias for Western European corporates (the percentage of ratings with positive outlooks less that of ratings with negative outlooks) was at -0.5% at the end of August. Financials retain a very positive net bias at 10.9%, close to multiyear highs, while NFCs at -3.9% also remain close to the top of their historical range (see chart 11).
- **In sector terms:** Most cyclically sensitive industries have seen improving outlook biases (see table 2). Areas under ratings pressure reflect particular industry strains and disruption – the extreme pressures on retailers brought about by internet shopping, online delivery, and price competition, for example – rather than broader cyclical challenges.

Chart 10

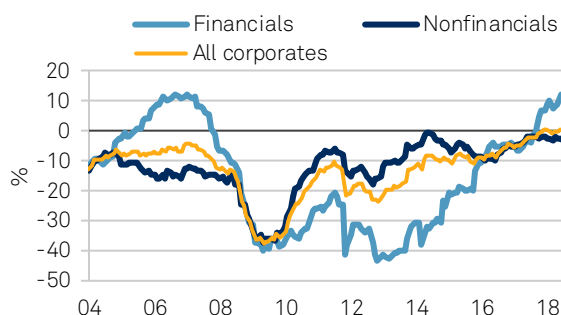
Europe - Positive rating actions dominate in 2018



*Data as of August 2018. PNFCs-Private nonfinancial corporates.
Source: S&P Global Fixed Income Research

Chart 11

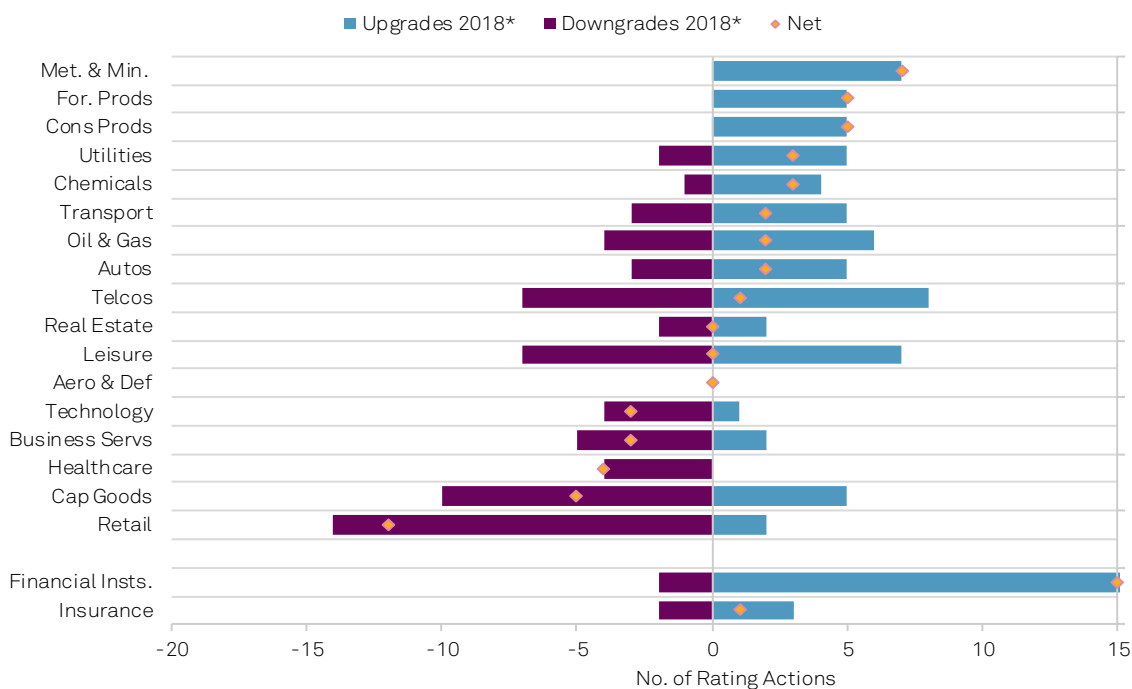
European corporate rating bias remains positive



Net ratings bias is positive bias minus negative bias. Source: S&P Global Fixed Income Research

Chart 12

European 2017-2018 Corporate Ratings Rating Actions by Sector



Source: S&P Global Ratings, S&P Global Fixed Income Research. Data as of Aug 31, 2018.

