

Credit Conditions EMEA:

Double, Double Toil And Trouble

June 27, 2019

Key Takeaways

- **Overall:** Heightened near-term (mainly geopolitical) risks are feeding uncertainty and weighing on economic fundamentals notwithstanding the Fed's and ECB's easing bias. Overall, the outlook for ratings has a more negative tilt after its recent gradual decline.
- **What's changed:** Financial markets have welcomed the proactive policy response of the Fed and ECB to counter the risk of an accelerating trade-induced slowdown in the global economy. How long this persists in the face of heightened uncertainty and growing near-term risks remains an open question.
- **Risks and imbalances:** The geopolitical and political landscape is becoming more divisive and unpredictable. This raises the risk of unintended consequences with Brexit, trade, and fiscal imbalances in Italy being the most material known risks for the region.
- **Macroeconomic conditions:** The EU growth outlook remains subdued mainly due to external demand weakness, with domestic demand held up by a vibrant labor market and high capacity utilization. We see no signs of inflation picking up anytime soon.
- **Financing conditions:** The macroeconomic outlook will prevent the ECB from raising rates until second-quarter 2021 in our view. While beneficial for servicing and raising debt, this also reflects the underlying economic fragility across the system and presents business challenges for banks' profitability, insurers' earnings, and activity in structured finance.
- **Sector themes:**
 - Banks.** Capital and asset quality remain solid, although low rates and a flat yield curve increase the conundrum of improving bank profitability.
 - Corporates.** Weaker operating conditions are evident in several sectors most exposed to the slowdown in global trade, while conditions remain satisfactory for most domestic sectors.
 - Structured Finance.** Based on fundamentals, benign credit performance will likely continue. Issuance volumes are rising as regulatory uncertainty dissipates, though TLTRO III will likely dampen growth.
 - Insurance.** Falling yields present material challenges for investment returns.
 - Public Finance.** A disruptive Brexit would be credit negative for U.K. social housing, universities, and local governments.

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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 June 24, 2019. The title makes reference to a line from "Macbeth," by William Shakespeare.)

Table 1

Top European Risks

Global trade

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

The risk trend for global trade has taken a turn for the worse as the U.S. moves to target key strategic industries in China. While Europe is not (yet) directly involved in this bilateral negotiation, the threat of U.S. auto tariffs, deferred for six months, would have serious financial repercussions for the auto industry in Europe if deployed.

Disruptive Brexit

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

Our base case remains that the U.K. will not leave the EU without a deal. However, we see a high and growing risk of a disruptive no-deal Brexit. This follows the resignation of the U.K. prime minister, the emergence of the Brexit Party, and the likely policy direction of the new prime minister putting a no-deal Brexit back on the table as a negotiating tool.

Fiscal imbalances in Italy

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

Although Italy benefits from substantial balance-of-payments surpluses and high private-sector savings, the sovereign has material vulnerability to downside risks over our rating horizon due to the combination of political risk, high government debt, and a weak economy.

Weakening European political cohesion

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

Populists continue to undermine support for established centrist parties, creating a more fragmented and divisive political landscape with the risk that multilateral institutions lose support, policy becomes less predictable, and governments become less willing to respond in a timely basis to emerging crises.

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 relevant for Turkish banks and to a lesser extent for Qatari banks. The stock of external debt of Turkish banks has been on a downward trend, pointing to lower rollover rates and a higher cost of refinancing.

Geopolitical risk

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

This risk remains elevated and closely monitored by investors. Regional tensions have increased over the past quarter because of tighter U.S. sanctions and accusations of retaliation against GCC-based infrastructure and shipping vessels.

More selective global investors

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

The change in the Fed's rate outlook is creating some breathing space to countries that depend highly on external debt. However, the underlying reasons for the pause, and particularly concerns over global growth, are creating new risks.

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?

On the surface, credit conditions in Europe, the Middle East, and Africa have stabilized and have even shown some improvement, for instance in funding costs, since the European Central Bank and the U.S. Federal Reserve recently adopted dovish stances. Growth in Europe remains subdued and heavily reliant on domestic demand. This is largely reflected in our ratings where rating actions in Europe have stabilized in the second quarter and the net balance of all corporate ratings outlooks at -6.0, while slipping, remains well above the long-term average of -12.5%.

Yet, we see an underlying fragility given the mounting risks and vulnerabilities. Many of these risks are geopolitical or political, and by definition are difficult to predict. And, while these risks have had only fairly limited economic or financial market consequences so far, we remain concerned that the cumulative effect could reach a tipping point for financial markets with contagion spreading to the real economy. The reduction in global trade volumes, the rapid fall in sales volumes for semiconductors, and weakness in inflation prospects (partly commodity driven; see charts 1 and 2), all point to growing sensitivity given the current risk environment.

The risks of a no-deal Brexit, and an escalation in trade tensions embroiling Europe, remain high with upward pressure after recent developments. With many senior political leaders stepping down in Europe, and given the diminishing authority of multilateral institutions, seeking compromise and resolving conflicts are becoming harder. This could accentuate the severity of these downside risks if they should materialize.

In this context, the European Commission's report released on June 5, 2019, about Italy's (BBB/Negative) budgetary compliance, highlighted the country's lack of progress toward agreed benchmarks for debt reduction under the Stability and Growth Pact. The combination of political risk, high government debt, and funding costs higher than nominal GDP means that Italy's public finances remain a potential source of systemic vulnerability both for Italy and the eurozone.

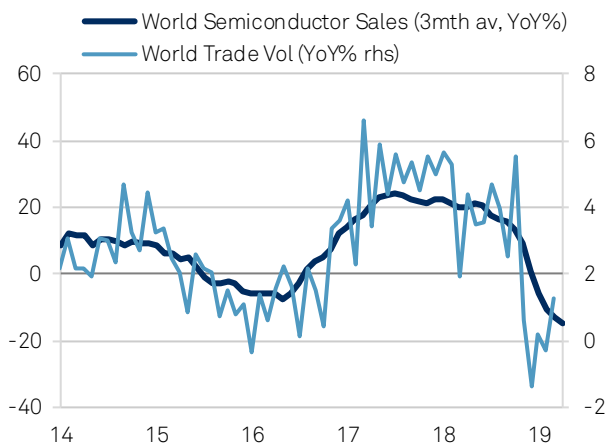
Another case in point is the unpredictable nature of the clash developing between Iran and the U.S. While we expect the Strait of Hormuz to remain open, we do see the possibility of tensions increasing further between Iran's and the U.S.'s respective regional allies with possible spillover effects in Iraq, Syria, and Yemen. In the unlikely event that the waterway became blocked, the credit implications could become more significant¹.

Growth remains subdued and heavily reliant on external demand.

We see an underlying fragility given mounting risks and uncertainties.

Chart 1

Global Trade Weak As The U.S.-China Confrontation Escalates



Source: CPB World Trade Monitor, Refinitiv. Data as April, 2019.

Chart 2

...While Eurozone Inflation Expectations Fall To Record Lows



Source: Eurostat, S&P GSCI Index, Refinitiv. Data as of June 13, 2019.

¹ How U.S.-Iran Tensions Might Affect Gulf Sovereign Ratings, Jun 11, 2019

Assessment of key risks in Europe

Global trade - High, worsening

The deterioration in the U.S.-China trade relationship continues as the U.S. raises the stakes by moving beyond tariffs, targeting key structural areas central to China's 2025 industrial strategy, namely innovation and technology. Most recently, Huawei has been placed on the U.S. Entity List, effectively banning suppliers from providing software or technology without a BIS license (from the U.S. Department of Commerce's Bureau of Industry and Security agency). We anticipate that Europe will become increasingly aligned with the U.S. in this strategic confrontation once the new EU Commission takes office. At the same time, the U.S.-EU relationship risks becoming more antagonistic and transactional. The threat of U.S. import tariffs on EU exports of auto and auto parts, although deferred for six months, would have serious financial repercussions for the industry and provoke a political response. Consideration is being given, particularly in France, to implementing "green protectionism" through a carbon tax at the EU border.

The threat of U.S. import tariffs on autos and auto parts would have serious financial repercussions.

While the deteriorating trade environment may have only limited rating implications so far, the ability of companies to pass on costs and substitute goods from other sources, as well as the duration of these tariffs, will determine the financial impact for specific companies. In the medium to longer term, changes to the global trading system would force many companies to reconfigure supply chains – at some considerable cost – with greater implications for ratings.

Disruptive Brexit – High, worsening

Our base case remains that the U.K. will not leave the EU without a deal. However, we see a high and growing risk of a disruptive no-deal Brexit. This follows the resignation of the U.K. prime minister, the emergence of the Brexit Party, and the policy direction of the candidates to become the new prime minister in late July, especially putting the no-deal option back on the table as a negotiating tool. Other avenues to break the impasse remain deadlocked, with no apparent willingness by the EU to reopen the Withdrawal Agreement. Also, opposition in the U.K. Parliament to frustrate the government by attempting to legislate to prevent a no-deal, win a vote of no confidence, or force a second referendum have come to nothing so far.

High and growing risk of a no-deal Brexit.

We believe a no-deal Brexit could push the U.K. into a moderate recession, with GDP falling by a cumulative 2.7% over two years. This would likely put downward pressure on rated U.K. entities, including the sovereign, and other non-U.K. entities with material U.K. country risk exposure.

