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Credit Conditions:

2017: Europe's Year Of Wait And See

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Credit Conditions:

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*(**Editor's Note:** S&P Global 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 sectors, as well as borrowing and lending trends for businesses and consumers. This article reflects the view developed during the EMEA Credit Conditions Committee discussion on Nov. 29, 2016.)*

Overall credit conditions in EMEA will not significantly improve in 2017. Compared with the U.S. and the U.K., eurozone household and nonfinancial companies are still carrying heavy debt burdens, which continue to impede a more robust recovery and credit growth. (That's notably with the exception of some economies like Spain.) Continued declines in profitability will keep on forcing banks to review their business models, while corporates in general will suffer from weak business and consumer confidence.

With Brexit and the election of Mr. Donald Trump as president of the U.S., 2016 is likely to go down as a year of historic political upheaval. While a major economy prepares to leave the world's largest trading bloc in manners still unclear, the world's largest economy enters uncharted political territory. The only thing we can be sure of is that 2017 will ring in political and economic uncertainty. Uncertainty can spark volatility, political and social unrest, and general risk aversion, which in turn can hurt business confidence, investment, lending and funding conditions, and ultimately growth. Unpredictable policymaking used to be the hallmark of developing economies. Not anymore, apparently. Furthermore, globalization and international trade, typically embraced by developed economies, are finding critics in populism and nationalistic movements in some of the world's largest trading countries. As a consequence, already subdued world trade growth is unlikely to improve anytime soon. This does not bode well for Europe, which relies more on international trade than, for example, the U.S.

Overview

- Overall credit conditions in EMEA will not improve next year.
- The year 2017 will likely ring in political and economic uncertainty, which can be negative for business confidence, investment, lending and funding conditions, and ultimately growth.
- We believe world trade growth is likely to remain subdued, which does not bode well for Europe.
- Amid rising populism, the more mainstream, pro-Europe parties will probably take on a more protectionist and a generally more nationalistic and Eurosceptic stance.
- The ECB is less likely to cut interest rates again because of the strengthening dollar, but may extend quantitative easing.
- The chances of tough Brexit negotiations have actually increased, and we still expect a cut in U.K. interest rates in the second quarter of 2017 because of an economic slowdown.
- The eurozone economic recovery remains resilient, but inflation has failed to pick up.
- Continued declines in profitability will keep on forcing banks to review their business models.
- We believe a new interest rate cycle may have begun with the recent rise in bond yields.
- Corporates in general will suffer from weak business and consumer confidence.
- We expect European structured finance credit performance to remain benign in 2017.

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In turning his campaign promises into policy, will President Trump focus more on the ones that speak directly to his core voters--immigration, trade and tariffs, and infrastructure--or the ones that speak more directly to Corporate America--corporate tax cuts, or the dilution of Dodd-Frank? Too early to tell. In any case, for some ideas like increased spending on infrastructure, the impact on the real economy is going to take a few years.

As for the U.K., we believe that the chances have actually increased of the government facing tough negotiations in Brexit talks, which could end in an EU exit without trade ties to the bloc. The latest High Court decision could delay the triggering of Article 50 past the U.K. government's self-imposed March deadline. It also means that any negotiations with the EU regarding an exit strategy could become more difficult if the U.K. Parliament were to start playing a more active role in them.

Negotiations could become protracted and more uncertain as France, Germany, and the Netherlands go into elections mode. The current governing parties of these countries do not seem inclined to concessions to the British government, fearing it could play into the hands of anti-European opposition parties.

As Europe goes to the polls, anxiety abounds

On Dec. 4, 2016, Italians will vote in a constitutional referendum. The polls show a fair chance that the result will go against the government's wishes. If that happens, we don't believe it will be credit negative for the sovereign's creditworthiness, but it could ignite a financial market sell-off and volatility. Market participants could paint this as a crucial set-back for a government that has broadly seen as pushing for reforms in many areas of the economy, which Italy needs, particularly in the banking system, still haunted by unresolved nonperforming loans. Eurosceptic parties are against the referendum. (See "Ratings On Italy Affirmed At 'BBB-/A-3'; Outlook Stable," published on Nov. 11, 2016, on RatingsDirect.)

On the same day, Austrians will go back to the polls to elect a president because elections in May were annulled due to voting irregularities. As in May, the race is expected to be very tight and Austria could become the first European democracy in many decades with a far-right head of state, whose campaign rhetoric has been vocal on mass immigration and Euroscepticism.

These two events could give an additional boost to growing populist, anti-establishment, and anti-Europe sentiment as three large European democracies elect leaders in 2017: France, the Netherlands, and Germany.

