

Q2 Credit conditions: tighter for longer as central banks juggle financial risk, inflation?

30 March 2023

Scope Q2 Macroeconomic and Markets Outlook

Macroeconomic Assumptions

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GDP Growth	Credit Spreads	Inflation & Unemployment	Default Rates	Rates & FX
Growth slowdown in 2023, recovery by 2024	European Credit Spreads to remain elevated & volatile	Global inflation to remain uncomfortably high in 2023	Default Rate set to rise this year from very low levels	stronger EUR for rest of the year
0.8% - 1.8% Euro area -0.6% - 1.1% United Kingdom 2.7% - 3.4% Global	460 bps High Yield 160 bps Investment Grade	5.8% Euro area 7.5% United Kingdom 4.5% United States	4% Scope Corporate distress rate	1.11 EUR/USD 1.17 GBP/EUR

Tailwinds		Headwinds	
Falling inflation (energy, intermediate products)	✓	✗	persistent core inflation & hawkish central bank policies
Improving economic sentiment in Europe	✓	✗	concerns over financial stability (banks, real estate)
Limited refinancing needs & high corporate cash levels	✓	✗	lower corporate margins
Resilient domestic demand (high employment, fiscal support)	✓	✗	falling real incomes
China reopening	✓	✗	challenging fiscal dynamics



Ratings

Agenda

- **Latest Economic Trends**
- Financial Conditions
- Credit Markets

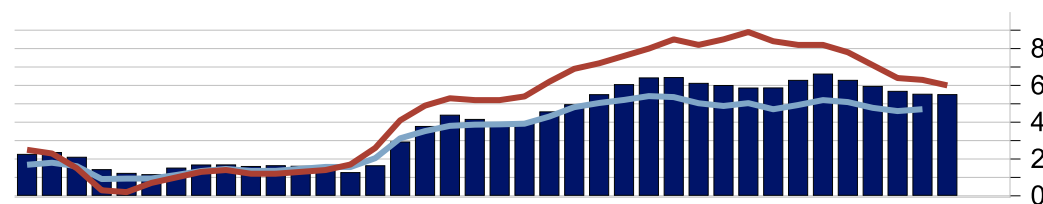


Inflation to remain higher for longer due to sticky core inflation

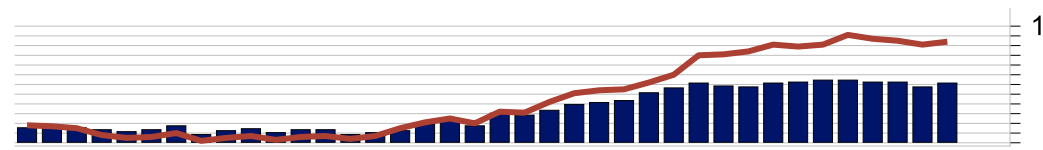
Headline inflation peaked in 2022 but core inflation continues to rise across euro area

Core & Headline Inflation (YOY %)

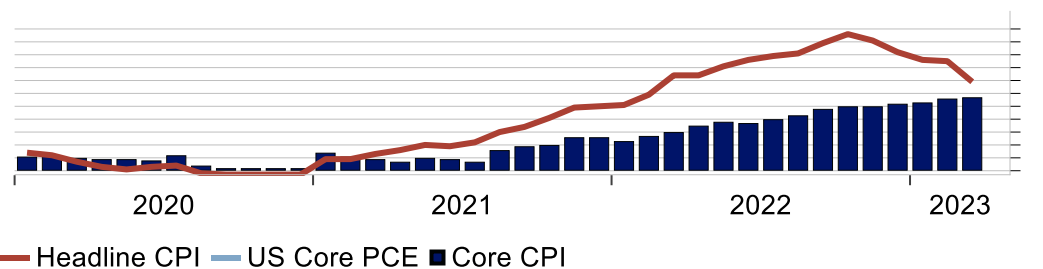
US core inflation stuck at elevated level