Fiscal imbalances in Italy – Elevated, worsening

Although the Italian economy has recovered somewhat in recent years, it continues to present material vulnerability to downside risks over our rating horizon due to the combination of political risk, high government debt, and weak economic growth. Recent downward revisions to growth forecasts, doubts about the political commitment to the EU's Stability and Growth Pact, and periodic concerns about currency convertibility raise the risk of a repricing of Italian sovereign debt. Italy is the fourth-largest EU economy, and the interlinkages among sovereign, bank, and household debt highlight the risks of systemic contagion.

Weakening European political cohesion - Elevated, unchanged

While the EU parliamentary elections did not result in the populist surge that many feared, nonetheless the two centrist European parties (European People's Party, Progressive Alliance of Socialists and Democrats) lost their majority for the first time. Populist right-wing groups (including the U.K. Brexit Party) still hold about one-quarter of the seats in the EU Parliament while The Greens at 10% (7%) were the main beneficiaries.

Even so, at the national level the populist challenge (particularly in France and Italy) continues to undermine support for established centrist parties, creating a more fragmented and divisive political landscape. The risks, in an ever more nationalistic world, are that multilateral institutions lose support and influence, policy becomes less predictable, cross-border coordination is undermined, and governments become less willing to respond on a timely basis to emerging crises.

Assessment of key risks in the Middle East and Africa

Dependence on external debt – Very high, unchanged

Turkish banks' external debt has continued to decline, pointing to lower rollover rates than in the past, which we view as credit negative. As of April 30, 2019, the total stock of external debt of private-sector Turkish banks stood at \$148.2 billion (\$64.6 billion of short-term debt and \$83.6 billion of long-term debt, including \$33.9 billion of private-sector banks' debt coming to maturity in the next 12 months). This stock was \$3.1 billion lower than at year-end 2018, pointing to a continued decline in rollover rates, higher costs, and greater concerns by investors about the country's policy direction. We expect the lack of investor confidence to continue restricting Turkish banks' capacity to access capital markets at manageable prices. We therefore anticipate that banks will be unable to roll over the full extent of their short-term debts over the next few quarters.

The stock of foreign currency liquid assets increased slightly in the first four months of 2019, reaching \$101.1 billion compared with \$92.7 billion at year-end 2018. These assets continue to provide some leeway for banks to withstand more stress, but it is worth mentioning that about \$62.6 billion comprise banks' exposures to the central bank, meaning that a lower rollover rate will displace the problems to the central bank's balance sheet. Other main risks for Turkish banks include our expectations for deterioration in their asset quality indicators. Responding to these issues, the Turkish government recently announced some economic measures to strengthen the domestic banking sector. These include a Turkish lira (TRY) 28 billion capital injection, in foreign currency, into state banks and the creation of two funds to take over some nonperforming loans related to the construction and energy sectors. We acknowledge that the announced capital increase might benefit the solvency of state-owned banks, and that other measures might benefit the overall system. However, we see significant implementation risk as many details of the reform package are still missing and we believe that, at this stage, it might be insufficient to significantly reassure market participants. We expect banks' reported nonperforming loans to double over 2019 and 2020 to about 6%-8% of total loans and problematic loans (which include restructured loans) to climb to about 20% of total loans.

For Qatari banks, the stock of external debt at the end of March 2019 has exceeded the level it reached at year-end 2016 and is back to what we consider as high levels. Given the nonsticky and confidence-sensitive nature of nonresident deposits, we consider external funding a factor that could negatively affect Qatari banks.

Mounting geopolitical risk in the GCC - Elevated, worsening

Tensions increased in May 2019 after exemptions ended on sanctions on countries buying oil from Iran. Since then, Iran has been accused of retaliating by allegedly damaging infrastructure and commercial shipping vessels in the Gulf. Iran is also now threatening to restart its nuclear program. In our base case, we do not expect direct military conflict between the U.S. and Iran or their regional allies. Furthermore, we expect the Strait of Hormuz to remain open. That said, we see the possibility of tensions increasing further between Iran's and the U.S.'s respective regional allies, with possible spillover effects in Iraq, Syria, and Yemen. Unpredictability in the region could increase should Russian support for Iran become more pronounced. In the short term, ongoing or rising tensions could result in higher oil prices, increasing fiscal revenues from oil exports for the oil-exporting countries. If tensions do not abate, the impact could be offset by an increase in funding costs, a reduction in investors' appetite for instruments coming from the GCC region, or major foreign funding outflows. In the unlikely scenario of a significant escalation leading to blockage of the Strait of Hormuz (even for a few days), the ratings on GCC sovereigns and banks could come under significant pressure.

More selective global investors - Moderate, unchanged

The change in the U.S. Federal Reserve's rate outlook and the European Central Bank (ECB) is maintaining lower interest rates for longer is helpful for global liquidity. However, investors are becoming more selective because they are concerned about the underlying reasons for these changes in global monetary policy. That means the cost of funding, for GCC issuers, will remain higher than it used to be and liquidity channeled from developed markets to the region will reduce.

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We anticipate that Turkish banks will be unable to fully roll over short-term debt.

Financing conditions

Eurozone

Changes in guidance from the U.S. Federal Reserve and the ECB as the economic and inflation outlook slows have engendered a further sharp fall in the cost of bond market funding. We anticipate that financing conditions in the bond market will ease further for nonfinancial corporate borrowers, particularly for investment-grade and 'BB' rated companies. The funding environment for lower-rated nonfinancial corporates that increasingly raise debt finance from the non-bank sector appears more nuanced, however.

At one level, the subdued growth environment in the region, combined with heightened near-term political and geopolitical event risks, has introduced an element of caution into the leveraged buyout (LBO) market. Investors are showing some discipline in differentiating between more cyclical and aggressively structured deals. And from the issuers' perspective, the requirement for new funding currently appears limited, as M&A volumes remain surprisingly low and most refinancing has already been undertaken. This can be seen in issuance activity for both leveraged loans and high yield, where volumes are down by 40% and 25% respectively in the year to end-May, compared with the same period in 2018. Refinancing is largely off the agenda, with 83% of outstanding leveraged loans in S&P European Leveraged Loan Index originated in 2017 and 2018.

Since 2013, CLO vehicles have again become important buyers in the leveraged loan market, as investors seek attractive risk-adjusted returns from a product structured to avoid mark-to-market and liquidity mismatch risks. One element of CLO structures designed to protect senior noteholders during the reinvestment period is a cap placed on the proportion of underlying assets that can be rated in the 'CCC' category. Typically, if downgrades of corporate obligors in the collateral pool cause the 'CCC' proportion to exceed about 5%-10%, then the CCC collateral that exceeds this threshold will have its face value reduced in the calculation of certain collateral coverage tests. Ultimately, if this leads to a coverage test failure, the CLO would divert cash flow to pay down senior noteholders until the vehicle delevers enough to restore compliance with the tests. In this context, we observe that the proportion of 'B-' rated loans in S&P European Leveraged Loan Index has almost doubled to about 11% by par value since December 2017 partly due to new 'B-' rated loans entering the index, while the proportion in the 'CCC' and 'CC' categories has remained stable at less than 2% since late 2016. This highlights a potential increase in sensitivity to a turn in the operating environment, which could cause the number of downgrades to 'CCC' to increase.

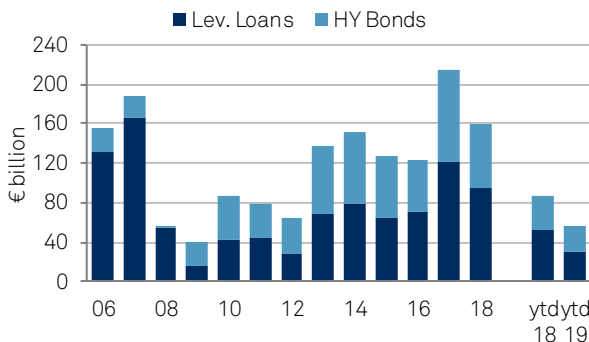
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'B-' rated loans in ELLI have doubled since Dec 2017.

Chart 3

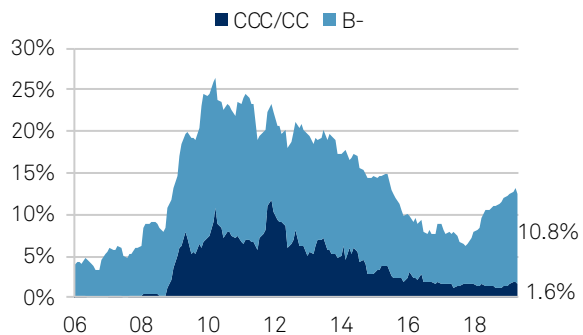
European Leveraged Finance Issuance



Source: Source: S&P Global Ratings; LCD, an offering of S&P Global Market Intelligence. Ytd – data to end May.

Chart 4

European Leveraged Loan Index – Share of Index Rated 'B-' and CCC by Value of Facility Rating



Source: Source: S&P Global Ratings; LCD, an offering of S&P Global Market Intelligence.