Although we do not expect that the more anti-Europe parties in these three countries will actually win, the political rhetoric from the more mainstream, pro-Europe parties will probably take on a more protectionist, and a generally more nationalistic and Eurosceptic, stance in an attempt to hold onto voters. So the question really is whether, come 2018, confidence in the European project will grow or further recede.

Monetary policy diverges

We believe a new interest rate cycle may have begun with the recent rise in bond yields, and a divergence in monetary policy on the two sides of the Atlantic. In the U.S., interest rate expectations have risen meaningfully, and the U.S. Federal Reserve is poised to tighten. We project one rate increase in December 2016, two in 2017, and three in 2018. On the other hand, as the recovery in Europe is still shallow, the European Central Bank (ECB) is likely to keep its accommodative stance to contain the steepening yield curve, see "Rising Bond Yields Spell More QE For The Eurozone," published on Nov. 30, 2016.

We see less of a chance that the ECB will cut interest rates again, mainly because we expect the euro to stay weak and competitive toward the dollar in 2017. At the same time, to meet its inflation target of close to 2%, we believe that the ECB will likely extend quantitative easing for another six months after March with a view to start tapering the program after that. In Europe, long-term rates touched a low early this year, and have started to rise gently. For the benchmark German government bond, we're forecasting an average yield of 0.1% for 2016, 0.7% for 2017, and 1.1% for 2018.

As for the Bank of England (BoE), when Brexit negotiations actually start, we still expect a cut in interest rates in the second quarter of 2017 as the U.K. economy slows, though less than we previously forecast.

What's in store for Russian sanctions?

While the media is awash with speculation that the new U.S. president-elect, Donald Trump, will take a softer stance on Russia, this is far from certain. Mr. Trump's foreign policy nominees so far are Kremlin hardliners. Although a watering down of the sanctions would slightly aid the economy, it is unlikely to kick start the recovery. That's because Russian banks and corporates, which have reduced their external exposures significantly due to the sanctions, are likely to tread back into international markets with caution.

A "Trump tantrum" hits EMEA emerging markets

The tightening of global financial conditions in the aftermath of the U.S. elections is putting pressure on currency and bond markets in emerging markets, particularly those highly dependent on foreign flows, such as Turkey and South Africa. Markets are now pricing a steeper path for the U.S. interest rates, leading (yet again) to a reassessment of the attractiveness of emerging market assets. A "Trump tantrum" led to a wave of outflows from emerging markets globally after the U.S. elections. The Institute of International Finance, in a preliminary estimate, puts an outflow out of emerging markets' debt and equities in November at US$24 billion.

Meanwhile, commodity prices have stabilized. Oil prices have increased above the $50 mark after the unexpected agreement from the OPEC meeting to cut supply was reached. Moreover, expectations of higher infrastructure spending in the U.S. have boosted prices of industrial metals, such as copper and iron ore. It is too early to say whether this bullishness will last, but it looks like the worst is over for commodity producers.

Risks And Imbalances

We are currently tracking the same set of risks to credit conditions as in the past quarter. We believe the uncertainty around Brexit negotiations has not abated as the March deadline approaches. We also do not detect any sign of softening from the EU, and in the recent Autumn Statement the U.K. government actually admitted that growth and debt projections for the country have deteriorated partly due to Brexit.

Table 1

Top EMEA Risks

	Risk level	Risk trend	Comment
BREXIT: Negative impact on U.K. and EU economies; possible confidence shock.	High	Increasing	CHANGE: Risk trend to Increasing from Stable. Subdued short term impact on UK economy so far but now also government expectations on growth have been reduced. Still high level of uncertainty on negotations and increased risk of hard negotations.
Increased uncertainty in the European political landscapes with risk of escalation in populism and extreme nationalistic views, anti-immigration or protectionist measures that raise barries to international trade, disrupt investment and challenge Europe's governability and continued economic and political integration.	High	Stable	NO CHANGE: Very busy political schedule of elections and referendums for the next 9 months in an ever divided political arena in major European economies.
Persistently low or negative interest rates that can result in weaker profitability, risk taking, asset-bubble creation, increasing pension liabilities, as well as impediments to the swift deleveraging of private- and public-sector debt.	Elevated	Increasing	NO CHANGE: Both ECB and BofE expected to maintain an accomodative policy for most of 2017.
Geopolitical risks -- terrorism, Middle East turmoil, specifically Syria and Europe's migration crisis -- that threaten global security, leads to increased risk aversion and undermines global growth	Elevated	Stable	NO CHANGE: Risk of acts of terrorism as busy election year in Europe ahead.
Protracted weakening of long-term growth in international trade due to e.g. a slowdown in China and commodity-driven emerging markets or increased protectionism.	Elevated	Stable	NO CHANGE: whether upcoming US presidency will implement a protectionist stance is still to be seen.

