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Default, Transition, and Recovery:

The European Speculative-Grade Corporate Default Rate Could Rise To 3.6% By March 2024 As Stressors Mount

May 15, 2023

CREDIT RESEARCH & INSIGHTS

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Key Takeaways

- We expect the European trailing-12-month speculative-grade corporate default rate to reach 3.6% by March 2024, from 2.8% in March 2023. The combination of rising interest rates, slowing growth, and still elevated input costs could lead to falling earnings and more defaults, particularly distressed exchanges and other out-of-court restructurings.
- A prolonged growth slowdown or recession could push the default rate higher--to 5.5% in our pessimistic case. And if core inflation remains elevated, central banks may need to tighten beyond current expectations, cutting further into spending, investment, and cash flow.
- Much will depend on how inflation and economic growth evolve in the next few months. Although not in our base-case assumptions, if recent declines in headline inflation translate into lower core inflation, interest rates could fall, opening up market demand for riskier debt, even if not to 2021 levels.

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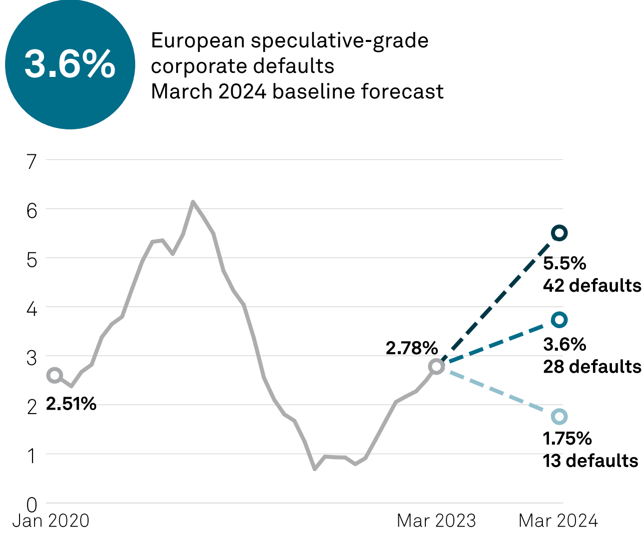
European defaults will rise on confluence of stressors



As of March 2023, S&P Global Ratings rates 771 European speculative-grade corporate issuers

Pessimistic scenario: This scenario includes slower economic growth or recession, combined with persistent core inflation, resulting in a default rate past 5%. Already slowing cash flow would have even less room to maneuver.

Base scenario: Regional economic growth is expected to stagnate, and it's likely that central banks will raise rates further given stubborn core inflation. Much will depend on the timing and duration of the confluence of high interest rates, input costs, and slowing top-line growth.

Optimistic scenario: In a best-case scenario, we think defaults could decline slightly from their current levels to about 1.75%. Upside economic surprises could continue, and markets remain comparably optimistic considering growth expectations and the addition of bank sector stress. Rapidly falling input costs could continue and pull core inflation down, easing interest rate policy choices.

Data as of March 31, 2023. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro©.
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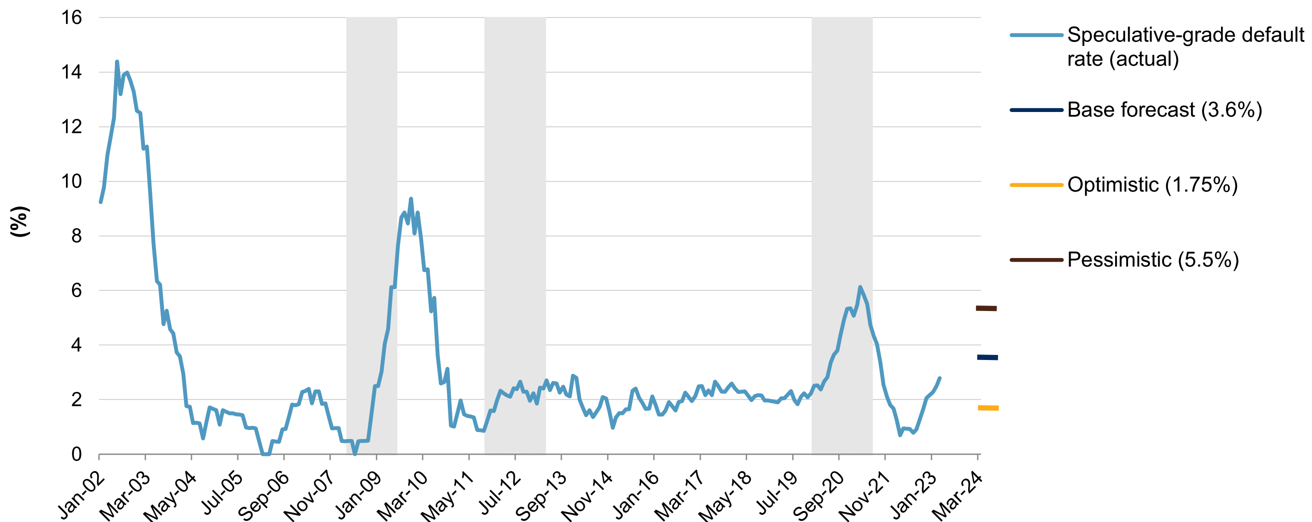
Chart 1

European trailing-12-month speculative-grade default rate and March 2024 forecast