Table 2

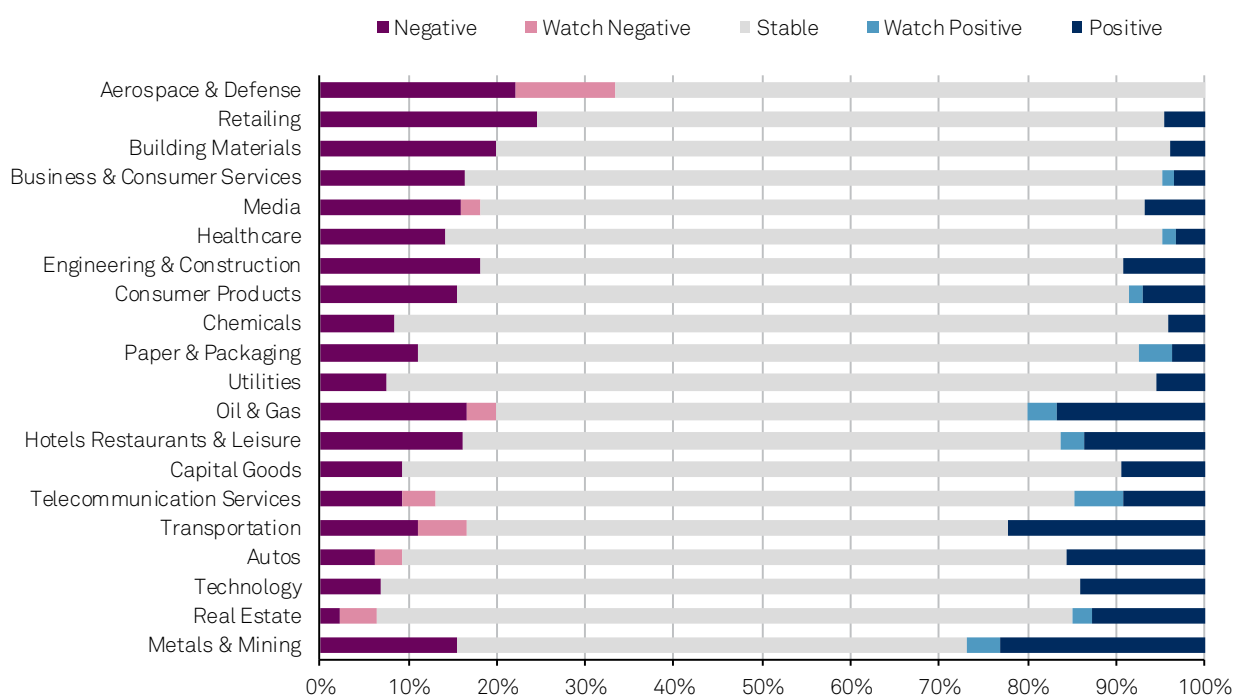
European Nonfinancial Corporate Net Outlook Bias by Industry

	Entities (No.)	Q4 13	Q4 14	Q4 15	Q4 16	Q4 17	Q1 18	Q2 18	Aug 18
Aerospace & Defense	9	+16.7	-16.7	+0.0	-33.3	-37.5	-33.3	-22.2	-33.3
Retailing	65	-4.0	-3.0	-10.0	-2.1	-4.7	-6.3	-17.9	-20.0
Building Materials	25	-15.4	+26.7	+6.3	+5.6	-28.6	-28.6	-20.0	-16.0
Business & Consumer Services	85	+10.0	-2.5	-5.8	-3.2	-10.0	-4.7	-13.3	-11.8
Media	44	+5.0	+0.0	-6.7	+2.8	-10.3	-7.3	-11.1	-11.4
Healthcare	64	+4.3	-3.2	-2.3	-3.8	-16.9	-19.7	-10.8	-9.4
Engineering & Construction	11	-20.0	+12.5	-25.0	-22.2	-45.5	-45.5	-9.1	-9.1
Consumer Products	71	-7.5	-9.3	-6.7	+1.8	+4.6	+0.0	-5.6	-7.0
Chemicals	48	-4.0	-6.7	-19.4	-11.8	-6.7	-6.5	+0.0	-4.2
Paper & Packaging	27	+0.0	+0.0	+0.0	+28.6	+17.4	+16.0	+6.7	-3.7
Utilities	93	-17.4	-5.6	+0.0	-8.0	-10.0	-9.9	-4.3	-2.2
Capital Goods	64	-2.9	-5.0	-15.9	-28.3	-5.2	-4.7	+0.0	+0.0
Hotels Restaurants & Leisure	37	-7.1	+16.7	-8.3	+3.3	+0.0	+2.8	-2.6	+0.0
Oil & Gas	30	+0.0	-28.0	-56.0	-48.1	-13.8	+0.0	+0.0	+0.0
Telecommunication Services	54	-11.4	-12.8	+2.2	+8.5	+2.0	+0.0	-1.8	+1.9
Transportation	54	-20.6	-7.0	-6.1	-15.4	-3.8	-3.8	+8.6	+5.6
Autos	32	+10.0	+4.2	-8.0	+7.4	+20.7	+13.3	+12.5	+6.3
Technology	43	-9.1	+5.9	+8.7	+10.0	+7.1	+6.8	+4.3	+7.0
Real Estate	47	+9.1	+4.0	-10.0	+6.1	+8.7	+4.3	+10.2	+8.5
Metals & Mining	26	-55.6	-20.0	-47.4	+0.0	+8.3	+3.8	+7.7	+11.5
Western Europe	929	-7.1	-4.0	-8.7	-4.4	-4.2	-4.3	-3.5	-3.9