Macroeconomic developments and assumptions

- We expect the eurozone economy to expand by 1.1% this year and 1.3% in 2020 and 2021.
- External demand weakness is the main factor weighing on growth, while domestic demand remains strong, supported by a vibrant labor market and high capacity utilization.
- The ECB will keep rates low for longer. We think global trade uncertainties and inflation are still well below target will prevent the ECB from raising rates until second-quarter 2021.
- In the U.K., we expect growth of only 1% in 2019 due to ongoing Brexit uncertainty, weak investment, and some unwinding in inventories.
- The more dovish guidance from the Fed and ECB should support capital flows to emerging markets, bearing in mind rising downside risks to global growth, amid escalating trade disputes and geopolitical tensions.

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Eurozone

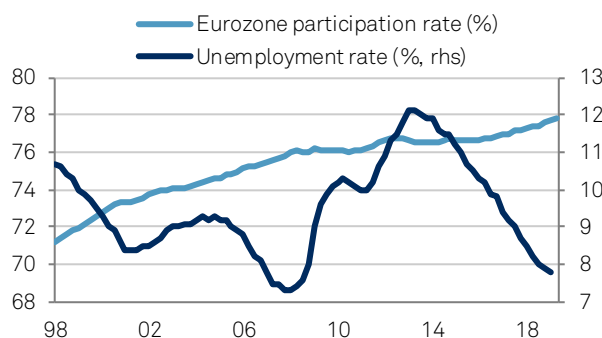
What's changed?

The eurozone economy surprised on the upside in the first quarter, with GDP growth expanding by 0.4% on the quarter. In spite of weak global trade dynamics, net trade added a little to growth. But what really boosted the economy was the strength of domestic demand (adding 0.5 percentage point to growth).

While the weakness of global trade continues to weigh on European manufacturing sectors, a strong labor market continues to underpin demand in the services and construction sectors. As such, the eurozone unemployment rate dropped to 7.6% in April, coming ever closer to its lowest level of 7.3% seen in 2008. This comes as the participation rate is increasing, with the eurozone employment rate for the population aged 15 to 64 years at 67.7% in the first quarter, up from 65.8% in 2008, the highest on record (see chart 5). Considering that job vacancies have reached a record high, it seems that structural and consequently lasting trends are supporting labor markets. A tight labor market is not only adding to household income through job creation, but also through higher wages. Adding to that, inflation remains low – thanks to low energy prices – and thus households are set to see their purchasing power expand further, supporting consumption.

Chart 5

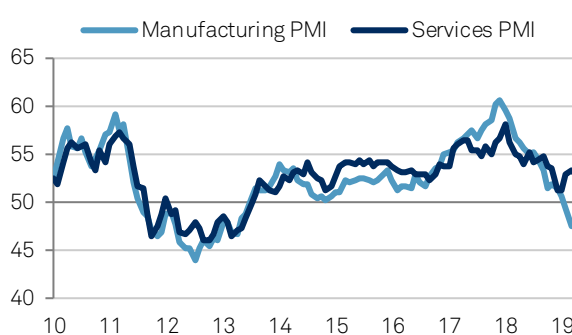
Eurozone Labor Market Is Creating Jobs And Boosting Household Incomes



Source: Eurostat, Oxford Economics, S&P Global

Chart 6

How Long Can The Dichotomy Between Services And Manufacturing Continue?



Source: IHS Markit, S&P Global

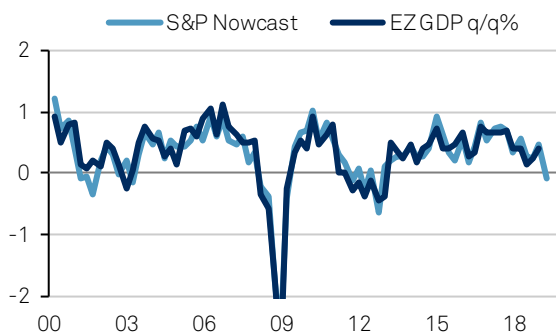
Meanwhile, although hurt the most by the weakness in external demand, European industry continues to report capacity utilization rates above long-term averages and rising expected months of production and equipment as a limit to activity. In a context of easy financial conditions – thanks to the ECB's loose monetary policy – and negative long-term interest rates in real terms, we expect firms to continue to increase capital investment, even if more slowly than in the past two years given uncertainty about global trade.

Credit Conditions EMEA: Double, Double Toil and Trouble

That being said, it would seem that the dichotomy in performance between services and manufacturing cannot go on forever (see chart 6). As such, the longer external demand weakness goes on, the more likely it is to spill over into domestic demand. For now, we are not worried about this: For EMEA, our GDP Nowcast points to -0.1% growth in the second quarter, but our recession model points to low recession risk, at about a 10% probability in the next 12 months (see charts 7 and 8). But we note that downside risks to growth, linked to weak global trade, are tilted to the downside.

Chart 7

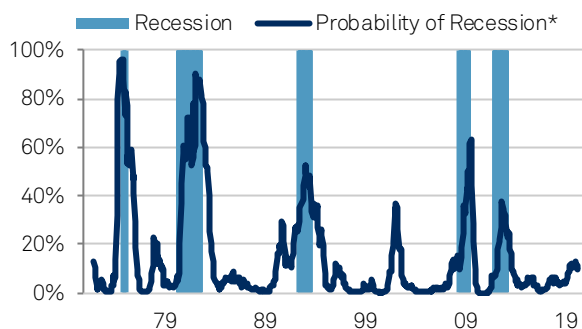
Our Nowcast Indicator Points To -0.1% Growth In Q2



Source: Eurostat, S&P Global

Chart 8

Eurozone Recession Probability Is On The Rise But Still Marginal, Being Close To 10% In The Next 12 Months



* Model based on real M1, the yield curve and term premium Source: CEPR, ECB, S&P Global

As for the downside risks to growth, core inflation is still hovering about 1%, and a more dovish Fed will keep the ECB in that mode for much longer. We expect it won't be in a position to raise rates before at least the second quarter of 2021 and thus will continue to operate with a large balance sheet at least until the end of 2022. In a scenario where the Fed cuts rates and this leads to a tightening of financing conditions in the eurozone through a strengthening of the euro, we think the ECB could even loosen monetary policy further, for example by adjusting its forward guidance, cutting the deposit rate by 10 basis points, or easing the terms of the third round of targeted longer-term refinancing operations (TLTRO III) for banks.

ECB won't be in a position to raise rates before Q2 2021.

Key assumptions

- GDP growth will remain slightly below its potential growth rate, rising by 1.1% this year, and from then on continuing to reconverge toward its potential of 1.3%.
- Inflation will remain low this year on the back of lower energy prices. For now, we see headline inflation averaging 1.3% over the next two years. But eventually, stronger wage pressures should feed into higher core inflation.
- The ECB won't raise rates until the second-quarter of 2021 in a context of low inflation, persisting downside risks to growth, and a more dovish Fed.
- The euro is set to stay weak at least until mid-2021 because of looser monetary policy and sustained global uncertainties that will continue to support the dollar as a safe-haven asset.

Key risks

Weakening external demand is the main downside risk to growth. The risk of a further escalation in the trade war has not abated. For now, the EU remains on the sidelines. The U.S. administration has postponed a possible hike in tariffs on EU cars to October, and the EU is unlikely to have a clear position on trade until the new European Commission is appointed by the end of October.

U.K.

What's changed?

Surprisingly strong growth in the first quarter of this year was largely driven by extraordinary stockpiling activity in the manufacturing sector ahead of a possible no-deal Brexit in April, not because the economy was particularly robust. The economy will continue to face strong headwinds.

Key assumptions

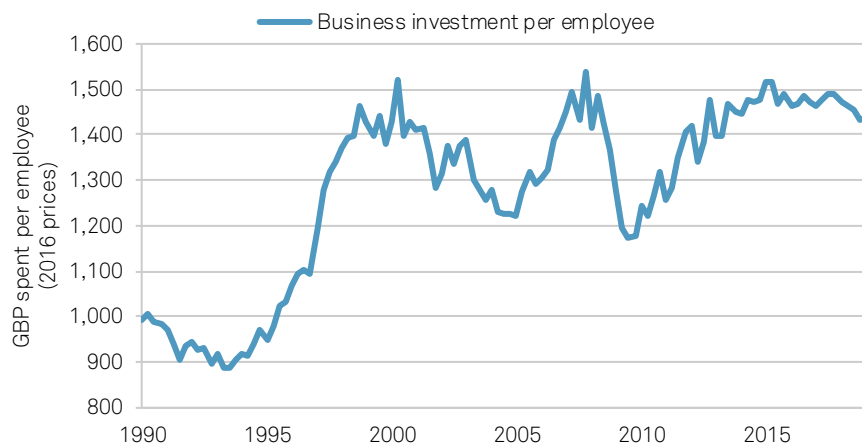
With the postponement of the Brexit deadline to end-October, activity in the second quarter will feature an unwinding of inventories and a moderate contraction in activity without much help from the much larger services sector. However, we expect the economy to return to modest growth thereafter. Moreover, uncertainty over the final shape of Brexit will now last through most of the year, weighing particularly on business investment.

For 2019 as a whole, we continue to expect growth of just 1.2%. The economy will be supported by the ongoing strength of the labor market and by nominal wages continuing to rise above inflation, although the pace of pay growth could slow somewhat. The resulting boost to household incomes continues to underpin consumer spending. Some labor market strength stems from the generally greater reluctance by businesses since 2016 to spend on long-term investment, which is often irreversible, and is compensated by hiring more staff (see chart 9).

Labor market strength stems from reluctance to spend on long-term investment.