Shaded areas are periods of recession as defined by the Center for Economic Policy Research. Data as of March 31, 2023. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.
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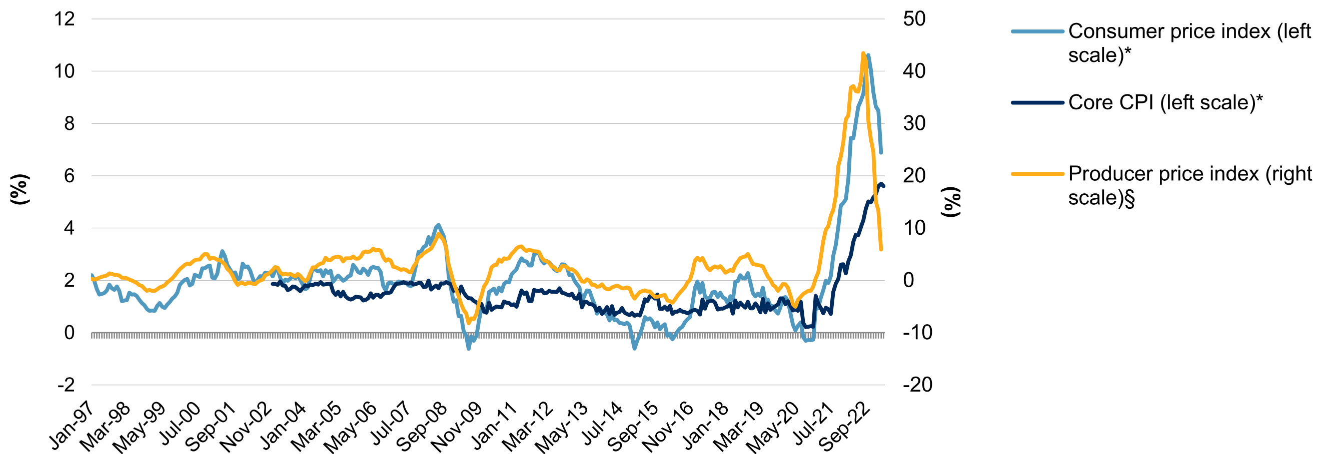
Confluence Of Pressures Raises Our Base Case

Baseline: S&P Global Ratings Credit Research & Insights expects the European trailing-12-month speculative-grade corporate default rate to rise to 3.6% by March 2024 from 2.8% as of March 2023 (see chart 1). Economic growth has surprised to the upside in late 2022 to early 2023, though our economists still expect regional growth to stagnate later in the year. Some of the current growth may be coming at the expense of activity in 2024, which our economists recently revised down from their prior forecast. Interest rates continue to rise, particularly on floating-rate debt, which companies we rate in the 'B' category use heavily. Input costs are falling quickly but remain well above historical norms. And with core inflation still high, central banks will likely have to raise rates further than currently expected (see chart 2). Corporate earnings reports are showing slowing growth--to nearly flat from a year earlier--and a large decline in consumer cyclicals. This is particularly important given the large presence of the consumer-reliant sectors, particularly among the 'CCC'/'C' rated population.

Chart 2

Declining producer prices should bode well for stretched corporates



*Harmonized index of consumer prices--all items for the Euro area. §PPI, total industry (excluding construction). Sources: ECB, FRED, and S&P Global Ratings Credit Research & Insights.
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Optimistic scenario: We forecast the default rate could fall to 1.75%. In a best-case scenario, we think the default rate could decline slightly to about 1.75% through next March. Upside economic surprises could continue, and markets remain comparably optimistic, with bond spreads tight relative to economic fundamentals and the additional volatility from recent bank sector stress. Headline inflation readings at both the consumer and producer levels have been declining consistently, and energy prices remain lower with the winter in the rearview mirror. We expect the European Central Bank (ECB) and Bank of England to continue raising rates, but a decline in core inflation toward 2% would create room for interest rates to fall, spurring demand for riskier debt.

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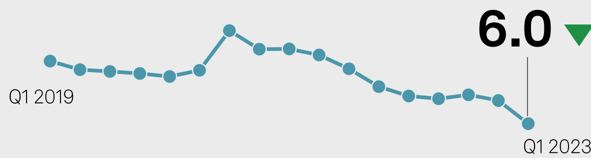
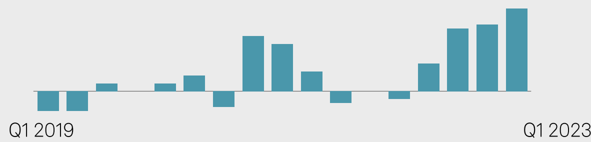
Pessimistic scenario: We forecast the default rate could rise to 5.5%. In a scenario of slower economic growth or recession, combined with persistent core inflation, the default rate could rise past 5%. Already slowing earnings could leave less room to maneuver amid elevated interest rates and slower top-line growth. In addition, the Russia-Ukraine conflict continues, and though no disruptive actions are in our base-case right now, the conflict is likely to remain a factor for some time, posing elevated risks for Europe.

Macro Factors

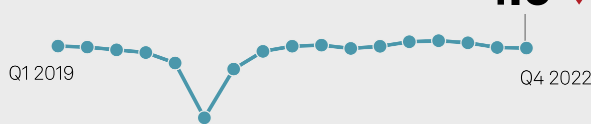
European unemployment rate (%)



ECB euro area lending survey (%)



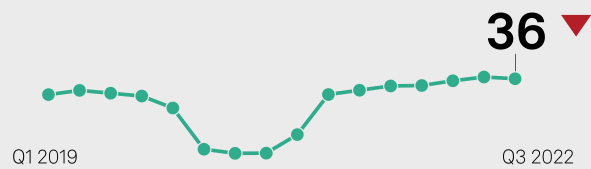
Euro area industrial production (index)



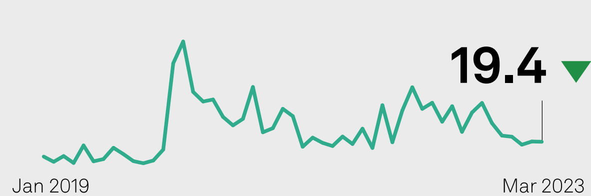
Euro area (10-yr less 3-month, bps)