UK inflation recedes from very high peak

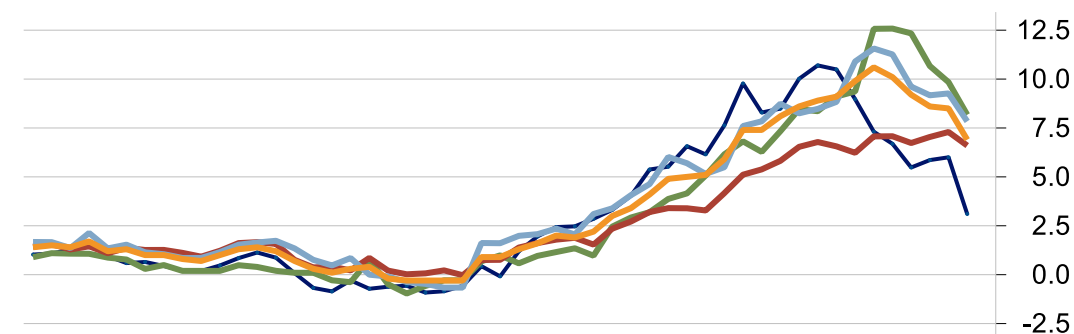


Euro Area core inflation keeps increasing

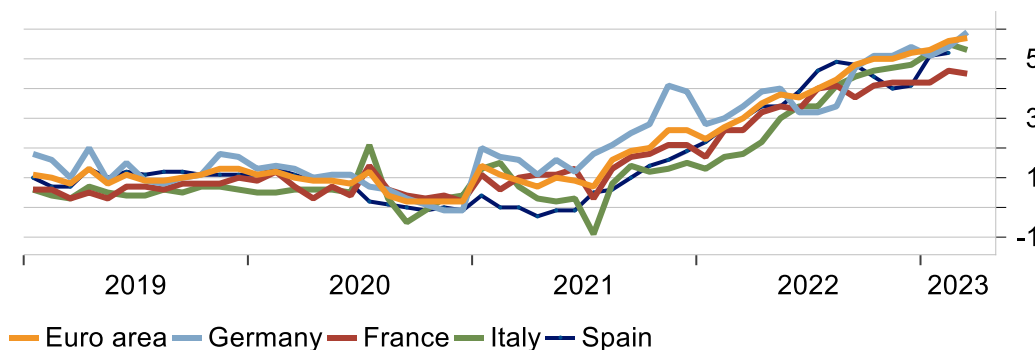


Euro Area Inflation

Spain & Germany lead decline in headline inflation in March



Core inflation rises steadily across euro area



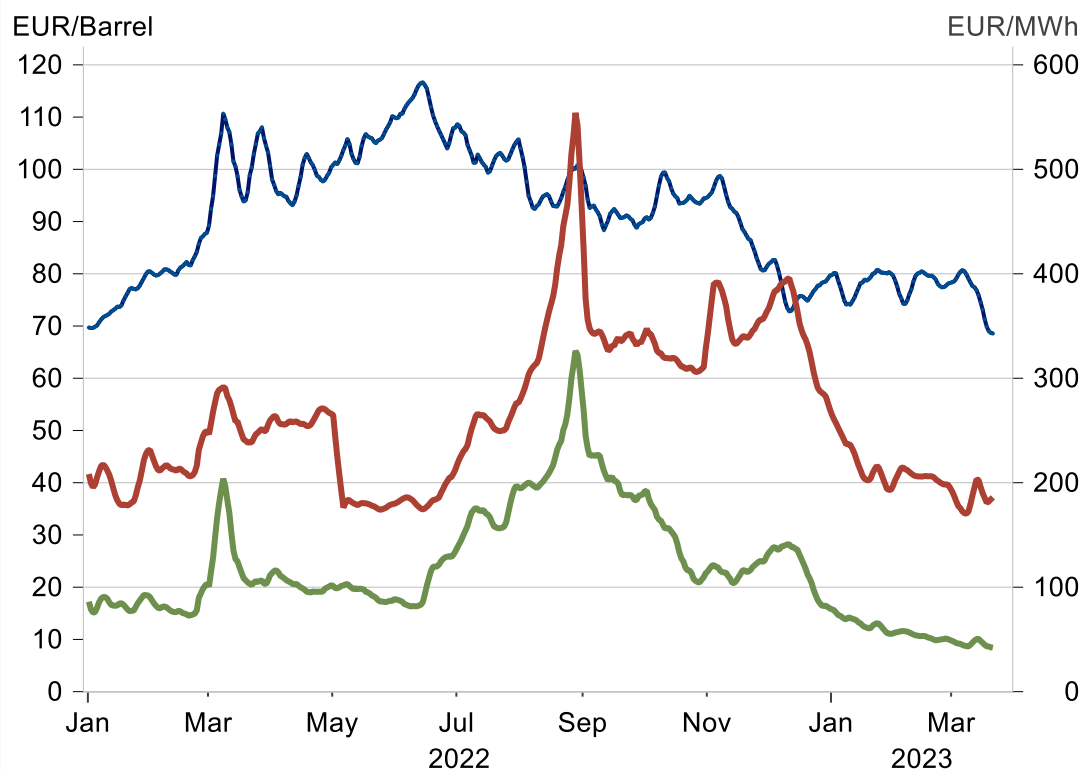
Source: National statistical authorities, Eurostat

Headline inflation recedes due to lower energy prices and stabilising cost of food

Oil and commodities prices fall on slower global demand. Gas and electricity prices fall on improving supply.

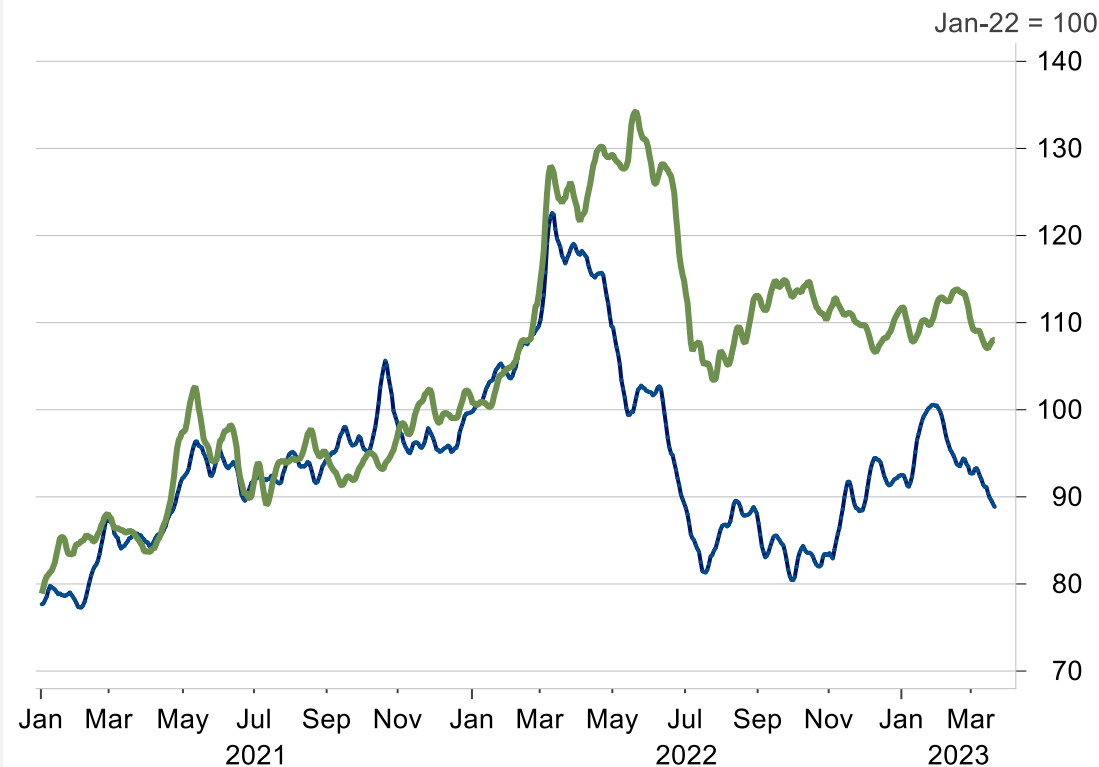
European energy prices drop back towards 2021