Chart 9

U.K. Business Investment Per Employee



Source: ONS, S&P Global Ratings calculations

Investment spending has also been weak because of decisions by businesses in anticipation of Brexit to relocate operations to other EU destinations, or expand operations there, rather than in the U.K. This will weaken U.K. economic prospects in the medium term.

The Bank of England has recently displayed a more hawkish attitude, suggesting it might raise rates quicker than markets expected. However, in our view, there will be no scope to do so against the backdrop of an economic contraction in the second quarter and slowing pay growth. Moreover, inflation has just returned to target, and wage growth will not exert much inflationary pressure in a relatively soft economic environment. Finally, and importantly, persistent Brexit uncertainty will also make it difficult to justify any rate hike just before or after Brexit.

Key risks

Our forecast rests on the assumption that the U.K. will not leave the EU without a deal. Risks to the forecasts are heavily skewed to the downside and are dominated by the risk of a disruptive Brexit, which we see as high and growing. Should this risk materialize, we would expect the U.K. economy to enter a recession and perform considerably worse over our forecast horizon (2019-2022).

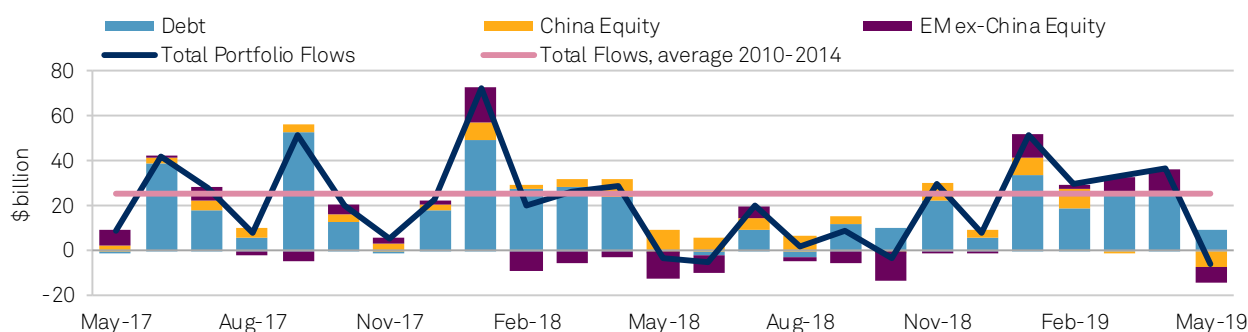
EMEA Emerging Markets

What's changed?

The escalation of trade tensions between the U.S. and China has curbed investors' enthusiasm for emerging-market assets brought about by the pause in the Fed hiking cycle in the first quarter. Cross-border investors pulled back \$15 billion from emerging-market equities in May (see chart 10), amid rising concerns about prospects for global growth and trade. Net foreign purchases of emerging-market debt continued, as further declines in market interest rates in advanced economies have increased the relative attractiveness of higher-yielding, emerging-market fixed-income instruments. Still, nonresident debt inflows into emerging markets softened to \$9 billion in May, down from the monthly average of \$26 billion from January through April. Yet after the Fed and the ECB adjusted their guidance in response to a slowdown in the economic and inflation outlook, foreign investors appear to have bought back emerging market assets during June,

Chart 10

Net Non-Resident Portfolio Flows to Emerging Markets



Source: IIF, S&P Global Ratings calculations

Global financing conditions are set to remain highly accommodative this year and next, with the U.S. Fed likely to cut interest rates this year and the ECB further delaying the rate hike, which we now expect in the second quarter of 2021. The reversal in the Fed tightening cycle, and much slower normalization of monetary policy by the ECB, should support capital flows to emerging markets. However, this shift toward more monetary accommodation is taking place in the context of rising downside risks to global growth amid escalating trade disputes and geopolitical tensions. With so many pressure points, investors' sentiment toward riskier assets is set to be fragile. In the volatile external environment, country-specific factors, such as economic prospects, policy uncertainties, and geopolitical disputes will be important drivers of sentiment toward EMEA emerging markets.

In a volatile global environment, country-specific factors will be important.

Russia

- Russia's GDP growth decelerated sharply in the first quarter, to 0.5% year on year, from 2.7% in fourth-quarter 2018. High-frequency data point to stronger growth next quarter.
- We think temporary factors are behind this weakness, chiefly a buildup in inventories in the fourth quarter in anticipation of the hike in the valued-added tax in the first quarter (to 20% from 18%), and destocking in the first quarter.
- Russian assets rallied, with investors seeing a receding risk of sanctions. The U.S. dollar RTS Index has risen 15% since end-March and 30% since the beginning of 2019. The government bond market has enjoyed strong inflows of foreign capital.
- The Central Bank cut the key rate by 25 basis point to 7.5% in June, while lowering its inflation and growth forecasts. We expect one more cut of 25 basis points next quarter.
- Economic growth is likely to remain subdued. Monetary policy remains tight, as the central bank only now has begun to unwind last year's defensive hikes. Fiscal policy tightened with the VAT hike, while the proposed public spending boost lags behind. We have lowered our GDP growth forecast to 1.3% in 2019, and maintained our forecast of 1.8% for 2020.

South Africa

- The South African economy contracted by an annualized 3.2% in the first quarter from the previous quarter, the worst quarterly drop in real GDP since 2009.
- The poor reading is in part due to temporary effects, notably electricity cuts and a strike in the gold-mining sector. More fundamentally, they reflect low business and consumer confidence, amid slow progress in tackling numerous structural impediments to growth.
- Depressed domestic demand helped to contain inflation, which is hovering around midpoint of the 3%-6% target range, with the latest reading at 4.5% in May.
- Following the victory of the African National Congress in the national elections in May with a clear (albeit reduced) majority, reforms may gain some momentum in the second half of this year. This would boost confidence and investment and support growth.
- We think that reform efforts will focus primarily on cutting costs, reducing ministerial head count, improving state-owned enterprises, and tackling corruption. At the same time, the government will likely continue to stay away from difficult and contentious issues such as widespread staff retrenchments in state-owned enterprises and tackling the labor unions. We forecast growth of 1% this year, rising to 1.6% in 2020.²

Turkey

- The Turkish economy posted a stronger than expected outturn in the first quarter, with real GDP expanding by a quarterly 1.3%. Annual GDP growth was still negative, at -2.6%.
- A sizable fiscal and credit stimulus, partly fueled by state-owned banks, supported the recovery. In our view, this upturn is unlikely to be sustained, and we still forecast a contraction in output of 1.8% for the full year.
- The country's financial markets have somewhat calmed but remain unstable. Domestic banks have retained foreign funding access and have largely rolled over maturing external debt. That said, the central bank's net foreign exchange reserves have trended downward.
- In June, Ekrem Imamoglu of the opposition Republican People's Party (CHP) won a rerun of the Istanbul mayoral election. In our view, the acknowledgement of the announced result by the government can be viewed as positive in the context of Turkey's institutional arrangements. That said, we expect political uncertainty to remain elevated in the near future. Specifically, it remains to be seen how the opposition's control of Istanbul can co-exist with the president's far-reaching powers on the national level.

Key risks

- A more pronounced slowdown in global growth would hurt Russian, South African, and Turkish exports since domestic growth drivers are weak. That may dent investors' confidence and risk appetite, especially if international trade flows are being disrupted and geopolitical tensions flare up. A sharp deceleration in foreign financial flows to EMEA emerging economies could result.
- The risk of additional U.S. sanctions on systemically important state-owned banks or on the stock of outstanding sovereign debt, continues to loom over Russia, although the risk of the sanctions being introduced this year has receded somewhat.
- Continuing problems at Eskom, South Africa's electricity utility, could lead to renewed electricity shortages, hitting growth of production directly and confidence indirectly.
- Turkey remains highly vulnerable to any worsening in investor sentiment, due to the high level of short-term external debt in the private sector. Unconventional policy responses to the episodes of market volatility as well as uncertainty about the direction of economic policy may further erode investors' sentiment and jeopardize the recovery. Further risks stem from geopolitical developments, including a dispute with the U.S. over a purchase of Russian missile systems that could result in sanctions as soon as this summer.

What to look for over the next quarter

- **Russia:** Any developments with sanction-related bills submitted to the U.S. Congress.
- **South Africa:** Progress with structural reforms, including the restructuring of the Eskom.
- **Turkey:** The direction of policies in the aftermath of the re-run of Istanbul mayoral election, as well as banks' asset quality trends and their access to foreign funding.