Note: We classify risk level as very low, low, moderate, elevated, high, or very high. We classify risk trend as stable, decreasing, or increasing.

Macroeconomic Environment

Eurozone: The recovery is resilient but inflation is still low

A range of hard and soft indicators released over the past two months has broadly confirmed our views about the resilience of the eurozone's recovery, both to negative shocks from abroad and various domestic uncertainties. Real GDP grew by 0.3% quarter on quarter in the third quarter, the same as in the second quarter. The Spanish economy continued to race ahead, expanding by 0.7% in the third quarter, the fastest of the largest eurozone economies. By contrast, economic growth slowed in Germany, to 0.2% in the third quarter, dragged down by weak exports. Meanwhile, the French economy rebounded after a weak second quarter, but growth remained modest at 0.2%. Italy's output was up 0.3%, after no growth in the second quarter. Markit PMIs (Purchasing Managers Indexes) for October suggest that the eurozone economy started the fourth quarter on a solid footing, with both manufacturing and service sector PMIs advancing in October. Encouragingly, German manufacturing PMI rose to 55, from an average of 54 in the third quarter, while services PMI rose by more than 3 points from September, to 54.1.

Inflation has failed to pick up, however. Consumer prices rose marginally to 0.5% year on year in October, but this was mainly due to the rise in energy prices. In fact, annual core inflation edged down to 0.75% in October, from 0.83% a month earlier. And while inflation expectations are trending up, they are still well below the ECB's 2% target. Despite the steadily improving labor market, wage growth remains muted, even in Germany, a country which is close to full employment.

U.K.: It won't be business as usual

Five months after the U.K.'s referendum vote to leave the E.U., the economy has yet to show signs of weakening as a result. Because of the economy's resilience as well as upward revisions to historical GDP data, we have revised our forecast upward. We now expect GDP growth of 2.1%, 1.4%, and 1.3% for 2016, 2017, and 2018.

The apparent lack of negative shocks doesn't mean it will be business as usual in coming years, but rather that the impact of Brexit will be felt more gradually, as consumers and businesses prepare and adjust to a changing economic environment. We believe the high degree of uncertainty in itself will lead some businesses to shelve investment plans, abandon them altogether, or decide to strengthen their presence elsewhere in the EU. Weak investment stands to be one of the key drivers of slower growth in the next few years. Inflation will squeeze household budgets, dampening economywide real income growth to below 1%. CPI inflation, which we forecast to run at 2.7% in 2017, up from 0.7% in 2016, will be stoked mainly by higher import prices, on the back of much weaker sterling, gradually feeding through to consumer prices via the supply chain.

Russia: A pick-up in investments and exports

We expect a resumption of growth in Russia to 1.3% in 2017 and 1.6% in 2018, after a contraction in real GDP of that we estimate at -0.6% this year. We think this muted recovery will rely on a modest pickup in investment, including a turnaround in the inventory cycle, and exports. We expect a meaningful rebound in private consumption only in 2018. We expect fiscal policy to remain restrictive next year, as the government pursues a consolidation path, but some fiscal relaxation appears likely ahead of the 2018 presidential election.

Turkey: weaker capital flows to continue

The outlook for capital flows in Turkey--which are essential for the country's growth model--has weakened considerably over past weeks, in our view. This is due to domestic political developments and heightened uncertainty, which tighter financial conditions globally are attenuating. Foreign portfolio flows into Turkey have been volatile this year, but have overall weakened since July, despite favorable financing conditions for emerging markets in the third quarter, and turned negative in September. IIF data signal continuing non-resident portfolio outflows out of Turkish debt in October-November. Meanwhile, export revenues have fallen by 8% year on year in the first nine months of 2016, largely due to a steep fall in tourism revenues.

Table 2

Main European Economic Indicators November 2016

Central Forecast									
	Germany	**France**	**Italy**	**Spain**	**Netherlands**	**Belgium**	**Eurozone**	**U.K.**	**Switzerland**
Real GDP (% change)									
2014	1.6	0.7	0.2	1.4	1.4	1.7	1.2	3.1	2.0
2015	1.5	1.2	0.6	3.2	2.0	1.5	1.9	2.2	0.8
2016f	1.8	1.3	0.9	3.2	2.0	1.3	1.6	2.1	1.6
2017f	1.4	1.3	0.8	2.3	1.5	1.3	1.4	1.4	1.5
2018f	1.3	1.4	0.9	2.0	1.4	1.2	1.3	1.3	1.5

Table 2

Main European Economic Indicators November 2016 (cont.)