Source: S&P Global Ratings

Chart 13

European Corporate Ratings Bias Distribution by Sector



Source: S&P Global Ratings, Data as of Aug 31, 2018. *Excludes developing outlook or CreditWatch placements

Banks

- European banks' balance sheets remain sound (or continue improving in periphery countries), amid still fairly supportive economic conditions, but profitability is generally still subpar.
- The build-up of cushions of loss-absorbing instruments by large European banks continues, partly explaining our positive outlook bias.
- But, downside risks are increasing. The risk of a disruptive Brexit remains a concern as the March 2019 deadline approaches, as it could lead to a severe economic shock for U.K. banks to manage. And, financial markets are reacting quickly to increased political uncertainty, penalizing the more vulnerable banks.

What's changed?

Turkey. The escalating crisis in the country has been a negative, but manageable, credit development for a few of the large European banks with exposures in the country, notably BBVA, Unicredit, BNP Paribas, ING, and HSBC. These banks have enough business and geographic diversity and financial flexibility to mitigate any potential damage and thus their ratings remain unchanged. BBVA is the most exposed with about 11% of its assets in Turkey, which explains our revision of the bank's outlook to negative.

Bank governance. Apparent weaknesses in anti-money-laundering terrorist financing and sanctions at some European banks raise questions about internal controls and the quality and coordination of European authorities' oversight. After Latvia's ABLV Bank that was liquidated, Estonian Versobank AS whose license was suspended, and Pilatus Bank in Malta, attention has turned to larger players: Netherland's ING, which was recently fined due to shortcomings and saw its CFO resign, and Denmark's Danske Bank, which just some days ago recognized failures in the prevention of money laundering and corrupt practices in its Estonian branch over 2007-2015. The bank's CEO also submitted his resignation. In response to the control and governance deficiencies highlighted, we lowered our standalone credit profile assessment on the bank and most of its debt issue ratings (other than those on senior unsecured debt)². Furthermore, risks are also on the downside given uncertainty around the potential penalties from the ongoing investigation and ensuing reputational damage to the bank.

Key assumptions

- Brexit will not be disruptive and economic conditions in Europe will remain fairly supportive, thus pointing to banks' stable balance sheets and benign asset quality.
- Authorities will continue working to enhance bank resolvability.

Key risks

- **Disruptive Brexit.** U.K. banks would be the most vulnerable to a disorderly Brexit, which would most likely lead to the economy possibly contracting amid a domestic political crisis, leaving the property market vulnerable if unemployment rose. While other largely open European economies, like Ireland, Belgium, or the Netherlands, will also feel the impact of a disorderly Brexit, we expect banks in these countries to be able to accommodate it.
Addressing issues related to the regulatory uncertainty after Britain leaves the EU remains a challenge for banks in general. The lack of a reciprocal recognition of legal frameworks and enforceability of judgments between the U.K. and the EU could have implications for cross-border financing, derivative contracts, and the eligibility of debt instruments issued under English law for capital and Minimum Requirement for Own Funds and Eligible Liabilities requirements.
- **Global trade.** A more adverse economic outlook for the region, resulting from weaker global trade, would challenge our expectations of generally benign asset quality and slow the ongoing reduction of the stock of legacy problematic assets in eurozone countries on the periphery. It would also complicate the repositioning of banks' business models, including those that have

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Weaknesses in anti-money-laundering terrorist financing raise questions about internal controls

Regulatory uncertainty after Britain leaves the EU remains a challenge

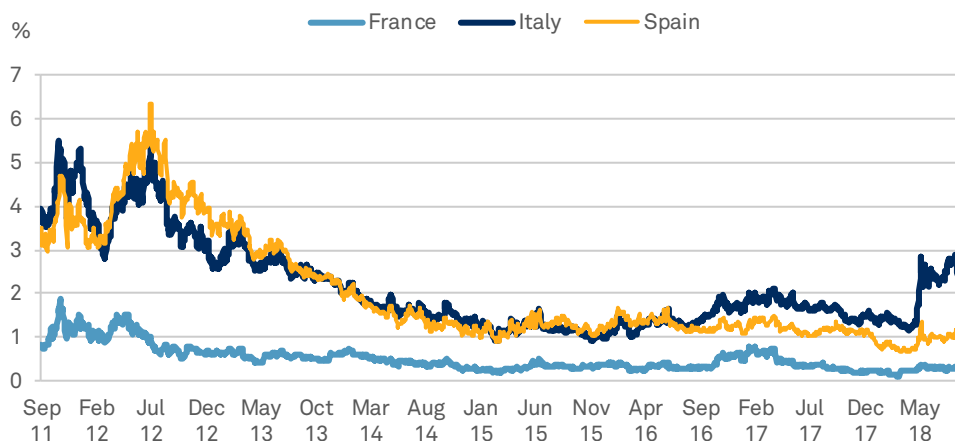
² “Danske Bank Outlook Revised To Negative, Hybrids Downgraded, On Further Disclosure On Money Laundering Issues In Estonia”, Sept. 25, 2018

not yet completed their restructuring programs, and would potentially stagnate banks' profitability at very low levels, weakening investor confidence in banks.