— Electricity, rhs — Natural Gas, rhs — Brent, lhs



Commodities prices driven by food cost

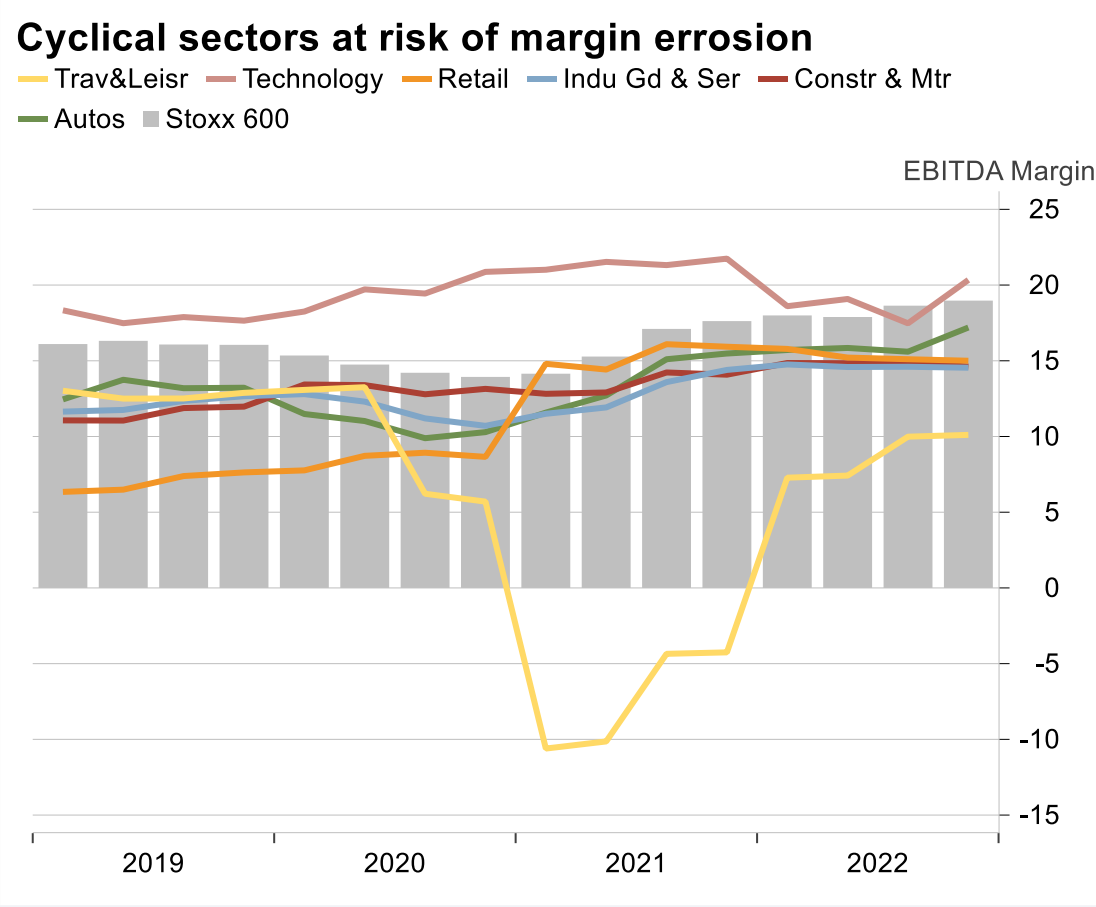
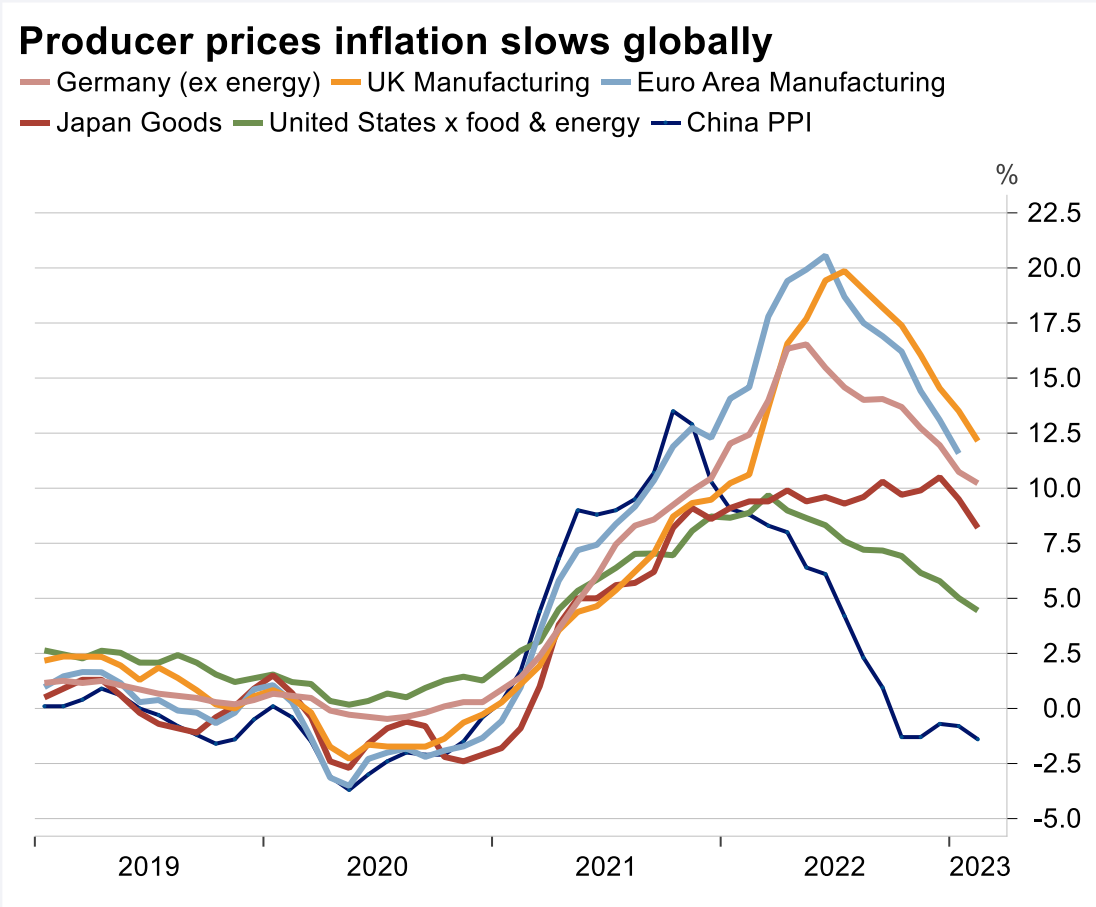
— Agricultural Products — Industrial Metals