CPI inflation (%)

2014	0.8	0.6	0.2	-0.2	0.3	0.5	0.4	1.5	0.0
2015	0.1	0.1	0.1	-0.6	0.2	0.6	0.0	0.1	-1.1
2016f	0.4	0.3	0.0	-0.4	0.2	1.8	0.2	0.7	-0.3
2017f	1.6	1.3	1.2	1.4	1.3	1.9	1.4	2.7	0.2
2018f	1.6	1.4	1.3	1.5	1.5	1.5	1.4	2.1	0.6

Unemployment rate (%)

2014	5.0	10.3	12.7	24.5	7.4	8.6	11.6	6.2	3.2
2015	4.6	10.4	11.9	22.1	6.9	8.5	10.9	5.4	3.3
2016f	4.2	9.9	11.5	19.8	6.0	8.1	10.0	5.0	3.4
2017f	4.2	9.6	11.2	17.8	5.6	7.8	9.4	5.5	3.4
2018f	4.4	9.4	10.8	16.3	5.6	7.6	9.1	5.7	3.3

10-year bond yield (yearly average)

2014	1.2	1.7	2.9	2.7	1.5	1.7	2.0	2.6	0.7
2015	0.5	0.8	1.7	1.7	0.7	0.9	1.2	1.9	-0.1
2016f	0.1	0.4	1.5	1.4	0.3	0.5	0.9	1.3	-0.4
2017f	0.7	1.0	2.3	1.9	0.9	1.1	1.4	1.5	0.4
2018f	1.1	1.4	2.5	2.3	1.3	1.4	1.7	1.9	0.7

Central banks policy rates (yearly average)

	ECB	BOE	SNB
2014	0.16	0.50	0.03
2015	0.05	0.50	-0.75
2016f	0.01	0.40	-0.75
2017f	0.00	0.10	-0.75
2018f	0.00	0.05	-0.63

Exchange rates (yearly average)

	USD/EUR	USD/GBP	EUR/GBP	CHF/USD	CHF/EUR
2014	1.33	1.65	1.24	0.91	1.21
2015	1.11	1.53	1.38	0.96	1.07
2016f	1.11	1.35	1.22	0.98	1.09
2017f	1.06	1.19	1.12	1.00	1.10
2018f	1.08	1.24	1.14	1.05	1.11

f--S&P Global forecast.

Sector Outlooks

Financial Institutions

Low interest rates will continue supporting low borrowing costs, but also constrain banks' ability to grow earnings and potentially lead to higher risk taking.

For as long as returns do not strengthen meaningfully, European banks (except in the Nordic region) will feel increasing pressure to undertake deeper measures to ensure their business models are sustainably profitable.

Met with modest business volume growth, and the need to continue investing in technology and meet demanding regulatory requirements, many management teams will have no choice but to address banks' excess capacity and operating inefficiencies, which low rates did not cause, but only made evident. Several large European banks (Commerzbank, ING, Lloyds, Banco Popular and Deutsche Banks, for example) over the past few months announced downsizing plans, which, however, will take some time to implement and yield results.

West European banks: Unresolved NPLs, less regulatory uncertainty, and continued digitalization

Banks in Southern Europe will continue holding a much larger stock of nonperforming assets than peers in the region. Although we are confident that nonperforming assets will continue gradually reducing in Spain and Ireland, as they benefited from government schemes that facilitated their recapitalization and transfer of risky exposures outside the banking system during the crisis, we think Italian and Portuguese banks will face more challenges in the absence of such initiatives. Conversely, we expect the cost of risk in the rest of Western Europe to remain low, supported by very low rates, despite the existence of some pockets of risk in oil and gas and shipping exposures.

Although banks will continue operating under much more stringent regulatory requirements than before the financial crisis, at least we think that in 2017 regulatory uncertainty will abate. That's because pending changes (such as Basel's refinements of capital requirements, including changes to enhance the comparability of risk-weighted assets, the final design of long-term funding requirements and the leverage ratio, as well as requirements for minimum requirement for own funds and eligible liabilities or MREL), are expected to be communicated toward the end of 2016. We note as well the flexibility that the split of Pillar 2 requirements to be adopted in 2017 will provide to banks, by lowering the trigger point for suspending hybrid coupons.

We expect banks to continue on the path of digitalization, in turn allowing the downsizing of their traditional operating infrastructure. In our view the competition from fintechs will force banks to evolve and adapt, but will not threaten their predominant role as providers of financial services in coming years. We believe banks are conscious of the need to innovate to better serve clients and protect themselves against cyberattack, which as the recent Tesco Bank case shows will likely increase.