Corporate Factors

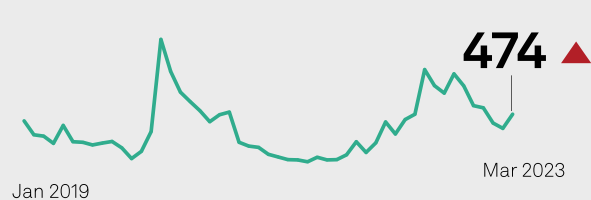
Net income ratio (nonfinancial, %)



EURO STOXX 50 Volatility (VSTOXX, index)



High yield spreads (bps)



Positive change Negative change No change

Note: ECB Lending Survey refers to net tightening for large firms. Except for the Leveraged Loan Distress ratio (Feb. 28, 2023) and net income ratio (Dec. 31, 2022), data is from Q1 2019 to Q1 2023. Sources: Eurostat; Economics and Country Risk from IHS Markit; Organization for Economic Co-operation and Development (OECD); ICE Benchmark Administration Limited (IBA); Leveraged Commentary and Data (LCD) from PitchBook, a Morningstar company; and Morningstar European Leveraged Loan Index (ELLI); EURO STOXX 50 Volatility (VSTOXX) Index; S&P Global Market Intelligence CreditPro®; S&P Global Ratings Credit Research & Insights.

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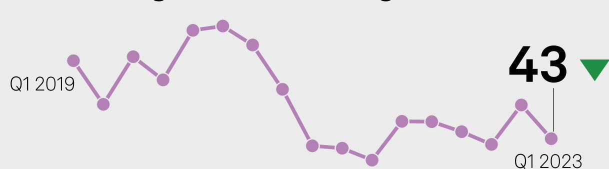
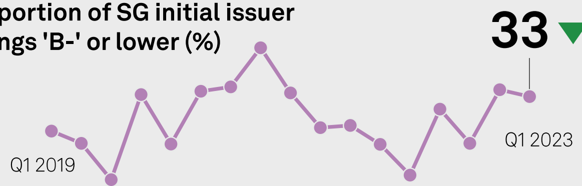
Rating Factors

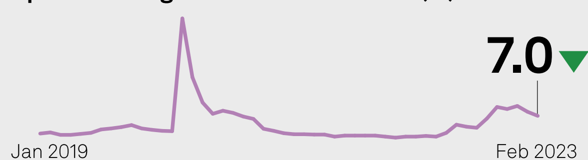
Ratio of downgrades to total rating actions* (%)



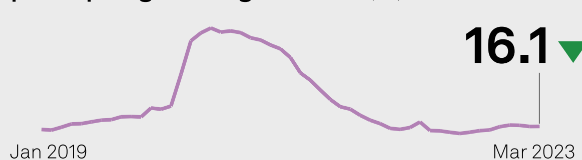
Proportion of SG initial issuer ratings 'B-' or lower (%)



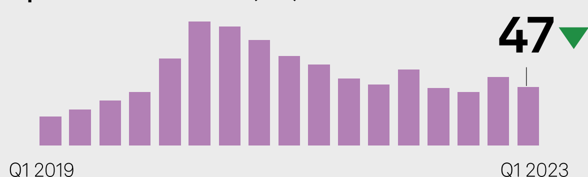
European leveraged loan distress ratio (%)



European spec-grade negative bias (%)



European weakest links (no.)



Positive change   Negative change   No change

*For speculative-grade entities only. Except for the Leveraged Loan Distress ratio (Feb. 28, 2023) and net income ratio (Dec. 31, 2022), data is from Q1 2019 to Q1 2023. Source: Eurostat; Economics and Country Risk from IHS Markit; Organization for Economic Co-operation and Development (OECD); ICE Benchmark Administration Limited (IBA); Leveraged Commentary and Data (LCD) from PitchBook, a Morningstar company; and Morningstar European Leveraged Loan Index (ELLI); EURO STOXX 50 Volatility (VSTOXX) Index; S&P Global Market Intelligence CreditPro®; S&P Global Ratings Credit Research & Insights.
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Issuance Is Down From Last Year, But Upcoming Maturities Are Manageable

Continued market volatility through the first quarter--primarily due to rapid interest rate hikes--kept issuers and investors on the sidelines. Combined leveraged loan and speculative-grade bond issuance fell off markedly versus the first four months of last year, posting a total of €47.3 billion through April (see chart 3). This is about 7% below last year's pace and much lower than the roughly €63.5 billion year-to-date average since 2018 (excluding the outsize €131.1 billion in 2021).

While issuers may have slightly higher cash balances than is typical, and most debt is maturing well past 2023, the ability to service existing debt will pose a bigger challenge if rates continue to rise and revenues start to flag, the latter being more likely. In such a scenario, a continued skittish primary market would pose a major obstacle to any speculative-grade issuers in urgent need of new funding. That said, 2023 is off to a more optimistic start in the high-yield segment, with €31.9 billion hitting the market--roughly €6 billion more than at this time last year. Although that's