² Summary: South Africa, May 24, 2019

Sector Themes

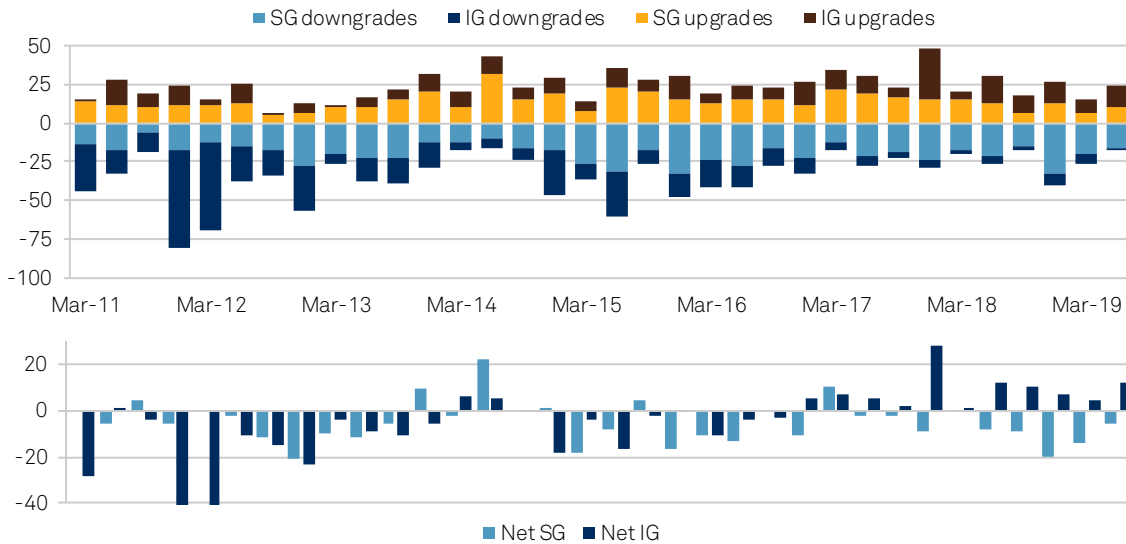
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- **Rating trends:** As a share of total rating actions, we continue to see net downgrades for speculative-grade nonfinancial corporates (NFCs), balanced actions in investment-grade NFCs, and net positive actions for financial institutions.
- **Rating Outlooks:** The outlook bias for corporates overall is still negative and sliding but remains well above average. The net outlook bias for NFCs stood at -8.1% at end-May, with consumer products, autos, retail, leisure, and health care with the highest negative bias.

Chart 11

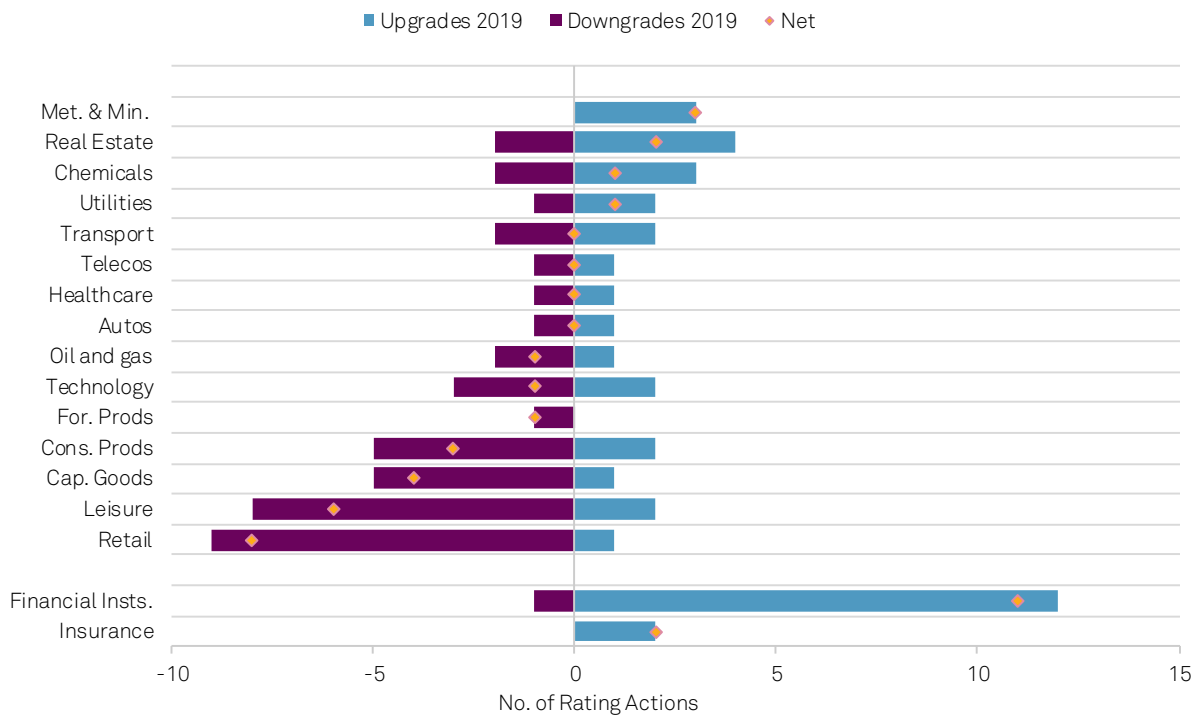
European Corporate Ratings Actions – Diverging Trends IG v SG Since Q2 2018



Source: S&P Global Fixed Income Research, Data as of May 31, 2019.

Chart 12

European Corporate Ratings Actions by Sector

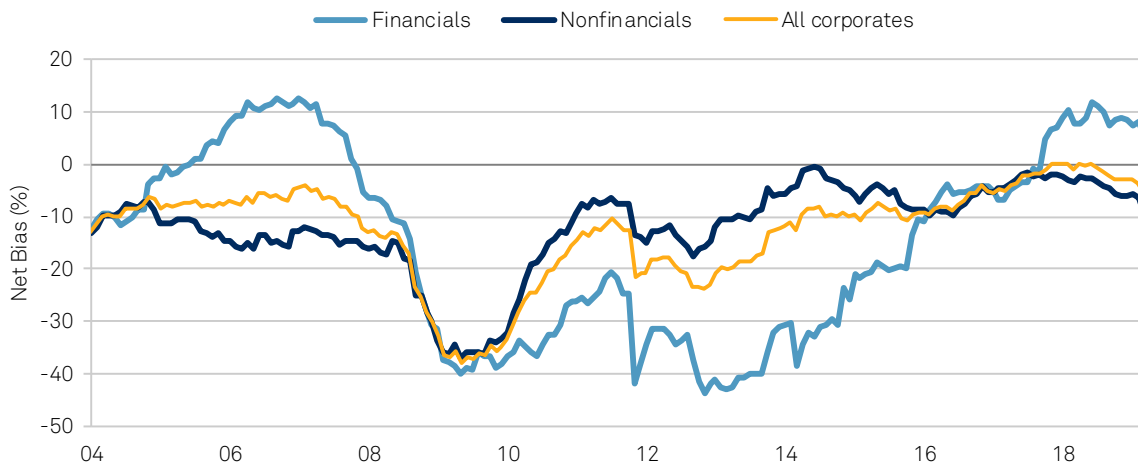


Source: S&P Global Fixed Income Research, Data year to end May 2019

Credit Conditions EMEA: Double, Double Toil and Trouble

Chart 13

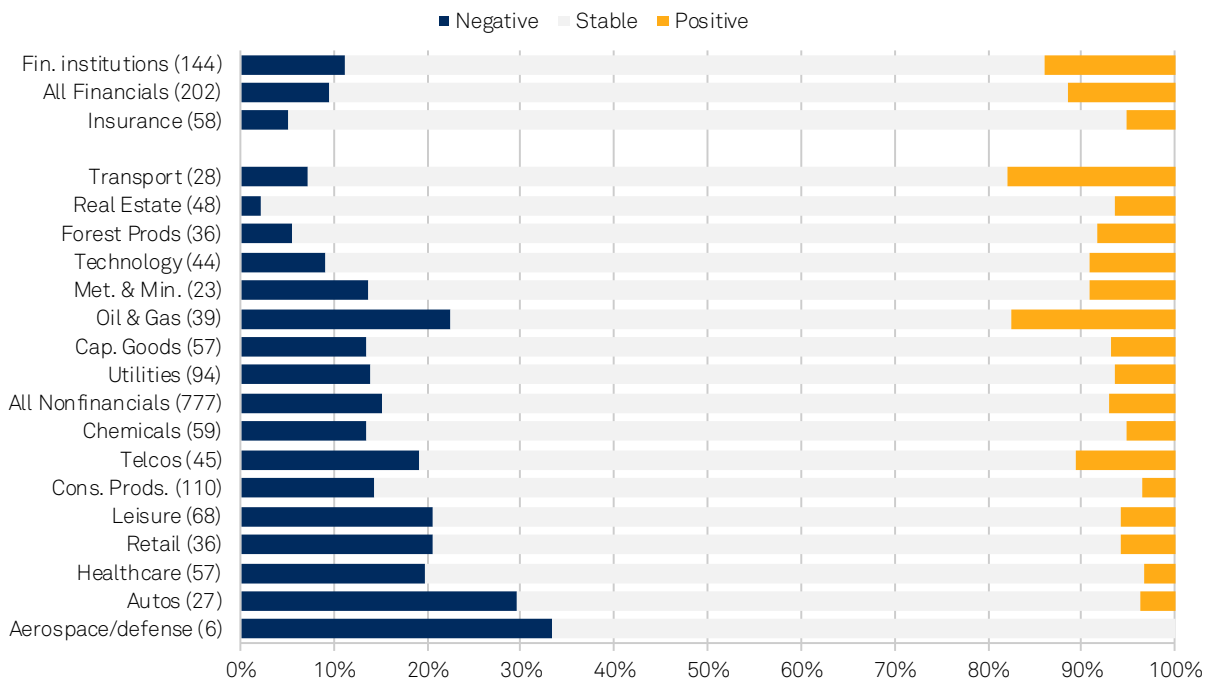
European Corporate Ratings Bias Slipping Lower



Source: S&P Global Fixed Income Research. Net ratings bias is positive bias minus negative bias. Data up to May 31, 2019

Chart 14

European Corporate Ratings Outlook Bias by Sector*



Source: S&P Global Fixed Income Research. Net ratings bias is positive bias minus negative bias. Data as of May 22, 2019. Figures in parentheses show issuer counts. *Excludes developing outlook or CreditWatch placements

Banks

- While issuer credit ratings activity remained biased toward upgrades in the first half of this year, we see a more nuanced picture ahead.
- Weaker economic growth and confirmation that interest rate rises are not to be expected will lead to renewed pressure on banks to address their subdued profitability, opening the door to further cost and business model adjustments.
- Capital and asset quality should remain solid, though.
- A disruptive Brexit, prolonged uncertainty about Italy's fiscal direction and politics, and an escalation of global trade tensions remain the main risks ahead for European banks.