- **Market repricing.** A sudden and meaningful repricing of risk as monetary conditions tighten could push up banks' funding costs, squeeze margins and profits, hit capital through the mark-to-market of securities portfolios, cool down lending and make it more expensive, and constrain weaker players' access to market financing (see chart 14). Similarly, those housing markets that have experienced more rapid price growth in prior years will be more vulnerable to a correction scenario.

Chart 14

Evolution of 10-Year Sovereign/Bund Spreads



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

What to look for over the next quarter

- **Results of the European Banking Authority stress test**, expected on Nov. 2, that regulators will use to help set capital requirements. A total of 49 banks, with assets of at least €30 billion, will participate in the exercise. The adverse macroeconomic stress scenario is generally slightly more severe than the one in 2016. Base line conditions, however, are better now. Banks also face the exercise with stronger capital cushions and a less risky asset base. The main methodological difference compared to 2016 is the application of IFRS 9, which will result in earlier recognition of credit loss provisioning.
- **The policy direction of the new government in Italy**, in particular on the economic and fiscal fronts. For Italian banks to continue repairing their balance sheets--a process far from being completed--continued economic growth and investor confidence will need to be preserved.
- **More clarity around the terms of Brexit**, including a potential solution to service discontinuity risks for uncollateralized and collateralized derivatives.
- **How the Turkish crisis evolves** and how European bank owners respond if their subsidiaries/operations in the country face further stress.

The EBA's stress scenario is slightly more severe than the one in 2016

Nonfinancial Corporates

- Satisfactory business conditions currently remain supportive for credit quality, but business prospects are showing signs of weakening in certain sectors.
- Margins in certain sectors appear to be softening due to rising input costs emanating from the labor market. Tariff pressures and surging electricity prices have also contributed.
- The two top risks are trade tensions escalating to include the European auto industry and the increasing nontrivial risk of a disruptive Brexit in March 2019.
- The increasing likelihood of a disruptive Brexit in March 2019 (while still not our base case) is now at a level that has become a rating consideration for the most exposed corporates.

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What's changed?

S&P Survey. While current business conditions remain satisfactory for all sectors apart from retail (see table 3), our business and sector rating outlooks over the next 12 months have shown some deterioration, with a significant number of sectors (eight) experiencing a downward shift this quarter. The last time our business outlook diffusion index fell from above 50% into negative territory was in February 2015 (see chart 15). The outlook for the European auto sector looks more challenging given trade tensions, while the rating outlook in retail has deteriorated further partly due to the weight of U.K. rated companies in this sector.

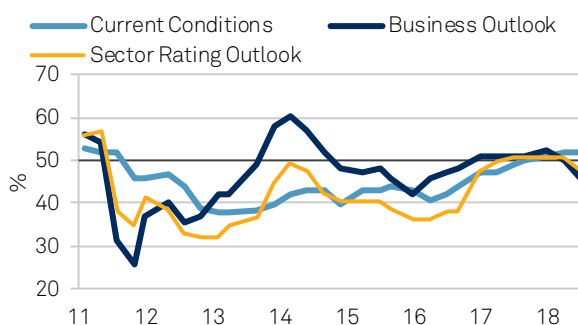
Trade. The global auto industry appears in the crosshairs of the ongoing trade imbroglio, particularly with the U.S. imposition of 25% tariffs on car imports from China, and China's counterstrike of 40% tariffs levied on U.S. auto imports into China. This is causing collateral damage for European car makers³. European carmakers that have invested heavily in China to develop their global supply chains are faced with a slowing market in China and higher costs of exporting to the U.S. Likely to suffer collateral damage are some European producers exporting to China out of the U.S. and even VW's Mexican facilities, which will experience cost pressures on sales into the U.S. if the latest NAFTA proposals are implemented to increase the minimum wage to \$16 per hour. And, that is even before a final decision is made on imposing 25% tariffs on U.S. auto imports from the EU.

The trade imbroglio is causing collateral damage for European car makers

Inflation. One theme filtering through from our sector teams is a gradual build-up in price pressures, particularly in those sectors where labor constraints have been evident for a while (see chart 16). These sectors include business and consumer services in some European countries (and also the U.S.) and engineering and construction. The challenge, as growth momentum in the economy slows, is to pass through these price increases to protect margins. Rising tariffs and energy prices, including the sharp increase in European electricity prices to seven-year highs over the summer, caused by the heat wave and the sharp price increase in carbon credits, are also contributory factors.