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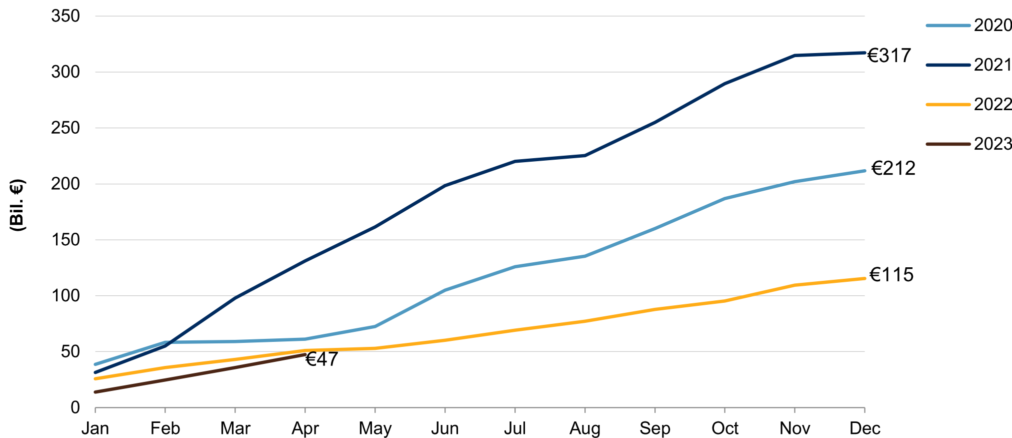
positive, it is still very early in the year to say markets have turned the corner given the uncertain landscape.

Chart 3

Speculative-grade debt issuance lags further in 2023



Data through April 30, 2023. Chart displays combined speculative-grade bond and leveraged loan issuance.
Sources: S&P Global Ratings Credit Research & Insights, Refinitiv, and Pitchbook LCD.
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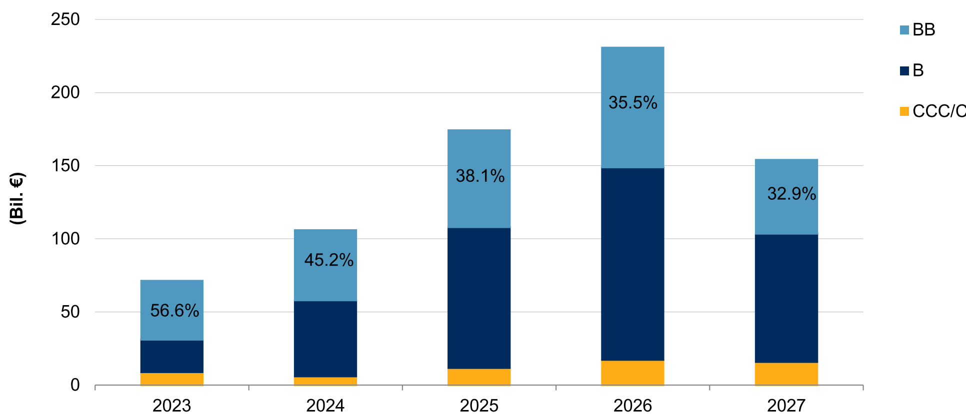
Even if markets don't completely shake their hesitation this year, upcoming maturities through 2024 remain manageable (see chart 4). We estimate €177 billion in total speculative-grade debt will come due through 2024, with €14.7 billion of that in the 'CCC'/'C' category. Of the €71.4 billion total due this year, a majority is from the 'BB' category, reflecting a lower likelihood of default. That said, 'B' maturities will pick up in 2024, and the total expands to €174 billion in 2025.

Chart 4

Near-term maturities are manageable, but they step up in 2025 and beyond



Source: S&P Global Ratings Credit Research & Insights.
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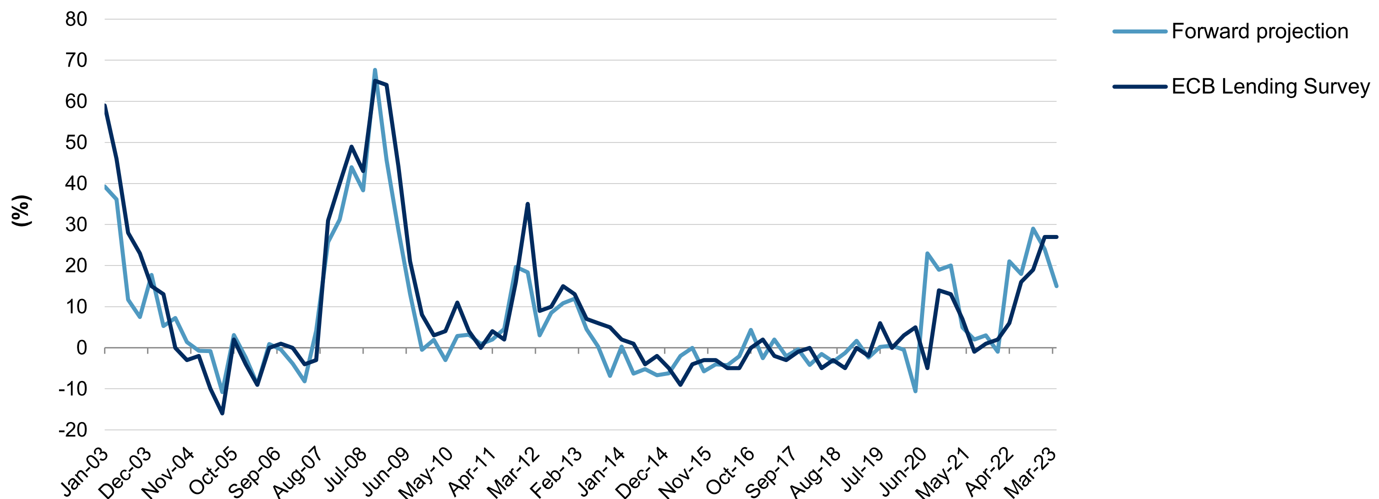
Lending Conditions Wobble Through Bank Stress

Euro area banks' pace of net tightening of credit standards in the first quarter remained at the highest level since the sovereign debt crisis in 2011. The tightening was in response to the deteriorating economic outlook, industry-specific risks, and decreased risk tolerance among senior loan officers. Balance sheet constraints also contributed to tighter bank lending in the first quarter as liquidity positions continue to be strained by central banks' diminishing liquidity support and ongoing TLTRO repayments. Even more notable than the high net tightening for lending standards, the drop in loan demand from borrowers was significant in the first quarter (net decline in demand of 38%), primarily driven by the level of interest rates. For the second quarter, a net 15% of euro area banks expect further, though moderate, credit tightening relative to the first quarter (see chart 5), while loan demand is also expected to fall, but less so than the 38% decline in the first quarter.