Source: ICE, GSCI

Goods price inflation receding fast

Producer prices are falling



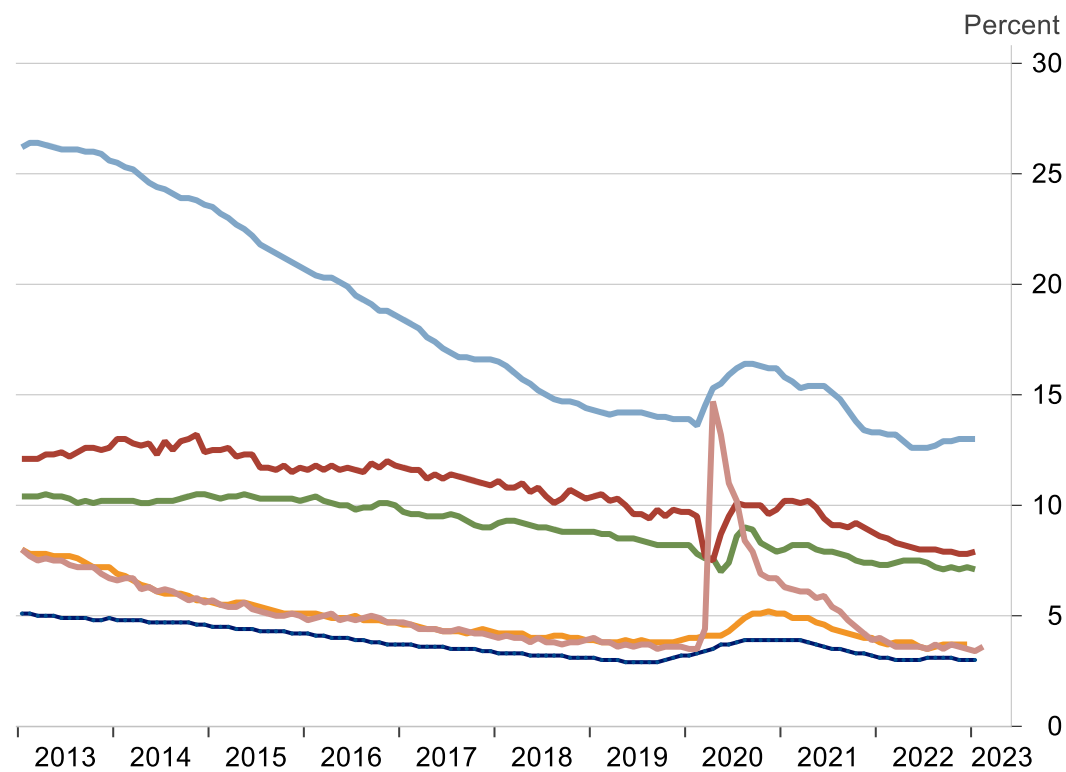
Source: National statistics offices, Bloomberg

Wage growth has yet to catch up with inflation

Euro-area wage growth is lagging that of the US and UK but momentum has increased recently

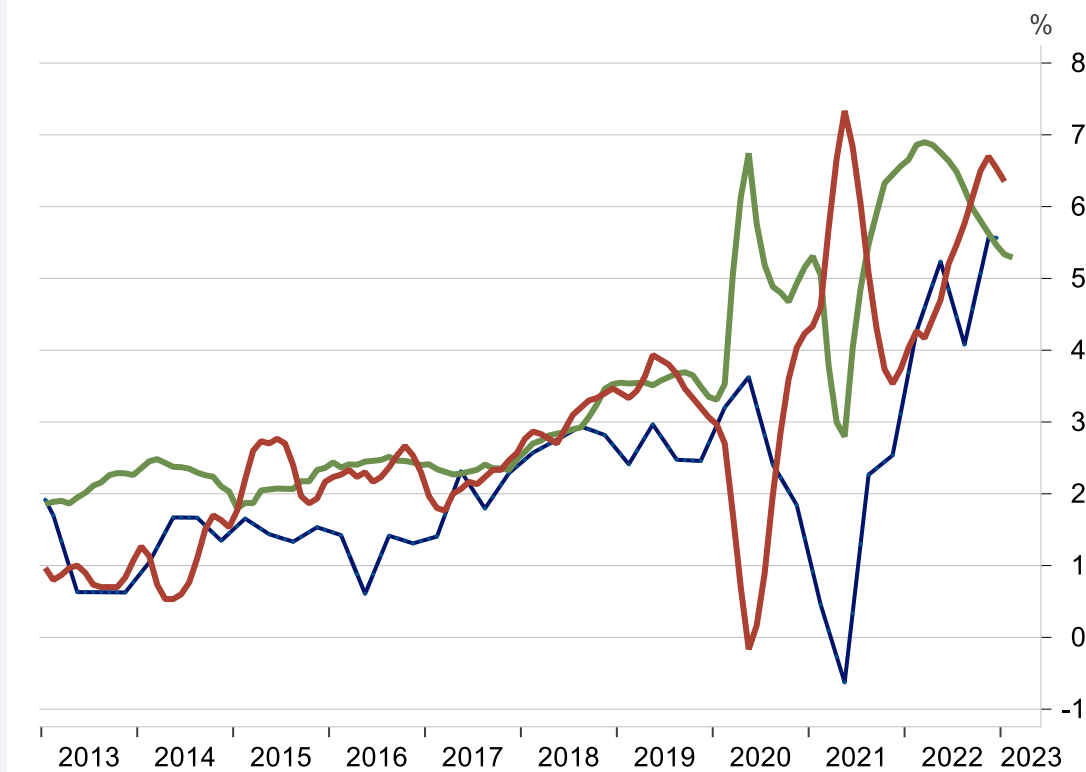
Low unemployment supports household sector