Banks benefit from certain competitive advantages: compared with the fintechs, they already have the clients, so they have to focus on retaining them rather than attracting them. Second, they have a full range of products where fintechs don't, which allows them to generate more business per client. Conversely, they are subject to stringent regulations, which limit their ability to be as competitive as fintechs on pricing.

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Central and Eastern Europe

Banks in the Czech Republic, Hungary, and Slovenia will benefit from better economic prospects owing to improved domestic demand. Even Croatia's economy, in the middle of a correction, has recently shown signs of increasing strength. Substantial legacy nonperforming loans still inhibit new lending in our view. Deleveraging will continue in Bulgaria amid sluggish economic growth. While we anticipate the Polish economy will grow, depreciation of the Polish zloty against most foreign currencies has reduced the capacity of private borrowers to serve their elevated foreign currency-denominated debt. In addition, government measures such as a new bank asset tax and increased regulatory costs will strain Polish banks' profitability.

Gulf Cooperation Council countries: Slowing growth and deteriorating profitability

We think the slowdown in loan growth that so far has characterized 2016 will persist in 2017, with growth stabilizing at about 5%.

Lower oil prices mean thinner liquidity since deposits from governments and their related entities account for between 15% and 35% of the deposit base of GCC banks. With the decline in liquidity, the cost of funding for banks has increased. In the same vein, the drop in economic growth exposed the most vulnerable borrowers, primarily subcontractors and small and midsize enterprises, leading to higher default rates and provisioning needs.

Overall, we think that banks' profitability will drop, prompting some to take a closer look at efficiency, potentially triggering mergers and acquisitions (M&A).

Turkey: vulnerability to external debt refinancing and moderately weaker asset quality

Following the attempted coup by a fraction of the armed forces, we believe the polarization of Turkey's political landscape has further eroded its institutional checks and balances. Foreign portfolio flows into Turkey have been volatile this year, but have weakened overall since July, despite the favorable financing environment for emerging markets in the third quarter.

The recent tightening of global financial conditions, coupled with a period of heightened unpredictability in the country, could constrain capital inflows into Turkey's externally leveraged economy.

As for the banking system, we continue to see external funding and asset quality vulnerability as the two main risks in 2017. According to our estimates, Turkish banks' gross external debt reached nearly $180 billion at midyear 2016, of which 45% is short term in nature.

South Africa: Banks' performance is better than expected but risks have not receded

Amid slow economic growth and political infighting--both of which are testing the strength and depth of South Africa's institutional capacity--the country's banking sector has outperformed our expectations. That's partly because of the positive endowment effect of not only of higher interest rates but also improving cost control and declining risk costs.

Household asset quality will deteriorate, we believe, but at slightly lower levels than our previous expectations. Meanwhile, corporate performance continues to be surprisingly robust, despite low commodity prices that are continuing to pressure mines.

Overall, we expect credit losses for banks will deteriorate slowly in 2017, with a bias toward poorer asset quality performance for banking groups that have larger retail books (especially for lower and mass markets) and exposures into the rest of Africa. Yet, systemic risks are lower than in some other emerging markets because of the closed rand system and minimal reliance on external and hard currency funding.

Corporates

It seems increasingly possible that growing public dissatisfaction with the current political establishment in the West threatens policy changes, some of which won't be positive for global businesses. Greater national self-interest would undermine support for global institutions and change the business rules of engagement between countries. This would likely create disruption or heightened competition for European corporates in many areas not least tax, global trade, associated supply chains, foreign exchange markets, and M&A.

Against this backdrop, although current business conditions for European corporates have ticked up over the past three months, they remain relatively weak on balance and the outlook shows little improvement. Indeed, our quarterly Credit Conditions Survey (see table 1 below) show business prospects remaining weak, or weakening moderately, over the next 12 months in 11 out of the 29 nonfinancial corporate sectors we cover. Only in four do we anticipate some moderate improvement, namely in the global aerospace and defense (mainly related to prospect of increased defense expenditure) and pharmaceutical sectors (pipeline prospects improving medium term despite some short-term uncertainties about the implications about the election of Donald Trump), as well as in the high-grade telecommunications (as operating conditions improve) and rail infrastructure sectors.

Several key developments that will play into our assessment of sector credit quality into 2017 are briefly considered below. These include the shape of the new Trump administration and its policy priorities, the implications of any economic slowdown in China as rebalancing takes effect, as well as how Brexit negotiations unfold.

Following the Trump election victory:

• Aerospace & defense: We have upgraded business prospects for defense due to high security threats, continuing immigration, and increase NATO burden-sharing among the allies in what we believe are long-term trends that will encourage greater military spending. An increased commitment to defense spending is already confirmed in the U.S. and France. Long lead times on defense programs will delay related earnings growth.