Many banks have been building buffers in preparation for more loan losses recently, and similar tightening ahead of an expected recession has been happening among U.S. banks. In both regions, demand for loans also trailed off at the end of 2022.

Chart 5

Loan lending conditions tighten, but some expected reduction is ahead



Sources: S&P Global Ratings Credit Research & Insights and ECB.

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In contrast to tightening conditions on corporate loans, bond markets have recently been reflecting a relative loosening of conditions. Through April 30, the speculative-grade bond spread reached 479 basis points (bps), down slightly from 498 bps at the end of 2022 (see chart 6). The spread has been volatile since January 2022, more recently widening from mid-August through the first half of October, likely in response to the threat that rapidly rising gas prices pose for the European economy. But they've fallen since, in line with declining gas prices, and reached 421 bps at the end of February. Some increase in risk aversion was to be expected after the bank sector

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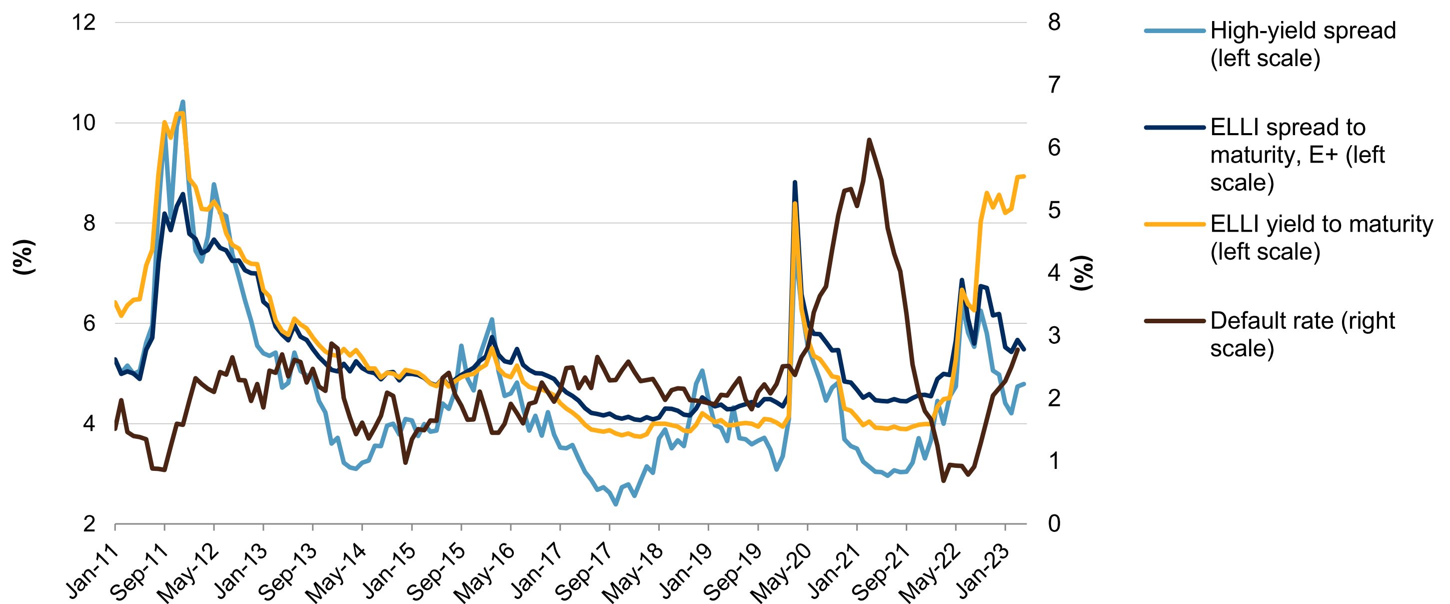
stress in the U.S. and Europe during March, but spreads are still lower than during the middle of 2022, even though all-in funding costs are much higher.

The relative risk of holding corporate debt can be a major indicator of future defaults because companies face pressure if they are unable to refinance maturing debt or service existing debt. In broad terms, speculative-grade spreads have been good indicators of future defaults based on a roughly one-year lead time. At current spreads, our baseline default rate forecast of 3.6% is roughly in line with or slightly above what the historical trend would suggest.

Chart 6

Bond spreads signal more optimism than loans



Sources: ICE Benchmark Administration Limited (IBA), ICE BofAML Euro High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis; ELLI (European Leverage Loan Index); Pitchbook LCD; S&P Global Ratings Credit Research & Insights; and S&P Global Market Intelligence's CreditPro®.

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Considering broad measures of financial market sentiment, economic activity, and liquidity, we estimate that at the end of March, the speculative-grade bond spread in Europe was about 174 bps below our estimate of 648 bps (see chart 7). The gap between the actual and estimated spread implies that bond markets may be overshooting somewhat in their recent optimistic stance.