— US — UK — Spain — Italy — France — Germany



Wage growth so far has not compensated for inflation

— UK reg AWE — USA AHE non-sup — ECB Labour Cost Index

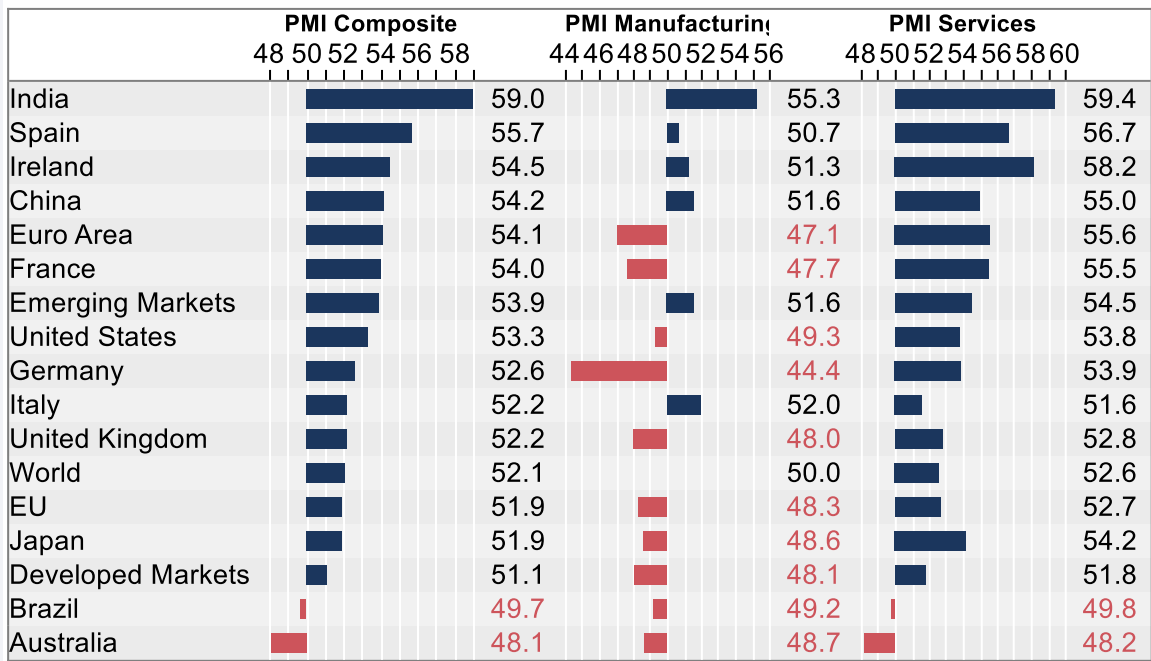


Source: National statistics offices, ECB

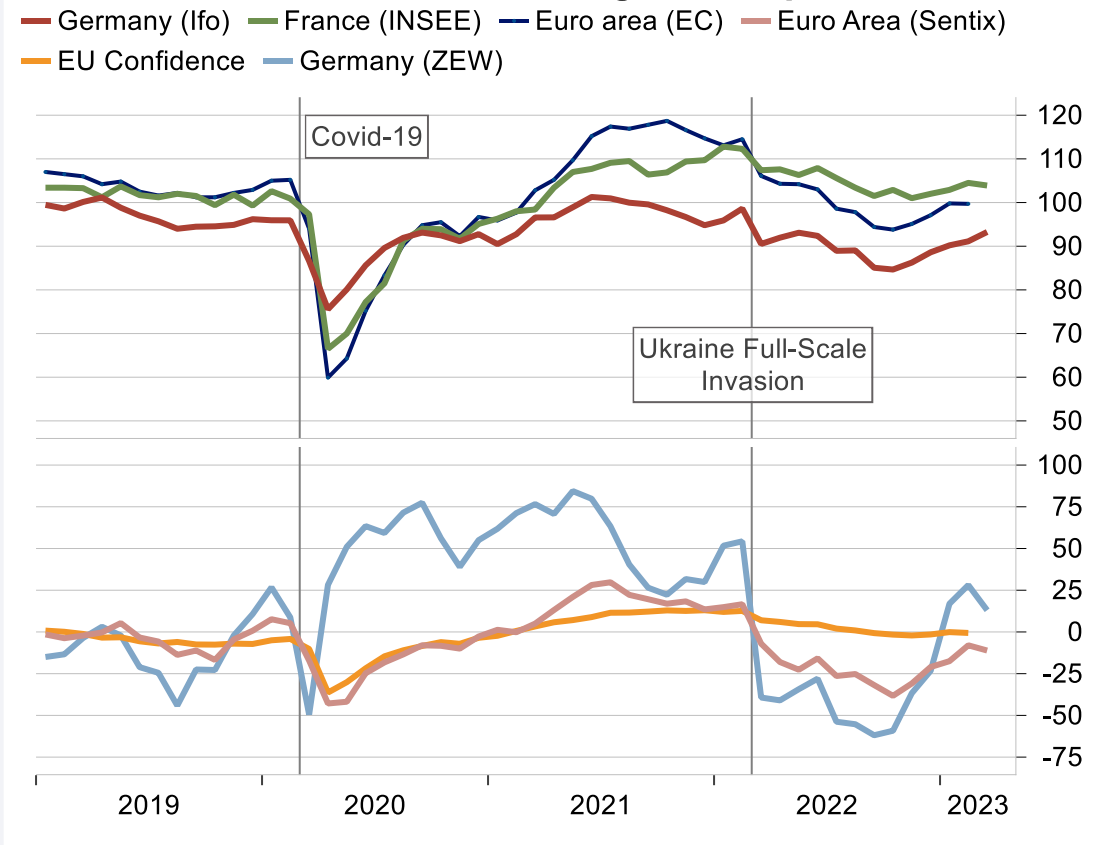
February's PMI surveys suggested improving economic sentiment

Improvement in Asia and services industries partly offset by weak European manufacturing sentiment

Strong services compensate weak manufacturing outlook



Business confidence recovering in Europe

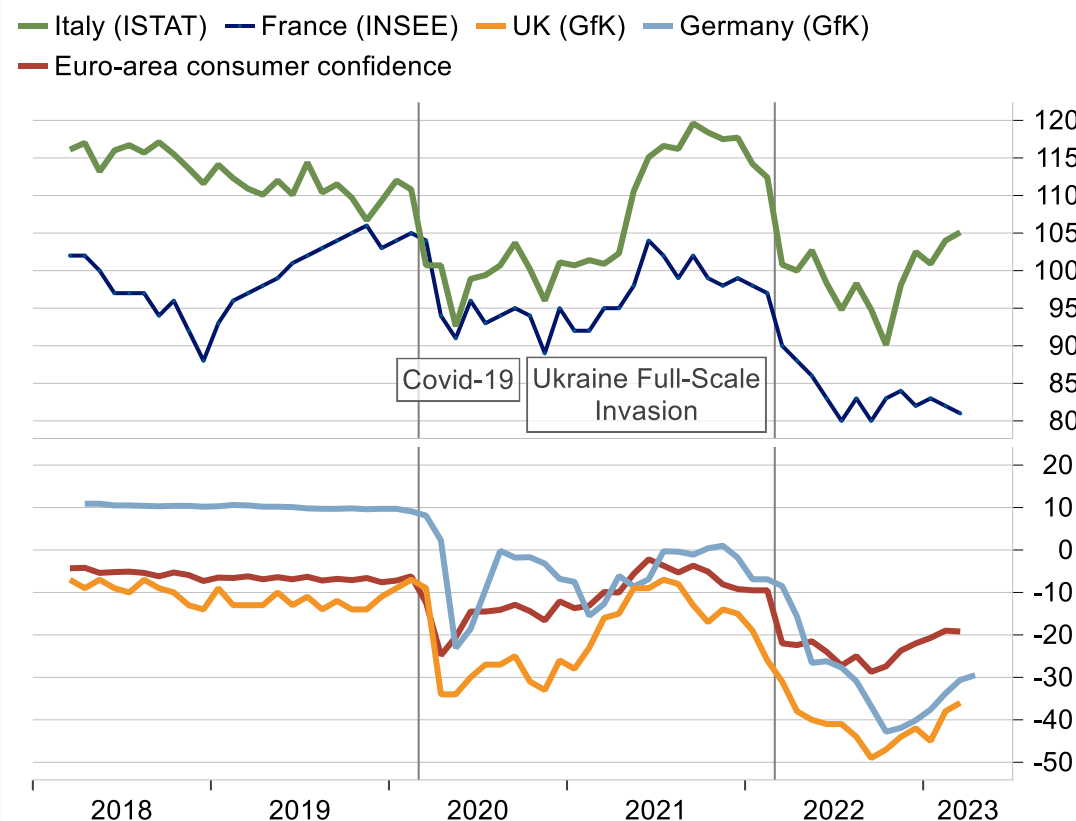


Source: Macrobond, ifo, INSEE, ZEW, European Commission, Sentix

Consumer confidence remains low due to falling real incomes

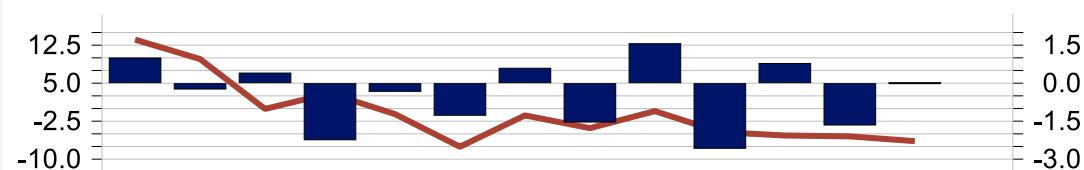
High energy costs and inflation weigh down on sentiment. Dwindling excess savings reduce spending power