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What's changed?

- Our rating actions over the past several years have acknowledged the improving macroeconomic backdrop and gradually strengthening balance sheets. However, the recovery of the European banking sector is now substantially complete – or at least, it has largely petered out. While the building of bail-in buffers could still improve prospects for some senior creditors, the sector faces an even stiffer challenge to improve profitability.
- European elections on May 26 reshaped Parliament. Pro-European political parties lost support and the two largest groups no longer hold the majority in the European Parliament, which mirrors greater fragmentation in national assemblies. This will require consensus among a broader set of interests than in the past and might result in more difficult decision-making that could impede progress toward completion of the important Banking Union project.
- The ECB announced a further postponement of interest rate hikes until at least the second half of 2020 and even opened the possibility of interest rate cuts (as did the Fed recently) and a resumption of quantitative easing, citing concerns about prolonged uncertainty. At the same time, the central bank announced conditions for TLTRO III, whose cost will range from 0.10% to 0.30% (assuming steady refinancing and deposit rates) depending on whether banks' lending grows at a certain rate. The low for longer scenario reduces the chances of a tailwind to banks' revenues anytime soon and adds pressure on banks to trim costs and consider adjustments to their business models. TLTRO III, in turn, will ensure that credit conditions will remain favorable for banks. Even if banks do not resort to TLTRO III, just having it as a backstop will contain banks' cost of funding. At this point, the opportunity for carry trade deals in many countries is limited, and generally banks have access to market funding at affordable prices, so we see TLTRO III only playing a differentiating role for second- and third-tier Italian banks, which would otherwise face higher funding costs.
- Merger discussions between Germany's large banks, Commerzbank AG and Deutsche Bank AG, did not conclude in a deal, and they are both back to their original stand-alone strategies. The road ahead remains challenging as they try to improve their subpar profitability and build up investors' confidence in the sustainability of their stand-alone strategies.
- Regulatory changes in the calculation of risk-weighted assets in Sweden, affecting primarily mortgage risk weights, led to downgrades of additional Tier 1 instruments issued by midsize banks SBAB and Landshypotek Bank, as the buffer between regulatory capital ratios and the mandatory conversion trigger narrowed.

The low for longer rate scenario adds pressure on banks to cut costs and adjust business models.

Key assumptions

- Accommodative monetary policy will ensure credit supply from banks and affordable credit conditions for borrowers.
- Authorities and banks will continue to enhance bank resolvability.

Key risks

- A disruptive Brexit that leads to a severe economic downturn in the U.K. This is still a plausible scenario. The adverse case for U.K. banks is that a no-deal Brexit leads to an economic downturn, with associated effects in subsequent years on unemployment, insolvencies and

Credit Conditions EMEA: Title

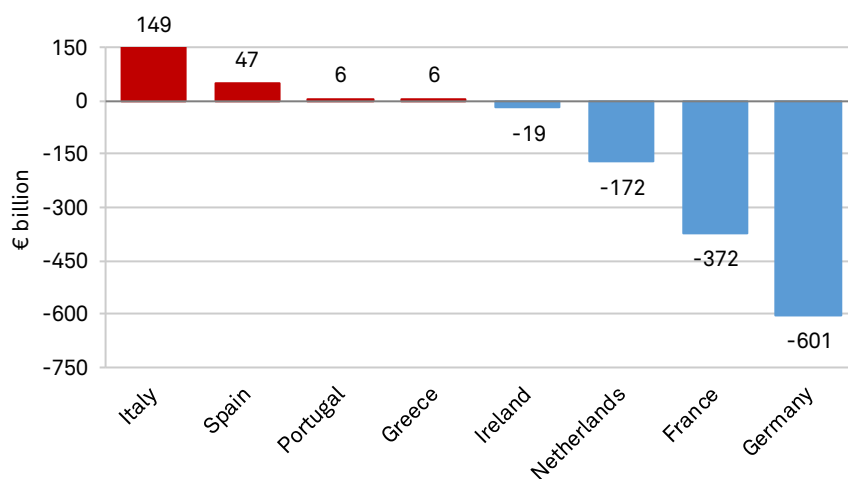
defaults, and collateral values. In case of a no-deal Brexit, we therefore think revisions of outlooks to negative would be more likely than downgrades for rated U.K. banks. We expect banks in other largely open European economies to be able to accommodate the effects of a no-deal Brexit.

- Prolonged uncertainty about fiscal imbalances in Italy and its related effect on the country's relationship with the EU. An erosion of both would constraint economic growth, curb the recovery of banks (notably because higher funding costs would slow the workout of problem assets and weaken profitability), and again raise doubts about old restructuring stories (like Banca Monte dei Paschi or Carige).
- A more adverse economic outlook for the region--most likely triggered by a further weakening of global trade--which would also prolong the extremely accommodative monetary policies in the region. Such a scenario would weaken banks' financials, notably profitability, eliminating tailwinds to revenues. Banks' weak profitability would potentially become a structural problem, questioning the long-term viability of some business models and constraining their financial flexibility amid likely weaker investor confidence. Lack of a decisive response by banks, for example, failing to address cost issues, would further underpin this weakness. A delayed normalization of interest rates would prolong pricing distortions in the market, could lead to higher risk taking, and the risk of a buildup in imbalances could resurface.

Revisions of U.K. bank outlooks to negative would be more likely than downgrades in a no-deal Brexit scenario.

Chart 15

Banks' Net ECB Borrowing/Lending as of April 2019



Source: ECB. Liquidity deposited at the ECB includes both the deposit facility and current accounts, thus also reserve requirements, but the latter are minor.

What to look for over the next quarter

- Political and fiscal developments in Italy and their impact on banks.
- Any further announcement by the ECB about economic and inflation expectations, the direction of monetary policy, and succession plans.
- The reaction among weakly profitable banks to the low for longer interest rate environment, likely including further in-market consolidation.
- Clarification by a growing number of systemic banks about how they will build their bail-in buffers, with further first-time issuances of senior nonpreferred debt.

Nonfinancial Corporates

- After a high number of downgrades in the fourth-quarter 2018 and first-quarter 2019, corporate rating actions have stabilized in the second quarter, although the ratings outlook bias has become more negative, mirroring our overall negative view of sector rating outlooks.
- Weaker operating conditions are evident in several sectors most exposed to the slowdown in global trade or those adapting to technological and environmental factors.
- Capital investment forecasts for 2019 worldwide are feeble and reflected in the decline in short-cycle capital goods orders, although capex may hold up slightly better in Europe.
- Low for longer ECB policy, while supportive for financing conditions, risks encouraging large aggressively structured LBOs, and higher defaults and lower recoveries in due course.

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What's changed?

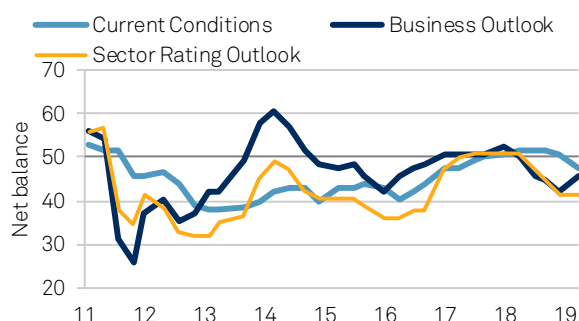
Overall the balance of outlooks on the ratings by sector for corporates remain somewhat negative, although the deterioration in the business outlook that we identified in our Credit Conditions survey in fourth-quarter 2018 and first-quarter 2019 appears to have stabilized (see chart 16). That largely reflects weaker operating conditions now being experienced in several sectors most exposed to the slowdown in global trade or those adapting to technological and environmental factors (see table 2 in the appendix).

- **Trade:** While the U.S. has postponed any decision on imposing auto tariffs until October, European multinationals inexorably are likely to be drawn into the escalating trade dispute between the U.S. and China, for two reasons. First, European companies with production facilities in the U.S. and exporting to China are already being hit by retaliatory tariffs. Second, as the trade dispute escalates into a strategic confrontation over future technological supremacy, Europe will find it difficult not to align with the U.S. given the commonality of the issues-- protection of intellectual property, market access, and a level playing field with domestic champions.
- **Autos:** We see business conditions in the auto industry currently as weak. Year to date (May 2019) auto sales were down by 2.4% in Western Europe (according to LMC Automotive), weaker than expected, due to increasing geopolitical tensions, including Brexit. Sales are particularly weak in the major markets of Spain (-5.1%), Italy (-3.9%), and the U.K. (-3.1%); sluggish in France (-0.1%); but picking up a little in Germany (+1.7%).
- **Capital goods:** The business environment is deteriorating in this sector as decreasing demand in short-cycle business so far this year is continuing across all regions, with China particularly affected by lower investment by manufacturing companies (see chart 17). This weakness is also being reflected in downstream industries such as the chemicals sector where margins are softening, particularly on the back of falling volumes in the auto sector and some slowdown in export activity.