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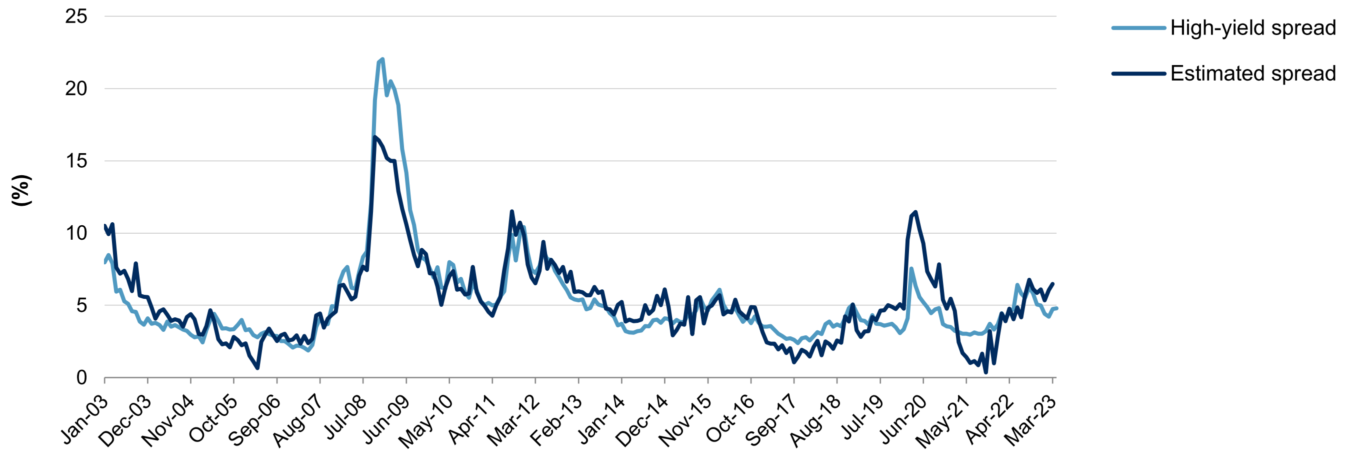
Chart 7

Current bond spread appears slightly optimistic



Sources: ICE Benchmark Administration Limited (IBA), ICE BofAML Euro High Yield Index Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis; and S&P Global Ratings Credit Research & Insights.

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Floating-Rate Benchmarks Continue To Rise

Considering the possible divergence between bond and loan market sentiment, much of the lower-rated debt ('B-' and below) in Europe is in the form of floating-rate loans, whose benchmark interest rates are rising in both Europe and the U.S. as central bank rates continue to climb (see chart 8). EURIBOR, though still well below LIBOR, is rising quickly, and many loans have very low floors--sometimes zero. If this trajectory continues, higher rates will continue cutting into profit margins for these issuers (especially as interest rate hedges mature), giving them less room to maneuver, particularly in the event of an economic slowdown or recession.

The overall near-term maturity profile of European speculative-grade issuers is fairly light and should be largely manageable this year, limiting the pain for companies rolling over their fixed-rate debt at current market rates. But the proportion of floating-rate debt among the lowest rating levels presents an issue in terms of increasing debt servicing costs. At the start of the year, outstanding debt rated 'B-' or lower totaled €238 billion, and 60% of that carries floating interest rates (see chart 9). The sectors most reliant on consumer spending lead the way on the floating-rate total--namely, consumer products, media and entertainment, and retail/restaurants.

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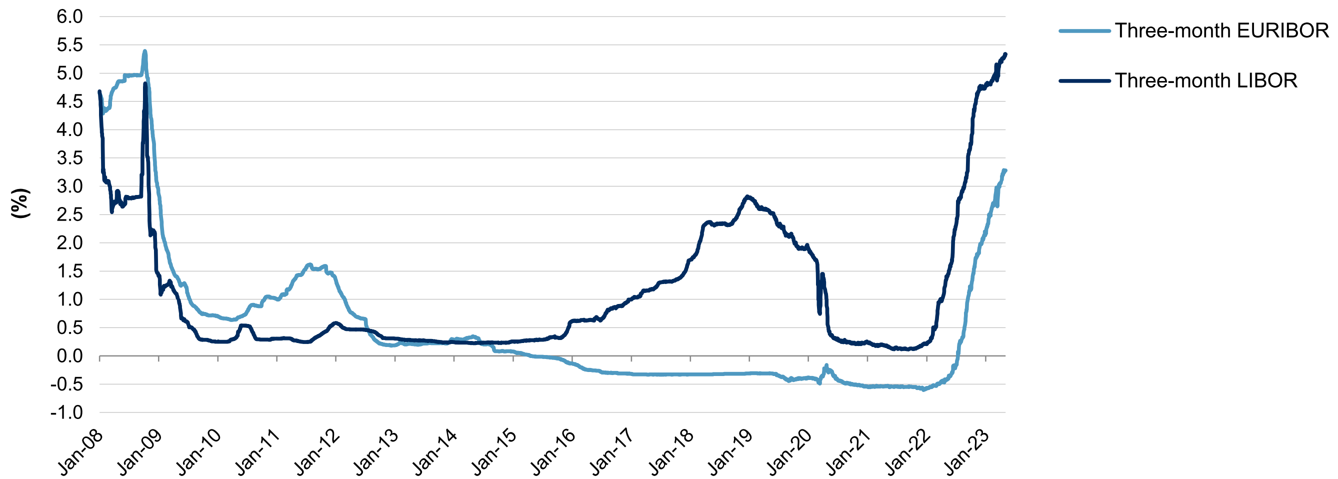
Chart 8

Floating rates keep rising, increasing interest costs with them



Sources: S&P Global Market Intelligence and S&P Global Ratings Credit Research & Insights.