Chart 15

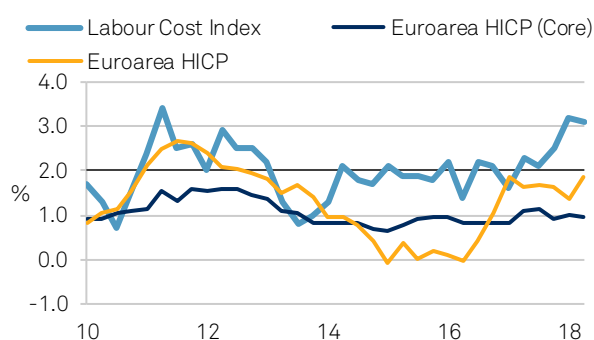
Corporate Credit Conditions Survey – Diffusion Index



Source: S&P Global Ratings

Chart 16

Eurozone Industrial and Construction Labor Costs Are Rising



Source: Thomson Reuters Datastream

³ "Trade Tensions: A Game Changer For Europe's Car Industry?" Sept. 18, 2018

U.K. Although the economy is growing broadly in line with the eurozone, this represents a relatively weaker position than in recent years. This is due to the fog of Brexit hanging over the country. One area where the private sector continues to experience headwinds is public contracts. Due to tight central government and local authority budgets, contract tenders are experiencing some delays, for instance for some digital transformation projects. And those that have been awarded usually go to the lowest-cost providers with little assessment of service quality. This presents a credit risk to the operator and potentially undermines service standards for the taxpayer.

Retail. Industry disruption continues to accelerate as e-commerce transforms customer behavior and preferences, increases the volatility of customer traffic, and impairs retailers' ability to maintain gross margins under competitive pricing pressure. In addition, development of omnichannel capabilities and, in particular, investment in digital platforms, as well as supplier and distribution networks are raising capital expenditure and operating expenditure. These challenges are putting upward pressure on working capital and exceptional expenses to the detriment of credit quality.

Key assumptions

- Domestic-facing sectors in the eurozone are benefitting from the continuing economic recovery and falling unemployment, while export sectors are facing a slowdown in orders as trade uncertainty persists.
- Nonfinancial corporates will accelerate the rollout of contingency plans in preparation for a worst-case disruptive Brexit at some cost to inventories and working capital.
- The outlook for European default rates remains benign, except for the competitive retail sector where changing consumer habits and technological advances are threatening business models.

Key risks

- **Disruptive Brexit.** Reverting to World Trade Organization rules in March 2019, without coordinated safeguarding measures, would result in disruption for many sectors ranging from manageable to severe. Even after implementing contingency plans, companies may still be caught up in supply chain bottlenecks, logistical delays at the border, or legal uncertainties after the sudden loss of regulatory recognition for certain activities. Aerospace and defense and autos and the transportation industry are examples of sectors materially exposed to regulatory risks.
- **Trade disruption.** A further material escalation in global trade tensions could undermine the global trading system. The auto sector could be the canary in the mine if higher tariffs slow sales and disrupt supply chains with associated cost implications. Shipping, logistics, capital goods, and investment could all be casualties if the U.S. and China find themselves in increasingly entrenched positions.
- **Commodity price volatility.** Rising interest rates, a stronger dollar, and growing trade tensions (risking future growth) are translating into weaker prices for some industrial commodities, notably copper and zinc. Some oversupply of iron ore in the seaborne market may weaken prices over the next two to three years as China's supply-side reforms take effect⁴. Oil prices remain high, however, pressuring margins in some sectors (shipping, chemicals).
- **Excessive leverage.** A growing concern as the credit cycle matures in Europe is weak or vulnerable companies with high debt levels generating little free operating cash flow and exhibiting minimal growth. Refinancing could become a real challenge particularly when funding costs start to rise. This can drive consolidation in many of these sectors that include chemicals, capital goods, business services, and retail sectors.
- **Turkey.** Our forecast for a recession in 2019 presents significant financial risk for Turkish corporates, particularly those that have any near-term liquidity issues or have substantial unhedged foreign currency borrowings. Credit quality could suffer for international companies with exposure to Turkey (for example, Italian construction company Astaldi).

Nonfinancial corporates will accelerate the rollout of contingency plans in preparation for a worst-case disruptive Brexit

⁴ "S&P Global Ratings Lowers Copper And Zinc Price Assumptions; Other Metal Price Assumptions Are Unchanged," Sept 11, 2018.

What to look for over the next quarter

- **Brexit.** Negotiations have reached a critical stage, but with a compromise solution still not in sight, the increasing likelihood of a disruptive Brexit in March 2019 (while still not our base case) is now at a level that has become a rating consideration for the most exposed corporates.
- **Trade.** Another milestone would be reached if the U.S. administration announced 25% tariffs on European auto imports on national security S232 grounds. A decision may be forthcoming at any time if the U.S. believes that progress toward a satisfactory U.S.-EU trade deal is stalling.