We see weaker operating conditions in several sectors most exposed to a slowdown in global trade.

Chart 16

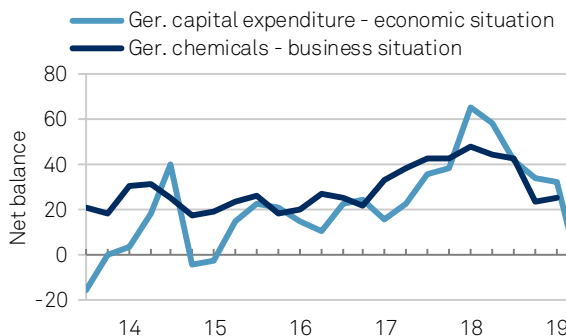
Corporate Credit Conditions Survey – Diffusion Index



Source: S&P Global Ratings. Net balance of respondents by sector - <50 is weak/negative; >50 is strong/positive

Chart 17

German Capital Expenditures Being Scaled Back



Source: IFO World Economic Survey May 2019, Refinitiv

Key assumptions

- **Autos:** In Europe, we no longer expect any growth in auto sales in 2019³, as geopolitical uncertainties (including Brexit) persist and as consumers wait for a wider range of new more environmentally friendly models to become available next year. European carmakers are not helped by a much weaker market in China where we now expect sales in 2019 to decrease by at least 3% even after the recent 3% cut in VAT in China for the manufacturing sector. Overall, we expect weaker margins in the European auto industry from foreign exchange volatility, trade tariffs, and pricing pressure in major markets. While inflexible R&D and capex spending will weaken free cash flow, the ratings impact is limited by headroom in credit ratios for investment-grade credits.
- **Capex:** Globally, we expect only a feeble 3% expansion in corporate capital expenditure in 2019 with IT experiencing a notable 4.4% contraction, with, more positively, industrials, materials, and utilities holding above 5% growth rates. Capital investment trends in Europe appear slightly stronger than the global average, with 4.3% growth expected overall for 2019⁴, which would be the third consecutive year of capex growth. All sectors bar communication services are expected to increase capex modestly.
- **IMO 2020:** For shipping we expect container liner business contracts to be amended to include bunker fuel adjustment clauses with spot freight rates rising to recover cost inflation. We also anticipate refining margins will get a lift from IMO 2020 (restricting marine sector emissions in international waters) in fourth-quarter 2019, if not before.

We expect only a feeble 3% expansion in global corporate capex in 2019.

Key risks

- **Trade:** Industries exposed to a likely extended period of U.S.-China tariffs – including on capital goods and technology industries – are being challenged to adapt their supply chains. Large players have already started to supply the U.S. from other locations, but smaller companies have much less flexibility to reorganize and avoid the tariffs, with meaningful negative consequences for their operational performance.
- **Auto tariffs:** While the U.S. administration has lifted the threat of 25% tariffs on the import of autos and auto parts for at least six months, the lack of progress on trade negotiations in our view suggests that 25% tariffs remain a very real risk. The impact on profitability would be sizable for the first two years before supply chains could be reconfigured.
- **Leveraged finance:** The ECB's low for longer policy stance from the ECB may encourage larger, more aggressively structured leveraged buyouts (LBOs) to capitalize on cheap and available financing. This would raise the risk of higher defaults and lower recoveries down the road when the cycle turns. However, for the next 12 months, we anticipate the European speculative-grade default rate to rise slowly toward 2.6% as debt service is low and debt maturities are extended.
- **Financial policy:** Decisions about financial policy remain a high risk in certain sectors. The business service sector, for instance, continues to consolidate with many companies continuing to operate with high debt levels and M&A, at high multiples, showing no sign of slowing down. In the telecom sector, transaction activity is picking back up via M&A (multiple convergence deals awaiting approvals) and, more defensively, asset sales (towers and fixed assets) being sold to **private equity** and infrastructure fund investors.

What to look for over the next quarter

- **Brexit:** How businesses deal with the uncertainty about how the U.K. will engineer Brexit. Hardening positions in both the EU and the U.K. highlight that maintaining contingency planning for the risk of a no deal remains prudent. Prevailing uncertainty as Oct. 31 approaches will likely continue, increasingly weighing on sterling, investment, business confidence, and real estate.
- **Technology:** How European governments respond to the U.S. placing Huawei on their restricted entity list. This has implications for the pursuit of multivendor strategies and timetables for rolling out 5G in Europe, although this may present business opportunities for companies such as Ericsson and Nokia.⁵

³ Worldwide Auto Sales Will Slump More Than Expected in 2019, May 06, 2019

⁴ Global Corporate Capex Survey, Jun 19, 2019

⁵ Bans On Huawei Will Hit Tech Harder Than Telecom, But Not Enough To Move The Ratings, Jun 12, 2019

Structured Finance

- Several technical standards under the EU's Securitization Regulation are still not final, although market participants are increasingly comfortable with the new regime.
- After stalling significantly early in the year, issuance has partly recovered as regulatory uncertainty begins to lift. However, the ECB's new round of cheap bank funding and a CLO slowdown may further weigh on volumes.
- Based on fundamentals, benign credit performance will likely continue, although some borrowers in underlying collateral pools could be sensitive to eventual rate rises.
- In the longer term, interest rate benchmark replacement or reform poses some operational risks for securitizations.

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What's changed?

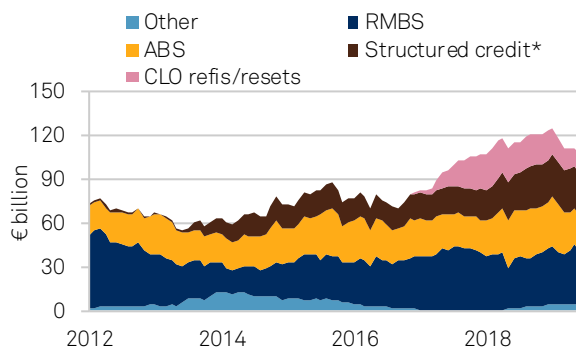
Disruption caused by the Jan. 1, 2019, implementation of the EU's new Securitization Regulation abated in the second quarter, although year-to-date issuance is still down by more than 25% (see chart 18). Uncertainties over eligibility criteria for the "simple, transparent, and standardized" (STS) label have moderated, as authorized verification agents have come online, facilitating a common understanding of the requirements. The first STS transaction priced in March and about 20 more have come to market since, according to the European Securities and Markets Authority. However, several technical standards for the new regulations—such as those covering disclosure requirements—are still not completely final and written into EU law, so uncertainty remains and some originators may stay away until there is greater clarity.

Several technical standards are not yet final.

The collateralized loan obligation (CLO) sector has so far been least affected by the regulatory upheaval, and year-to-date issuance has continued on a par with 2018 levels. However, the market looks set to cool in the second half of the year. Some Japanese bank investors that were heavy buyers of senior CLO tranches have now stepped away, while an influx of new CLO managers continue to establish European operations. However, there's little evidence that the CLO bid is boosting underlying origination volumes of leveraged loans. On the contrary, 12-month trailing loan originations have dropped by more than 40% from a peak in early 2018, suggesting that the rate of new CLO formation could halve in the rest of the year.

Chart 18

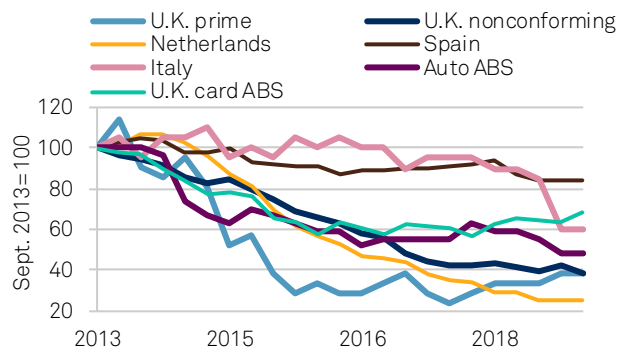
European Structured Finance Issuance, 12-Month Trailing



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

Chart 19

European Structured Finance 90+ Day Delinquency Indices, by Sector



Indices are of average 90+ day delinquencies across rated RMBS, unless stated otherwise. Source: S&P Global Ratings

Wide-reaching changes to interest rate benchmarks are proceeding along different lines and at different speeds globally, but the second quarter saw significant developments in the U.K. securitization market. In April, Nationwide priced the first pound sterling-denominated investor-placed securitization to reference the Sterling Overnight Index Average (SONIA) rate rather than the London Interbank Offered Rate (LIBOR), ahead of LIBOR's retirement by end-2021. Other originators have since followed suit, placing SONIA-linked tranches from eight transactions as of mid-June. Switching rate benchmarks in a securitization context has been more complex than for senior

Credit Conditions EMEA: Title

unsecured or covered bond issuance, as third parties such as model providers need to be ready for the change, in addition to issuers and investors.

Finally, the recently announced terms of the ECB's new round of TLTROs are somewhat less attractive for bank borrowers than in predecessor schemes. Although TLTRO III will likely dampen structured finance issuance, some originators may still have incentives to issue.