Consumer confidence remains low

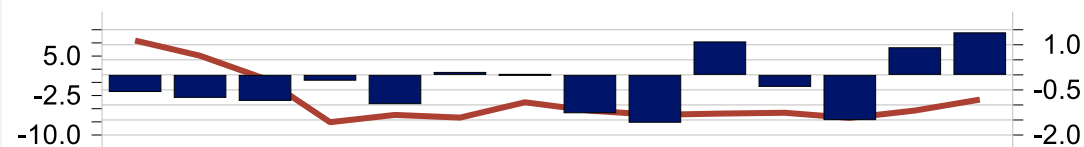


Retail sales show uneven pattern

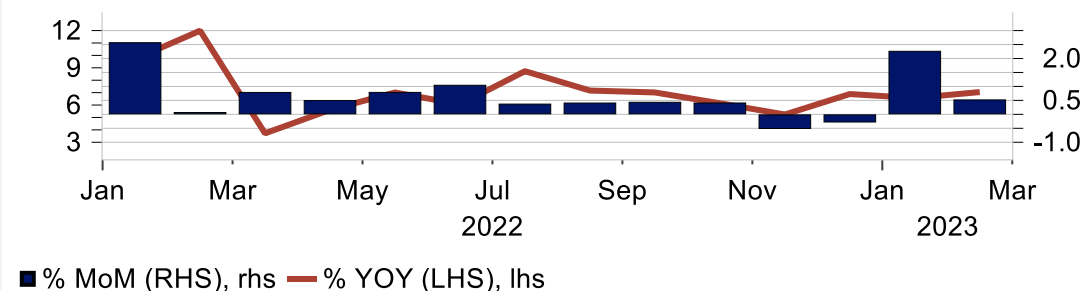
German retail sales stagnate in January



UK retail sales recover in Q1



US retail sales bounce back from weak Q4



Source: National statistics offices, Eurostat, GfK

Scope core economic forecasts

Sharp slowdown, challenging fiscal dynamics, high inflation and rising rates

Country / Region	GDP Growth			Unemployment			Inflation		
	2022E	2023	2024	Actual	2023	2024	Actual	2023	2024
Euro Area	3.5	0.8	1.8	6.7	7.0	6.9	8.4	5.8	2.4
Germany	1.8 -	0.2	1.5	5.3	3.2	3.2	8.6	7.5	2.4
France	2.6	0.5	1.6	7.3	8.1	8.0	5.9	4.3	2.1
Italy	3.7	0.5	1.5	8.1	8.5	8.5	8.7	5.2	2.0
Spain	5.5	1.3	2.5	12.9	12.9	12.5	8.3	5.2	2.2
UK	4.2 -	0.6	1.1	3.7	4.2	4.5	9.1	7.5	3.1
USA	2.1	1.5	1.5	3.6	3.8	4.2	8.0	4.5	2.9
China	3.0	4.3	5.2	4.0	5.4	5.3	2.0	2.3	2.2
Japan	1.0	2.3	1.8	2.6	2.4	2.4	2.5	1.4	1.0
World	3.3	2.7	3.4					6.8	4.5

Source: Scope Ratings Forecasts, National Statistics Offices

Ratings

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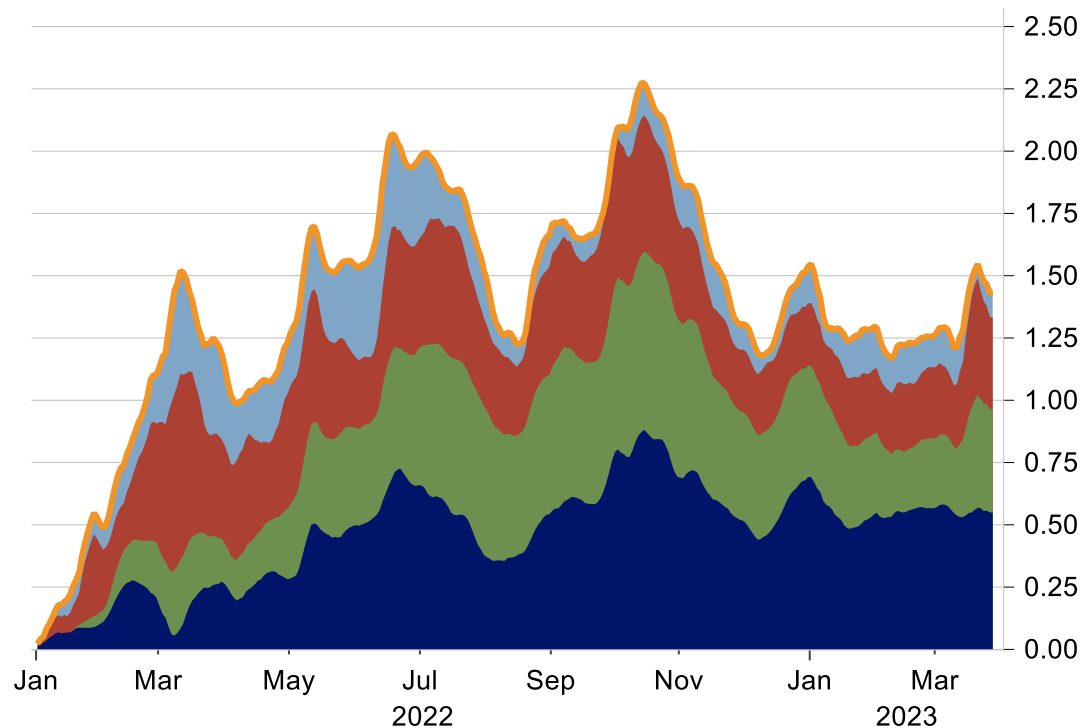


Financial conditions tighten in response to banking and inflation concerns

Rising risk aversion in credit and equity markets leads to tighter financial conditions in euro area and US