• European auto makers and suppliers: We think protectionist measures would take some time to implement and to the extent that rejigging source of production in the supply chain cannot accommodate the changes then tariffs would have some marginal impact on production and profitability. Appreciation of the U.S. dollar could actually help European carmakers in the short run. With the exception of Fiat (via Chrysler), European original equipment makers hold low single-digit market shares in the U.S. market. Their contribution to earnings is only meaningful for BMW and Daimler, and they both operate U.S.-based plants. Compared with other European equipment manufacturers, Volkswagen may be more exposed to a protectionist stance of the U.S. as it imports some models and components from Mexico. Higher U.S. tariffs and changes to the North American Free Trade Agreement (NAFTA) and the Korea-U.S. Free Trade Agreement, as well as abandonment of the proposed Trans-Pacific Partnership (TPP), could hurt the profitability and cash flow of most of those automakers that supply more than 50% of U.S. sales from Japan, Korea, and Mexico.

• Shipping: Weak volume growth (particularly on Asian and South American routes), combined with fleet capacity expansion, has kept charter rates (for containers, dry bulk, and gas carriers) depressed this year. Very limited new orders due to the weak operating environment, lack of funding, and record-level scrapping will trim growth in capacity and should help charter rates to rebound slightly next year. If Trump's protectionist rhetoric translates into widespread quotas and tariffs, global trade could suffer and delay any recovery in the global shipping industry.

• European technology companies: Many European technology companies that generate meaningful U.S. dollar revenues but have limited U.S. dollar operating expenses would benefit from a stronger U.S. dollar, similar to what they experienced in 2015.

• Cross-sector: More generally, the prospect of an expansionary fiscal stimulus in the U.S., at a time of full employment, is likely to boost headline inflation and make it easier for the Fed to normalize short-term rates. This policy stance will contrast sharply with a still weak economy in mainland Europe, still heavily reliant on monetary policy support. The implications for corporate funding in Europe? Expect the U.S. dollar to appreciate and longer-term financing costs to rise, albeit modestly, as we expect the ECB will likely extend their asset purchase program beyond March 2017.

In relation to the anticipated economic slowdown in China:

• Autos: Unless current fiscal incentives supporting sales of small cars in China are extended beyond 2017, we anticipate that car sales will grow by only 1%-2% in 2017 (versus 6%-7% in 2016), partly due to pollution and congestion charges dampening demand. This will dent the earnings of international automakers and their suppliers as they are heavily invested in this market.

• European airlines: Demand remains quite sluggish (mainly on Asian and Latin American long-haul routes) due to fears of political instability and terrorist threats, while strong price competition between carriers to maintain load factors will continue to squeeze margins. The incipient expansion of low-cost carriers into long-haul routes, and the stabilization in oil prices (depending on hedging strategies) only adds to the pressure on margins, though somewhat mitigated by ongoing cost efficiency efforts.

• Steel: The improvement in industry conditions in the second quarter has persisted. Higher pricing has broadly offset lower demand in key end markets in the U.S. and EU, and demand appears to have stabilized in China. Margins are under some pressure due to still chronic overcapacity (particularly in China), exacerbated by the surprising 150% spike in coking coal prices since the summer. Stability in the European steel industry in coming quarters will depend on the volume and competitiveness of steel imports, after the application of U.S. antidumping measures that may be ramped up further once Trump takes office in January.

Currency and Brexit uncertainty travails for the U.K.:

• Leisure: For hotels, we see slower than estimated demand growth leading to lower revenue per available room (RevPAR) due to terrorism in Europe, and some softness in U.K. hotel demand as consumers weigh the implications of the Brexit referendum.

• Real estate: Brexit-related uncertainties and the prospect of higher long-term gilt yields are unsettling the commercial real estate market in the U.K., with prime commercial real estate in the City of London most vulnerable to a slowdown.

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This is in contrast to most of Europe (bar Italy) where the gradual pick-up in real GDP, and in headline inflation, is boosting organic growth for real estate investment trusts (REITs). In addition, construction growth is benefitting the building materials sector, and we expect the recovery to support volumes and prices.

• Consumer products: Following the 12% effective depreciation in sterling since the June 23 referendum, rising input costs have started to feed through the supply chain. With static wage growth, we expect a decline in real disposable incomes that will likely dampen apparel sales and earnings, particularly once currency hedges run off through the course of 2017.