Key assumptions

- The European Commission may adopt the final draft of technical standards on disclosure requirements under the EU Securitization Regulation in the coming weeks, further reducing uncertainty and helping to unblock supply. That said, this and other technical standards for the new regulations will not formally become law until they pass through the newly constituted European Parliament, which may not happen for several months.
- While the terms of the ECB's new round of TLTROs will be somewhat tighter than in previous iterations, we believe they will still have some dampening effect on capital market funding volumes, including bank-originated securitization. The postponement of a normalization in policy rates will also postpone any uptick in investor demand for floating-rate European securitizations.
- In terms of credit performance, despite some recent downward revisions to our macroeconomic forecasts, we believe the environment remains sufficiently benign that neutral to positive ratings migration should continue across our European structured finance universe. In the year to end-March 2019, our ratings on average moved higher by more than one-fifth of a notch.

Neutral to positive
rating migration
should continue.

Key risks

Even as some recent securitizations have adopted new interest rate benchmarks, there are risks to existing transactions surrounding the replacement or reform of legacy rate benchmarks. Transactions typically reference LIBOR or the Euro Interbank Offered Rate (EURIBOR), for example, in several areas, including the note terms, any swap agreements, and the underlying loan documentation. Operationally, we think rate reform poses less risk than rate replacement in structured finance transactions. If the benchmark rate nominally continues to exist, transaction documentation would likely not require amendments, there would be no swap settlement payments, and there would be no risk of a timing mismatch between asset and liability rate switches. In a replacement scenario, various changes may be required, potentially affecting asset yields, bond coupons, and swap payments, which could have cash flow implications. Noteholder consent may also be required, which could be challenging to obtain, particularly for older deals.

There are currently no signs of deterioration in aggregate credit performance for the collateral pools backing most types of European securitizations that we rate (see chart 19). However, there may be some pent-up risks that could crystallize in a future scenario of rising interest rates, for example. For the U.K. nonconforming residential mortgage-backed securities that we rate, rising rates would immediately mean higher mortgage payments for many underlying borrowers. About 25% of these borrowers have been in arrears at least once during the past two years, with a larger cohort continually moving in and out of arrears, implying that they are "just about managing." In addition, rising rates make viable forbearance strategies more challenging for servicers to implement and could lead to more repossessions.

What to look for over the next quarter

- **EU Regulation:** Over the next quarter, we will follow developments in the implementation and operation of the new EU Securitization Regulation. The European Commission's adoption of new disclosure requirements will be particularly important, and we will track the timing of final ratification by the European Parliament. The growing volume of STS-labelled issuance will act as one barometer for the level of acceptance of the new regime. Whether originators apply for STS labels for legacy transactions, and whether pricing differentials emerge between STS and non-STS transactions will also be interesting.
- **Interest rate benchmark transition:** We will monitor the continued adoption of SONIA in pound sterling-denominated transactions, as well as developments in reforming EURIBOR and how originators' plan to change benchmarks for existing transactions.

Insurance

- Low long-term interest rates persist and now affect even more European countries, weighing on reinvestment rates and life insurers' investment margins.
- Provided investment-grade bond yields continue to fall, non-life insurers in most European markets will need to stick to strict pricing discipline to maintain healthy technical margins.
- Business diversification for Western European insurance groups between life and non-life insurance, accompanied by solid capital positions, remains a key strength for the sector.
- While not off the table, concerns about a disruptive Brexit and subsequent capital market volatility appear to be postponed for the time being.
- We believe the global reinsurance sector faces competitive business conditions as the influx of alternative capital, albeit at a slower rate, remains a challenge to reinsurers' business models.

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What's changed?

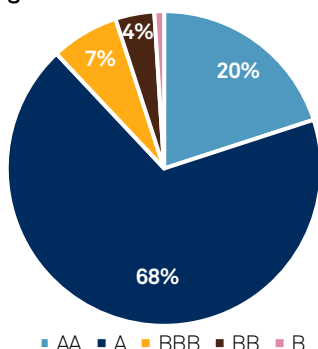
We lowered our long-term interest rate forecasts for some European countries and the eurozone further, and now expect a gradual increase even later than before. Following Switzerland, German bund yields are back into negative territory and yields on French 10-year bonds are at new lows close to 0%. Despite many mitigating actions of Western European life insurers over the last decade to reduce guaranteed yields and focus on cost efficiency, we expect pressure to continue on earnings from the life segment in many Western European countries.

Low long-term yields will continue to pressure earnings of life companies.

The delay to Brexit has reduced risks to insurers' balance sheets from increased capital market volatility for the time being.

Chart 20

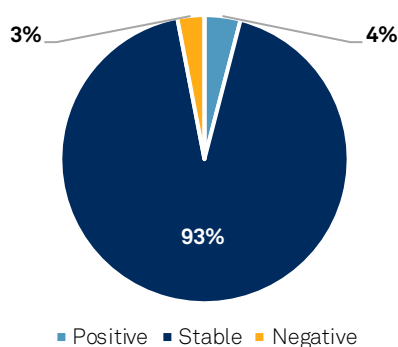
Rating Distribution for the EMEA Insurance Sector



Source: S&P Global Ratings (Jun. 11, 2019)

Chart 21

Outlook Distribution for the EMEA Insurance Sector



Source: S&P Global Ratings (Jun. 11, 2019)

Key assumptions

- A delayed, gradual increase in long-term yields. European insurers are generally well diversified between life and non-life, and strongly capitalized to weather the impact.
- Non-life insurance is to remain a key pillar for earnings, pricing discipline is here to stay, with moderate earnings growth alongside GDP growth.
- Brexit will be manageable for European insurers, even U.K. insurers. The delay will provide more time for U.K. insurers with European operations to prepare.
- Following lower price increases than we expected for global reinsurance in 2018 and early 2019, it seemed that no amount of catastrophe losses would be sufficient to harden the overall market. However, during 2019's April and June renewals, reinsurers saw some green shoots, with property catastrophe rate increases ranging 15% to 25% on loss-affected accounts. At this stage in the cycle, we characterize the current global reinsurance pricing environment as a hardening market rather than a hard one.

Key risks

- Long-term interest rates to remain low, eroding life insurers' earnings
- Capital market volatility, following a disruptive Brexit or geopolitical turmoil, for example

International Public Finance

- Our ratings on U.K.-based social housing providers, universities, and local governments are gradually absorbing Brexit uncertainty.
- The economic slowdown in Germany will likely result in smaller budgetary surpluses and higher borrowings for German states, but won't take a toll on their credit ratings.
- Spanish regions are gradually returning to the international bond market. A new central government, in the process of being formed, is unlikely to alter this trend.
- Reform of the Swiss corporate tax is on track, with changes due to come into force in 2020.
- Local tax reform in France may constrain the financial flexibility of cities and departments, but now we believe the impact will be less pronounced than we previously expected.

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What's changed?

- Continuing uncertainty about Brexit is exacerbating risks for U.K.-based public-sector entities. Currently more than one-half of our 45 public ratings on social housing, universities, and local governments have negative outlooks, reflecting a moderate probability of both sovereign-related and intrinsic downside case scenarios.
- Due to a gradual reduction of a base social rent and limited (albeit slightly increasing) state grants, English-based social housing providers (SHP) have substantially increased their dependence on receipts from sales of units on the open market and borrowings to cover investments. While Brexit uncertainty is softening the real estate market, especially in London, profit from outright sales and first-tranche shared ownership has dropped, leading to weakening performance and rising debt burden for some SHPs.
- We believe that the performance of U.K. universities may weaken unless they implement cost-saving measures. Higher pension contributions and salaries, especially for staff from outside the U.K., combined with potentially lower fees following the government's review of the fee structure, will likely force universities to become more proactive in cost cutting.
- Germany's economic slowdown will likely lead to slow revenue growth, lower budget surpluses, and larger borrowings for German states. We project in 2019-2022 that average annual real GDP growth will decrease to 1%. Nevertheless, we believe the regional governments will stick to their commitments to balance budgets by 2020 and avoid structural deficits beyond that.
- Spanish LRGs are forming their governments following the latest local, regional, national, and European election. Relatively solid economic growth has helped most Spanish regions to improve budgetary performance and reduce their debt burdens. However, the financial policies of new governments will make their mark under weaker economic growth projected for 2019-2022. Better finances restored investors' confidence in regional bonds. So far in 2019 five regions have returned to the capital markets.
- The Swiss nationwide referendum approved a federal corporate tax reform to make the country's tax code compliant with international rules. Cantons have been gradually taking decisions on cantonal parts of the corporate tax. We assume that change to both federal and cantonal parts of the tax will come into force in 2020 or 2021. We incorporate the anticipated changes in our financial forecasts on Swiss cantons.

More than half of ratings on social housing, universities, and local governments have negative outlooks.

Key assumptions

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

Key risks

- Disruptive Brexit would be credit negative for SHP, universities, and local governments.
- Economic slowdown would constrain the ability of local and regional governments to reinvest in public infrastructure.

What to look for over the next quarter

- Brexit: its impact on real estate prices and demand for higher education in the U.K.
- The financial policy of the Spanish government following parliamentary elections in May.
- The content of local tax reform, which the French central government will present to Parliament: We expect the French government to start negotiating local tax reform over the coming weeks and that it will be included in the state's finance law for 2020.

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