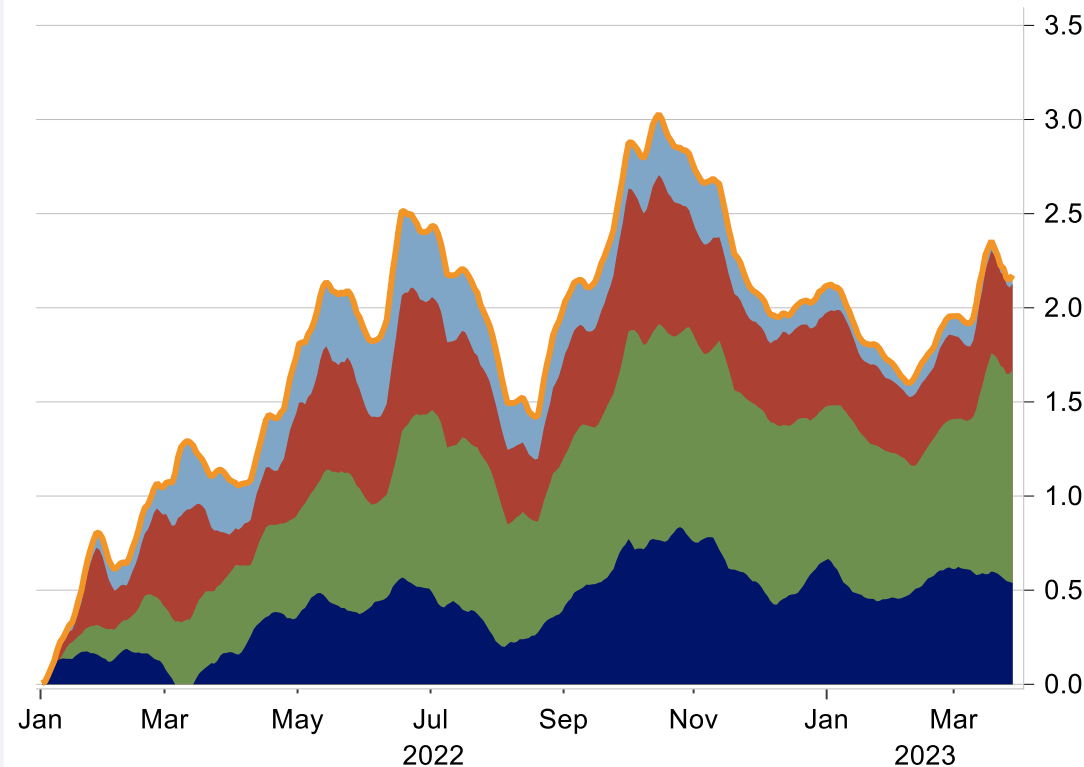
Tight conditions are biting even as energy shock wanes

— Scope FCI EUR Main Index — Terms of Trade — Equity Market — Credit Market — Rates Market



Financial cracks emerging from higher interest rates

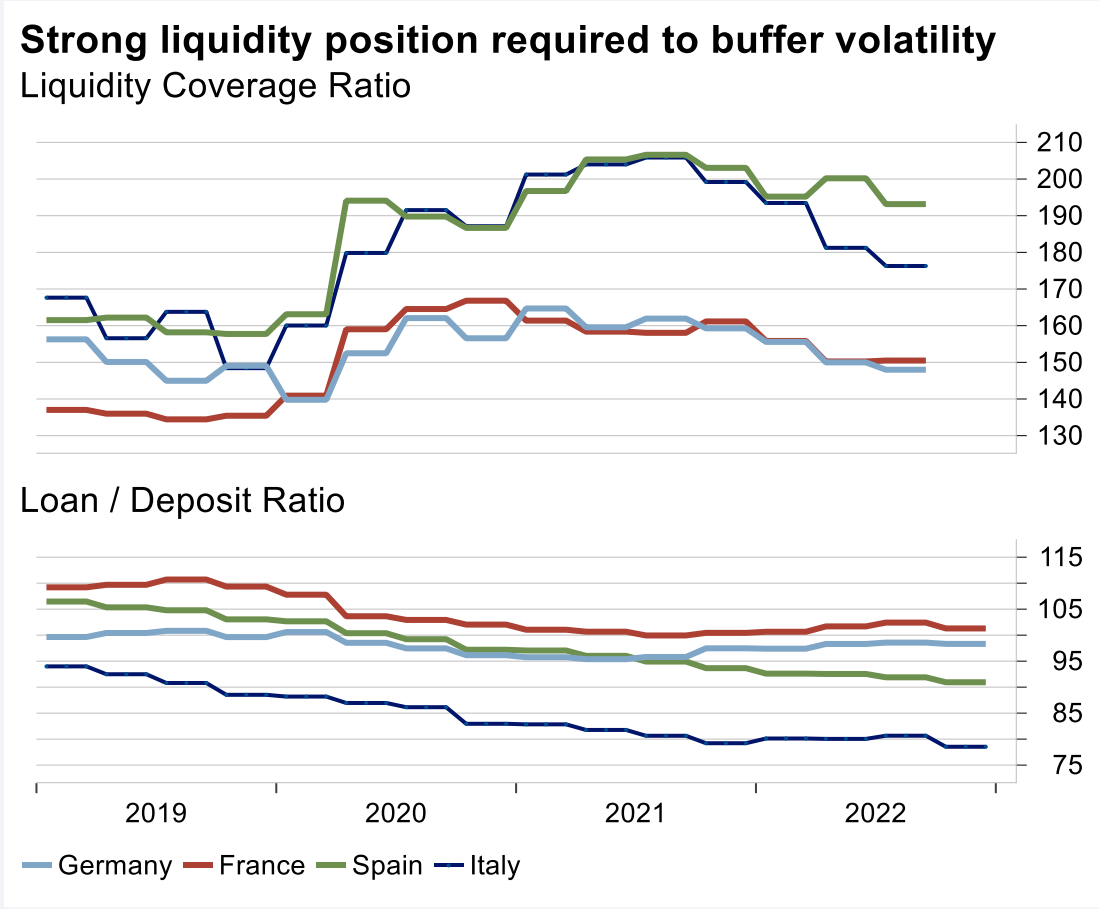
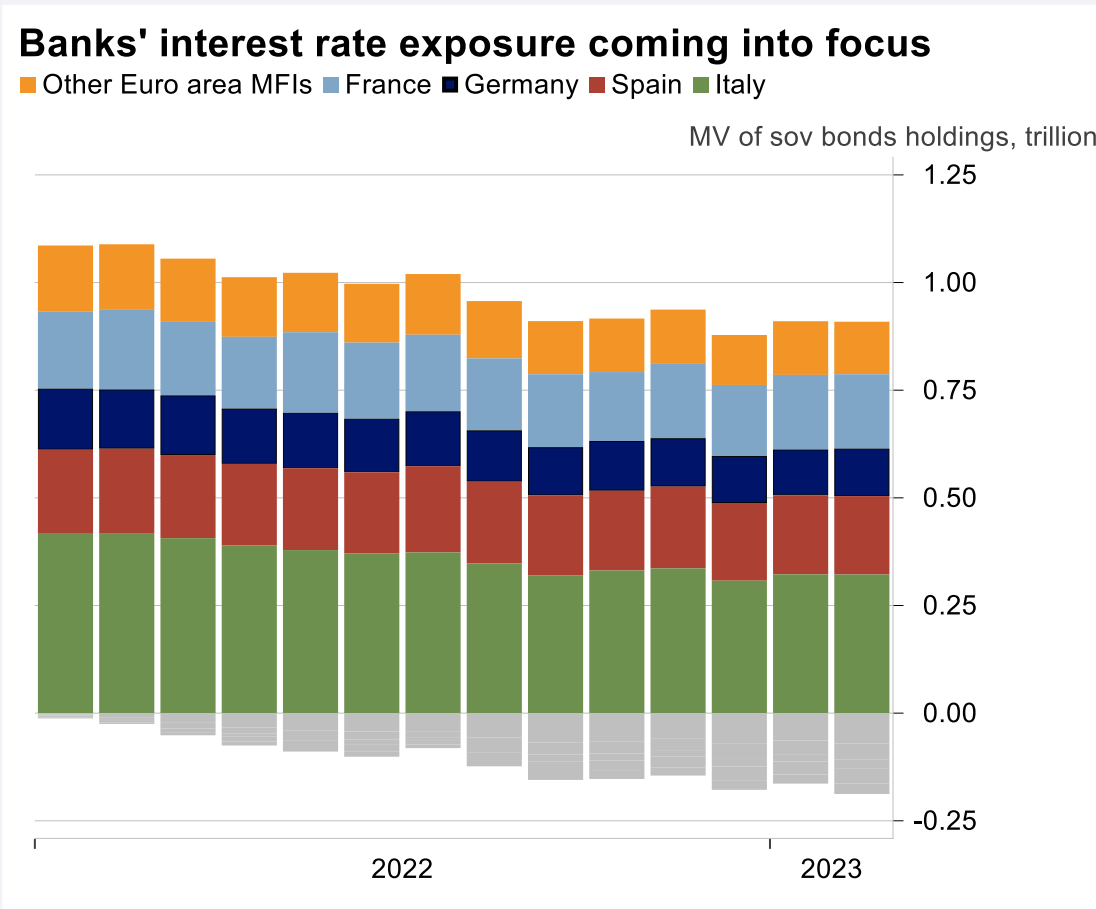
— Scope FCI USD Main Index — Terms of Trade — Equities — Credit — Rates