Table 3

European Corporate Credit Conditions Survey – September 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
Retail	Weak	Weaker	Decrease	Increase	Negative
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	No change	No Change	No Change	Stable to Negative
Aerospace & Defence	Satisfactory	No change	No Change	No Change	Stable
Autos – Manufacturers	Satisfactory	Moderately weaker	No Change	No Change	Stable
Autos – Suppliers	Satisfactory	Moderately weaker	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
Mining	Strong	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	No change	No Change	No Change	Stable
Steel	Strong	No change	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
Forest Products	Satisfactory	No change	Increase	No Change	Positive to Stable
Oil & Gas - Upstream	Strong	No change	Increase	No Change	Positive to Stable
Utilities - Unreg. Power & Gas	Satisfactory	Moderately stronger	No Change	No Change	Positive to Stable

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

Change indicators

Weaker since June 2018
Stronger since June 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.

Insurance

- In Western Europe, predominantly prudent investment policies, disciplined non-life insurance pricing, and gradual life product shifts support credit stability, while riskier investment strategies and nonstandard insurance policies remain a niche phenomenon.
- Emerging-market insurers' credit quality is often correlated with sovereign risk, economic and political uncertainties, and foreign exchange risks because of local investment exposures and dependency on local regulation.
- After severe catastrophe losses in 2017, the market saw modest price increases in 2018 but strong competition could slow pricing momentum heading into 2019. We assume a slightly improved earnings outlook for 2018-2019, while our stable sector outlook mainly reflects robust capitalization, strong enterprise risk management, and still-rational underwriting.

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What's changed?

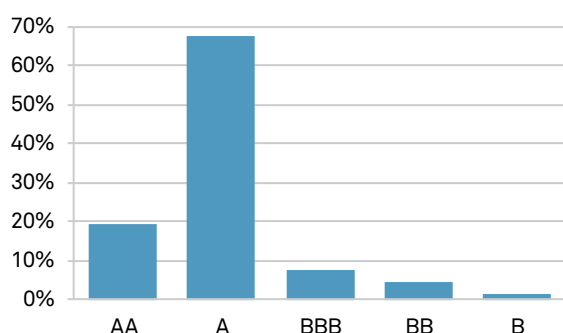
The longer-term trend toward life insurance products consuming less regulatory capital continues, with insurers no longer offering savings-type products with guarantees for long-term life insurance contracts. This has been evidenced by the pick-up in closed book transactions in Germany.

For composite insurance groups, non-life insurance and health insurance is often a diversifying element. Despite solid capitalization, we do not observe any excessive price competition threatening healthy margins.

With the expected end to ECB quantitative easing and Brexit approaching, uncertainty about capital market risks is increasing. Recently, spread widening materially weakened Italian insurers' solvency ratios and foreign exchange risks materialized for Turkey.

Chart 17

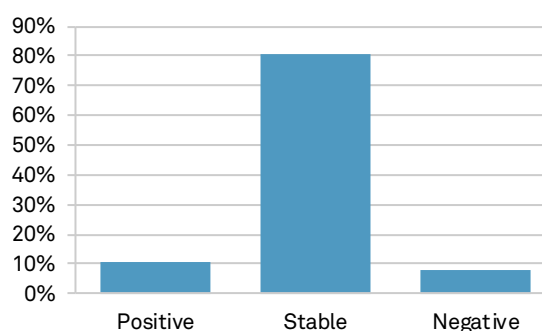
Rating Distribution for the EMEA Insurance Sector



Source: S&P Global Ratings (Sept. 6, 2018)

Chart 18

Outlook Distribution for the EMEA Insurance Sector



Source: S&P Global Ratings (Sept. 6, 2018)

Key assumptions

- Disciplined pricing in non-life insurance, with moderate growth alongside real GDP growth of about 0%-3%.
- Pressured pricing in the reinsurance sector, where we expect a 0% to 5% increase over 2018, with wide variations among lines and regions and fading momentum into 2019.

Key risks

- Interest rate sensitivity of life insurers' balance sheets remains a key risk as new business gradually shifts the profile of only the existing book of business.
- Multinational insurance groups face contractual continuity risks if disruptive Brexit potentially damages the insurance value chain.
- The end of the ECB's quantitative easing could cause some capital market dislocation, with any material spread widening dampening investment results and regulatory solvency ratios.

International Public Finance

- Brexit uncertainty has created an unfavorable business environment for U.K.-based social housing providers, universities, and local governments, and is weighing on the ratings.
- Spanish regions may gradually return to the international bond market following the new central government's intention to encourage this process.
- Local tax reform in France may reduce the financial flexibility of cities and departments.
- The election in Sweden may lead to a change in the financial policy of local governments.