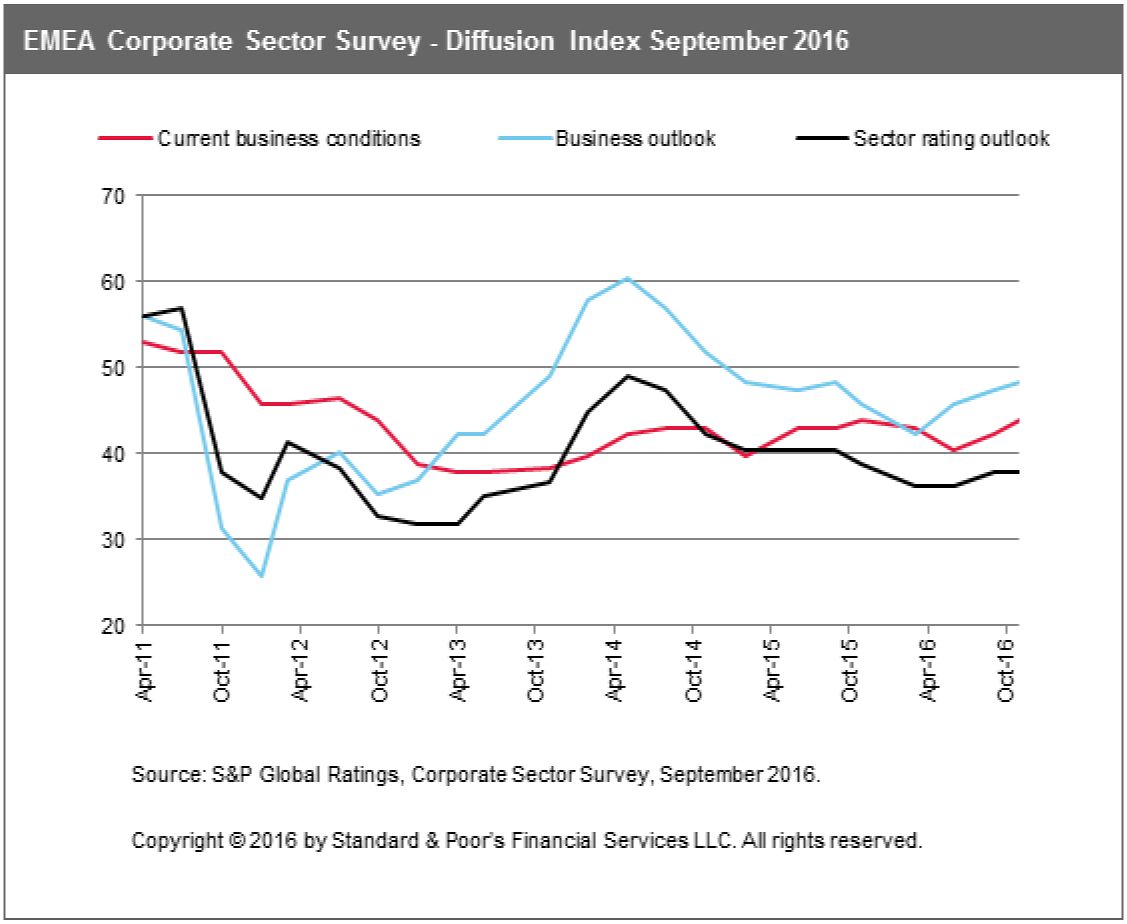
Chart 2

European Corporate Credit Conditions Survey

Sector	Business Conditions Current	Business Outlook 12mths	Financial Trends (FOCF) 12mths	Financial Trends (Capex) 12mths	Sector Outlook 12mths
Oil & Gas - Upstream	Very weak	No change	Increase	Substantial decrease	Negative
Transportation – Shipping	Weak	No change	No Change	Decrease	Negative
Utilities - Unregulated Power & Gas	Weak	No change	No Change	No Change	Negative
Autos – Manufacturers	Satisfactory	No change	No Change	Increase	Stable to Negative
Capital Goods	Satisfactory	No change	No Change	No Change	Stable to Negative
Chemicals	Satisfactory	No change	No Change	Decrease	Stable to Negative
Leisure	Satisfactory	No change	No Change	No Change	Stable to Negative
Media	Satisfactory	Moderately weaker	Decrease	No Change	Stable to Negative
Oil & Gas - Downstream	Weak	No change	Decrease	No Change	Stable to Negative
Retail	Satisfactory	Weaker	Decrease	No Change	Stable to Negative
Service Companies	Satisfactory	Moderately weaker	No Change	No Change	Stable to Negative
Transportation – Airlines	Weak	No change	No Change	Decrease	Stable to Negative
Aerospace & Defence	Satisfactory	Moderately stronger	No Change	No Change	Stable
Autos – Suppliers	Satisfactory	No change	No Change	No Change	Stable
Building Materials	Satisfactory	No change	No Change	Decrease	Stable
Consumer Goods	Satisfactory	No change	No Change	No Change	Stable
Mining	Weak	No change	No Change	No Change	Stable
Packaging	Satisfactory	No change	No Change	No Change	Stable
Pharma & Healthcare	Satisfactory	Moderately stronger	No Change	No Change	Stable
Real Estate	Satisfactory	No change	No Change	No Change	Stable
Steel	Satisfactory	No change	Increase	No Change	Stable
Technology	Satisfactory	No change	No Change	No Change	Stable
Telecoms – HY	Satisfactory	No change	Increase	No Change	Stable
Telecoms – IG	Satisfactory	Moderately stronger	No Change	No Change	Stable
Transp. Infra. – Airports	Satisfactory	No change	No Change	No Change	Stable
Transp. Infra. - Rail	Satisfactory	Moderately stronger	No Change	No Change	Stable
Transp. Infra. - Toll Roads	Satisfactory	No change	No Change	No Change	Stable
Utilities - Regulated	Satisfactory	Moderately weaker	Decrease	No Change	Stable
Forest Products	Satisfactory	Moderately weaker	No Change	No Change	Positive to Stable
Key:	Weaker Since Sep 2016			Stronger Since Sep 2016	