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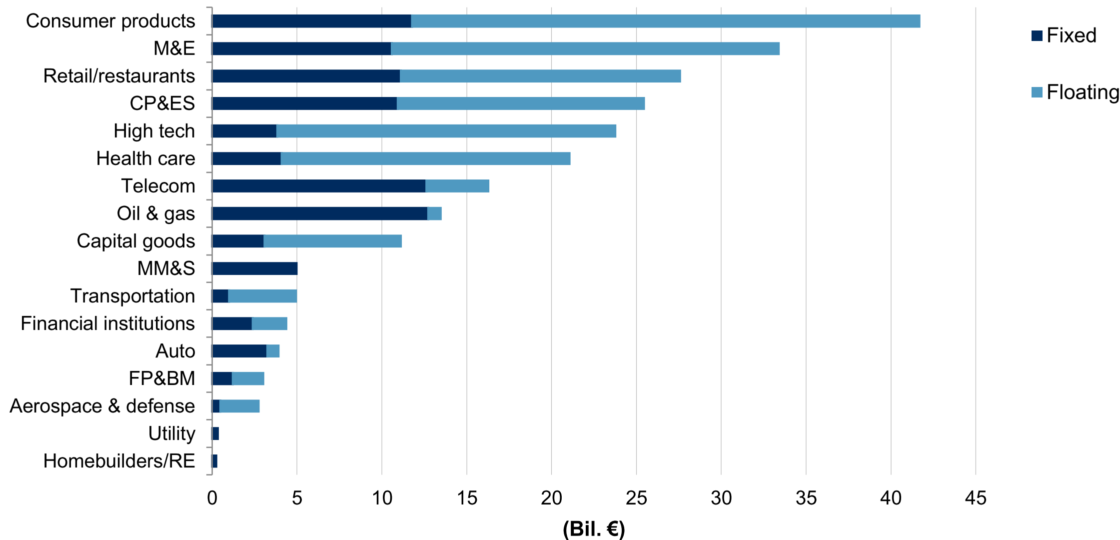
Chart 9

Debt rated 'B-' and below is more exposed to rising rates



Data as of Jan. 1, 2023. CP&ES--Chemicals, packaging, and environmental services. FP&BM--Forest products and building materials. Home/RE--Homebuilders/real estate companies. Media and entertainment includes the leisure sector. Includes bonds, loans, and revolving credit facilities that are rated by S&P Global Ratings. Source: S&P Global Ratings Credit Research & Insights.

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Consumer Strength Remains Key For Weaker Credits

One key point we've been watching is consumers' ability to continue propping up demand amid high energy prices, rising inflation, and slowing growth. How long that can continue given rising core inflation remains to be seen. Among our weakest rated issuers, rated in the 'CCC'/'C' category, over half are from consumer-reliant sectors and capital goods (see chart 10). The default rate for 'CCC'/'C' rated entities reached nearly 50% during the peak of the pandemic in late 2020, implying the potential for very high default risk should a worst-case scenario play out.

Chart 10

'CCC'/'C' ratings are heavily concentrated in consumer-reliant sectors

As of March 31, 2023. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence’s CreditPro®.

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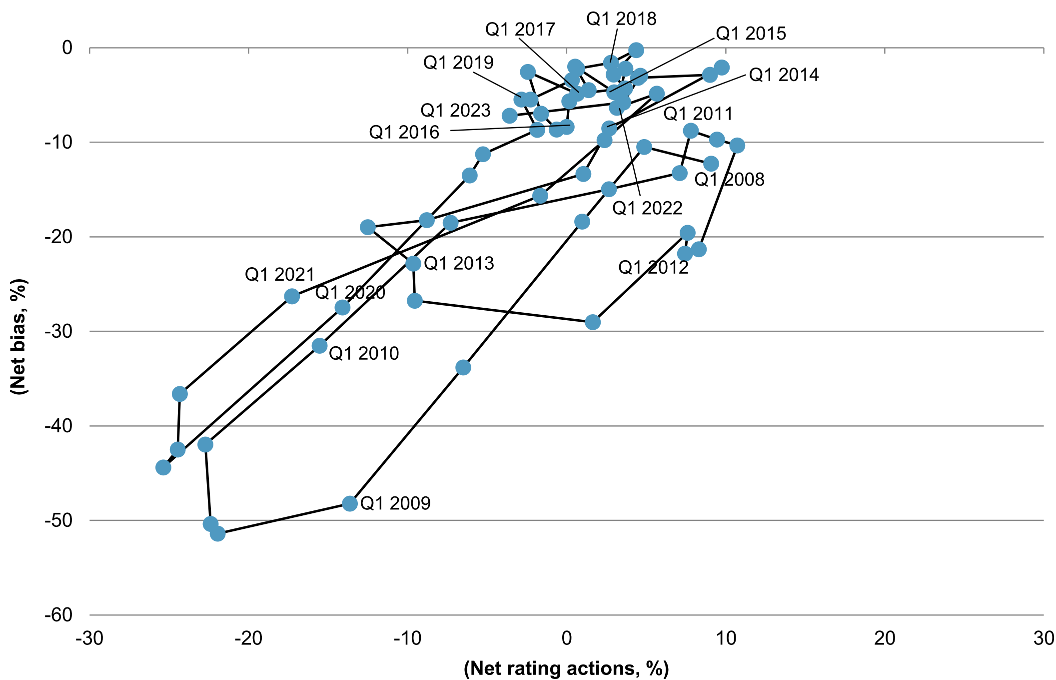
Credit Momentum Eases Further

In the 12 months ended March 2023, speculative-grade credit quality has deteriorated, with net rating actions falling to negative territory, but with a negative net bias implying more downgrades expected (see chart 11). Net speculative-grade rating actions turned negative in the prior 12 months for the first time since third-quarter 2021. The speculative-grade net rating bias (the positive bias minus the negative bias) fell to -7.2%, following a steady decline from an all-time high of -2.2% at the end of June 2022.