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What's changed?

Transport for London (TfL) announced that the central section of its landmark Crossrail project will be delayed for at least nine months until autumn 2019. We estimate this will lead to lower-than-projected revenues and potentially increase costs given the extended schedule. The delay adds to the TfL's already challenging environment: Brexit (reducing passenger traffic), a fare freeze until 2020, reduced grants from the central government, and subdued growth in passenger volumes.

Spain's new central government has defined a procedure for regions to gradually return to market-based financing that may improve access to funding. A decade ago, pre financial crisis, Spanish regions' public issuance accounted for half of their debt. The regions' issuance volumes in the bond markets was also the second highest among European local and regional governments (LRGs) after German LRGs. But at year-end 2017, public bond issues represented only 16% of the regions' debt and central government had become their main lender, providing almost 60% of total funding.

The Spanish central government announced that it would allow regions to refinance their structural short-term debt with long-term maturities. Such a refinancing would significantly reduce the liquidity risks of Spanish regions with sizable short-term debt. Spanish regions interested in this refinancing option will have to justify the structural nature of their short-term debt to the Spanish Ministry of Finance or the Secretary General of the Treasury before Oct. 31, 2018.

The recent parliamentary and local elections in Sweden resulted in a complex political situation, which may lead to a revision of intergovernmental relations between the central and local governments as well as amendments to local government budget policies. The right-wing populist party, the Sweden Democrats, gained support with 17.5% of votes in the general election, with traditional left and right blocks obtaining nearly 40% each.

Key assumptions

We believe that some U.K. social housing associations will significantly increase or maintain relatively high exposure to the development of housing for sale on the open market. Market sales activities, encompassing first-tranche shared ownership sales, outright sales, and land sales expose housing associations to cyclicalities and a higher level of competition in the residential property development sector. We think this reduces the visibility and predictability of future earnings, compared with those of a traditional housing association providing mainly social rent properties, and will reduce headroom to withstand external risks.

U.K. real estate prices will grow slowly, while social housing rents will start rising from 2020.

What to look for over the next quarter

- The effect of Brexit negotiations on macroeconomic conditions, real estate prices, and demand for higher education services in the U.K.
- How parliamentary and local elections in Sweden affect intergovernmental relations and fiscal policy both at the central and local levels.
- Whether Spanish regions widen their access to the capital markets and refinance their short-term debt into long-term funding with funding from the central government agency.
- The content of local tax reform, which the French central government is expected to present to the parliament. This could result in a lower financial flexibility for cities and departments.
- The vote of Switzerland's National Council on a corporate taxation reform (TP17).
- The effect of new U.S. sanctions on capital market conditions in Russia.

U.K. housing associations are becoming exposed to cyclicalities and a higher level of competition in the residential property development sector

Structured Finance

- Revisions to the treatment of securitizations in the regulatory liquidity coverage ratio could hamper banks' participation as investors.
- Issuance remains on an upward trend but may stall in early 2019 as originators get to grips with the details of implementing the new securitization regulation.
- Benign credit performance looks set to continue, though some sectors are exposed to widespread impacts from idiosyncratic events.

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What's changed?

In the third quarter, the European Commission (EC) adopted amendments to the rules that determine how securitizations are treated in the calculation of EU banks' liquidity coverage ratios (LCRs). One aim is to integrate in the LCR rules the definitions and terminology of the new "simple, transparent and standardized" (STS) securitization framework, which was finalized in 2017. As part of its wider Capital Markets Union initiative, the EC has suggested that re-regulation should help revive European securitization issuance, but the latest changes to the LCR rules could have the opposite effect, as they may reduce banks' incentives to invest in securitizations. Rather than giving preferential treatment to STS-labeled securities relative to current rules, the LCR amendments further restrict which securitizations may be counted in banks' buffer of high-quality liquid assets. Furthermore, the new rules do not contain any "grandfathering" provisions, so existing securitizations already held in banks' liquidity books will no longer be eligible.

The latest changes to the LCR rules may reduce banks' incentives to invest in securitizations.