1. Very strong/very weak = sharply above/below conditions unusual for the industry; Strong/weak = above/below average conditions for the industry
2. Stronger/weaker = more than 5% improvement/deterioration; Moderately stronger/weaker = up to 5% improvement/deterioration
3. Significantly higher/lower = substantial increase/decrease unusual for the industry; Higher/lower = increase/decrease
4. Positive/negative = material number of potential upgrades/downgrades; Positive to stable /negative to stable = modest number of potential rating and outlook changes

Chart 1



Structured Finance

Positive credit performance gathers momentum

The recent positive credit performance of European structured finance securities gained further momentum in the third quarter of 2016. The quarterly downgrade rate remained low at 1.3%, while the upgrade rate reached its highest level in many years, at 6.8%. Most of the downgrades continued to be on commercial mortgage-backed securities (CMBS), with most upgrades in the structured credit and residential mortgage-backed securities (RMBS) sectors.

The large number of upgrades in the third quarter helped the 12-month trailing average change in credit quality reach a new high, with European structured finance ratings moving up by an average of almost 0.4 notches in the 12 months to end-September 2016. On this measure, credit performance was positive for nearly all structured finance sectors at the end of the third quarter. RMBS ratings recorded a 12-month rise in credit quality for the first time since 2008, with an average upward rating movement of 0.2 notches and an upgrade rate of 7% during the quarter. By contrast, the CMBS sector continued to show net negative credit performance, with an average downward rating movement of 0.8 notches over the previous 12 months and a downgrade rate of 10% in the third quarter.

Looking ahead, we expect European structured finance credit performance to remain benign in 2017. At the end of

September, 1% of ratings were on CreditWatch with positive implications, while a negligible number were on CreditWatch negative, indicating likely aggregate ratings stability.

Evolving originator mix could spur supply, warrant caution in 2017

Investor-placed issuance of European securitizations in 2016 looks set to come in higher than the previous year, although benchmark covered bond issuance will drop significantly. Year-to-date issuance at end-October was up 9% and down 17%, respectively, for the two sectors. Monetary authorities' provision of low-cost term funding for banks—such as the ECB's targeted longer-term refinancing operations and the BoE's Term Funding Scheme—have curtailed eligible institutions' issuance of more costly debt market alternatives, including structured finance. However, in the securitization space this supply pressure has been outweighed by a growing trend toward nonbank transactions, amid wider evolution in lending models and the base of securitization originators.

Issuance in 2016 was boosted by flows of legacy assets, often originated by now-defunct lenders, traded as whole loan portfolios, and eventually funded via securitization by specialist asset managers. In 2017, there is scope for substantial further use of securitization in this context, in particular to finance NPLs. More significantly, some nonbank sponsors are incorporating securitization techniques into their business models in novel ways that ultimately fund newly originated credit. In particular, some asset managers have struck agreements with lenders to purchase a portion of their loan production, funding via securitization and retaining parts of the capital structure that suit their investment mandates. The first European securitizations of loans originated through peer-to-peer lending platforms in 2016 are examples of a related new trend.

While these developments may be positive for supply, they will also raise new questions over credit risk in the year ahead. Some of the new practices blur the lines between the traditional roles of originators and investors in the securitization market, while possibly spurring a form of "originate-to-distribute" lending model, in which alignment of interests may require consideration. These novel approaches also warrant caution when assessing operational risk and the track record of new participants and asset types.