Chart 11

Credit momentum turns, but slowly



Net bias--Positive bias minus negative bias. Net rating actions--Upgrade rate minus downgrade rate in the prior 12 months. Sources: S&P Global Ratings Credit Research & Insights and S&P Global Market Intelligence's CreditPro®.

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History shows that the rate of downgrades and net negative bias tend to lead the movement in the default rate by several quarters. Current downgrade rates and bias reflect a likely turning point in credit momentum, which should lead to more defaults, but the deterioration is still very mild.

Improvements in credit quality during the past two years have not been enough to make up for the declines during 2020, leaving speculative-grade issuers still much more vulnerable than historically (see chart 12).

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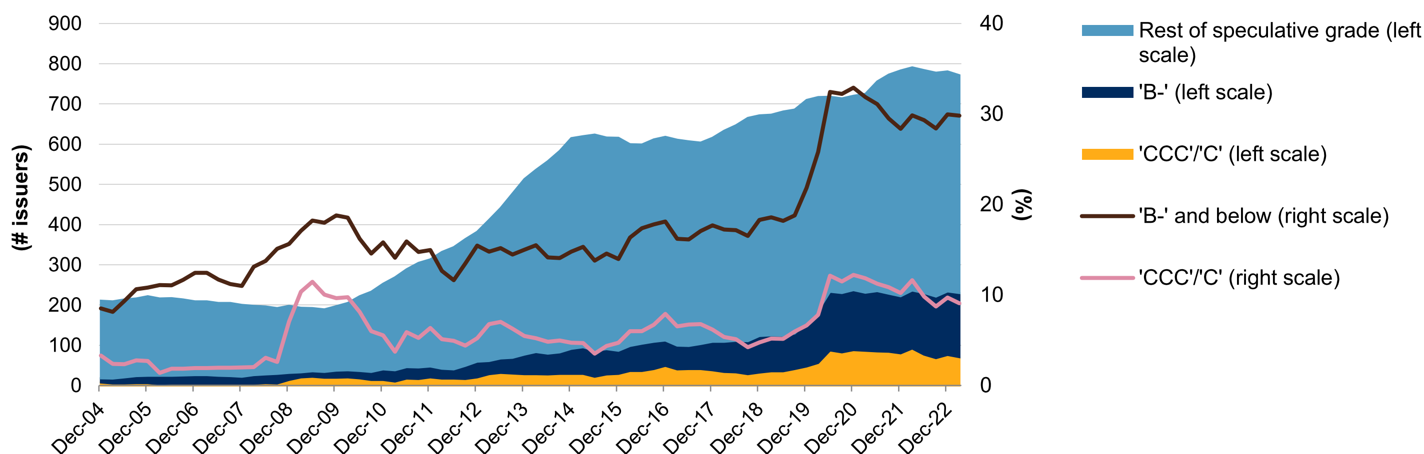
Chart 12



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Defaults Are Spread Across Subsectors

The European speculative-grade default tally through the first quarter was seven, with several subsectors each contributing one. The reasons for default were nearly equal between selective defaults and missed interest payments. The selective defaults were nearly all a result of debt restructuring with less favorable terms than those originally promised to shareholders. Meanwhile, missed interest payments were largely attributable to deteriorating operating performance across sectors in the region.

How We Determine Our European Default Rate Forecast

Our European default rate forecast is based on current observations and expectations of the likely path of the European economy and financial markets.

This report covers financial and nonfinancial speculative-grade corporate issuers. The scope and approach are consistent with those of our default and rating transition studies. In this report, our default rate projection incorporates inputs from S&P Global Ratings economists that also inform the analysis of our regional Credit Conditions Committees.

We determine our default rate forecast for speculative-grade European financial and nonfinancial companies based on a variety of quantitative and qualitative factors. The main components of the analysis are credit-related variables (for example, negative ratings bias and ratings distribution), the ECB bank lending survey, market-related variables (corporate credit spreads and the slope of the yield curve), economic variables (the unemployment rate), and financial variables (corporate profits). For example, increases in the negative ratings bias and the unemployment rate positively correlate with the speculative-grade default rate. As the proportion of issuers with negative outlooks or ratings on CreditWatch with negative implications increases, or the unemployment

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rate rises, the default rate usually increases.

This report covers issuers incorporated in the 31 countries of the European Economic Area, Switzerland, and certain other territories, such as the Channel Islands. The full list of included countries is: Austria, Belgium, the British Virgin Islands, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hungary, Iceland, Ireland, the Isle of Man, Italy, Jersey, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Monaco, Montenegro, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the U.K.

Two defaults in second-quarter 2022, from Petropavlovsk PLC and EuroChem Group AG, were captured as defaults from the U.K. and Switzerland, respectively, due to the locations of incorporation and corporate headquarters. The ratings on these issuers were subsequently withdrawn as of April 15, 2022, because these entities were considered to have substantial presences in Russia. We do not include Russia in our definition of Europe. If we were to remove these issuers from the count of defaults, the 12-month-trailing default rate ended March 2023 would have been approximately 2.5%, down from the 2.8% reported throughout this report.

Related Research

- Risky Credits: Europe's Q1 Fall Masks The Full Story, April 28, 2023
- Global Credit Conditions Q2 2023: Balancing Resilience And Turbulence, March 30, 2023
- Credit Conditions Europe Q2 2023: Costs Rising To Cure Inflation, March 28, 2023
- Economic Outlook Eurozone Q2 2023: Rate Rises Weigh On Return To Growth, March 27, 2023
- Economic Outlook U.K. Q2 2023: Growth Eludes This Year Even As Inflation Eases, March 27, 2023

This report does not constitute a rating action.

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