Chart 19

European Structured Finance Issuance, 12-Month Trailing

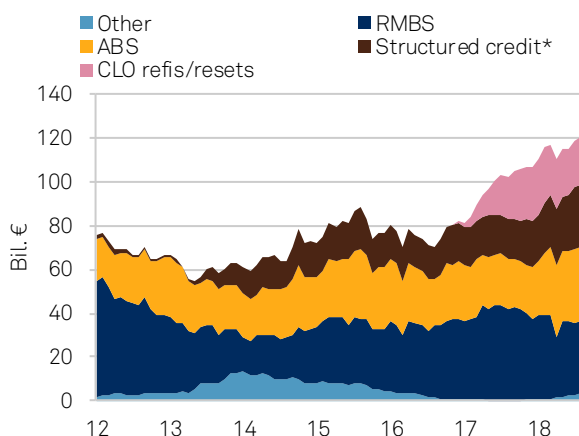
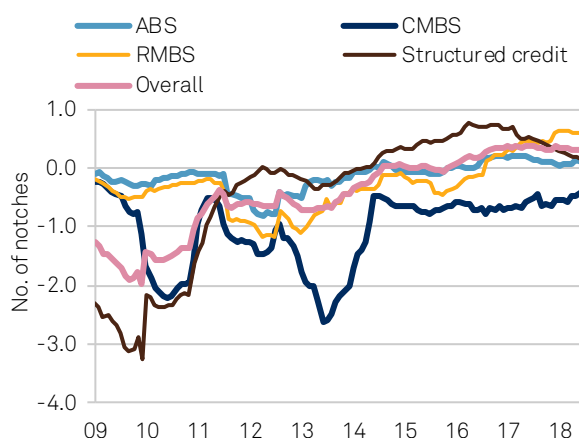


Chart 20

Average Change in Credit Quality, 12-Month Trailing



*Predominantly leveraged loan CLOs, but includes some other transaction types, for example, those backed by loans to small and midsize enterprises (SMEs). Source: S&P Global Fixed Income Research; LCD, an offering of S&P Global Market Intelligence.

Source: S&P Global Fixed Income Research

Key assumptions

In the medium term, we expect that increasing certainty over the regulatory environment for securitizations should prove supportive for investor demand and therefore originators' credit conditions. Also, as monetary policy begins to normalize, we expect that the floating-rate nature of most securitizations could make the asset class appealing to an increasing number of fixed-income investors, supporting volume growth (see chart 21). However, in the shorter term we believe that the challenges of complying with the EU's new securitization regulation from Jan. 1, 2019, could lead to some disruption. As regulators have not yet finalized and published all the technical standards surrounding the legislation, lingering uncertainties could trigger a significant pause in issuance early in 2019.

In terms of credit performance, our forecast of a benign macroeconomic environment suggests that neutral to positive ratings migration should continue across our European structured finance ratings universe (see chart 22). For example, during the third quarter of 2018 we changed our

Neutral to positive ratings migration should continue across our European structured finance ratings universe

outlook assumptions for the Irish and Portuguese residential mortgage markets, reducing our expected loss assumptions and leading to several ratings for residential mortgage-backed securities being placed on CreditWatch with positive implications.

Key risks

Some of our structured finance ratings may be susceptible to a widespread impact from an idiosyncratic event, such as a rating action on a widely used financial counterparty. In other words, certain groups of ratings are linked to very similar credit risks, affecting their joint behavior. This dynamic likely applies in the CLO sector. On average, any two post-crisis CLO tranches that we rate have nearly a 40% overlap in their underlying asset portfolios, while two CLOs from the same collateral manager have an average 70% portfolio overlap. This means that an uptick in defaults among corporate obligors favored by CLO managers could have a widespread effect on our CLO ratings.

What to look for over the next quarter

Over the next quarter, we will continue to monitor implementation of the new EU securitization regulation, as regulators finalize their interpretation of the legislative text and complete work on the technical standards and guidelines.

With the ECB's net asset purchases set to end in the fourth quarter, we will also watch for further spread widening that could worsen credit conditions for originators. That said, if the ECB continues to cover redemptions from its existing portfolio of asset-backed securities even after net purchases under the program end, gross purchases could still be fairly significant.

Related Research

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- Credit Conditions Latin America: Weakening Investor Sentiment Will Test Latin America's Decision Makers, Sept. 27, 2018
- Credit Conditions North America: U.S.-China Trade Tensions Threaten Favorable Conditions, Sept. 27, 2018
- Economic Research: Euro Weakness Is Not Over Yet, Sept. 26, 2018
- Danske Bank Outlook Revised To Negative, Hybrids Downgraded, On Further Disclosure On Money Laundering Issues In Estonia, Sept. 25, 2018
- Credit FAQ: Why We Don't Think South Africa's Credit Quality Will Suffer The Same Fate As Turkey's, Aug. 30, 2018
- When Insurance Regulators Across The Globe Ramp Up Their Rules, How Will Issuers Fare? Aug. 28, 2018
- European Corporate Credit Mid-Year Outlook: The Sense Of An Ending, Aug. 21, 2018
- Credit FAQ: What's Next For Turkish Issuers? Aug. 21, 2018
- Six Turkish Financial Institutions Downgraded On Heightened Credit Risks And Ongoing Depreciation Of The Turkish Lira, Aug. 17, 2018
- Industry Report Card: U.K. Banks Keep Calm And Carry On Amid Brexit Uncertainty, Aug. 13, 2018
- European Bank M&A: More Talk Than Action, Aug. 6, 2018
- Senior Nonpreferred Notes In Germany: The Best Of Both Worlds For German Banks, And Clarity For Investors, Jul. 10, 2018

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