Source: Scope Ratings, financial data providers. Scope's financial conditions indices measure the deviation of 10 financial variables from their long-term average (z-score) across interest rate, credit, equity, and commodities markets in EUR and USD.

Financial stability concerns re-emerge as interest rates rise

Banks' interest-rate and liquidity-risk management coming under scrutiny, presents monetary-policy constraint



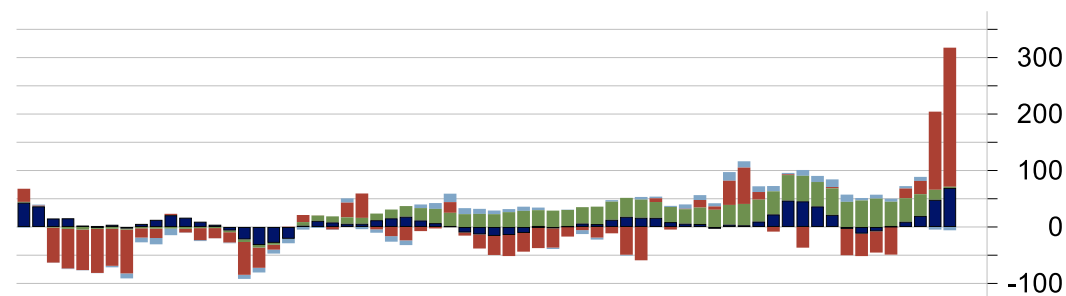
Source: Scope Ratings, bonds valued with dv01 of 500, ECB, EBA, Macrobond

US Banks suffer deposit outflows as interest rates rise too fast

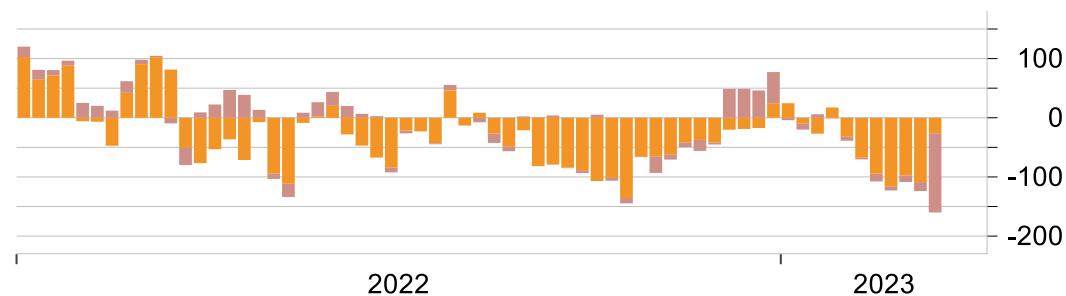
US Banks' liquidity position deteriorates as interest rates rise and depositors flee smaller banks

Depositors switch to high yielding money market funds

Money Market Fund Flows (\$bn, mom)



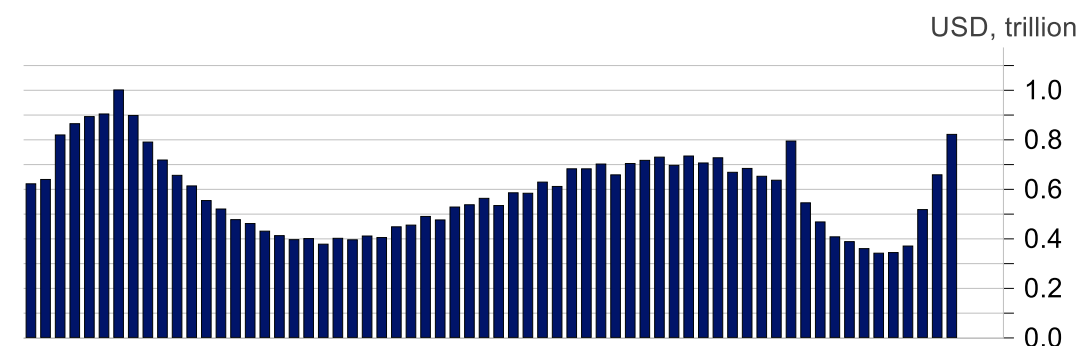
Deposit Flows (\$bn, mom)



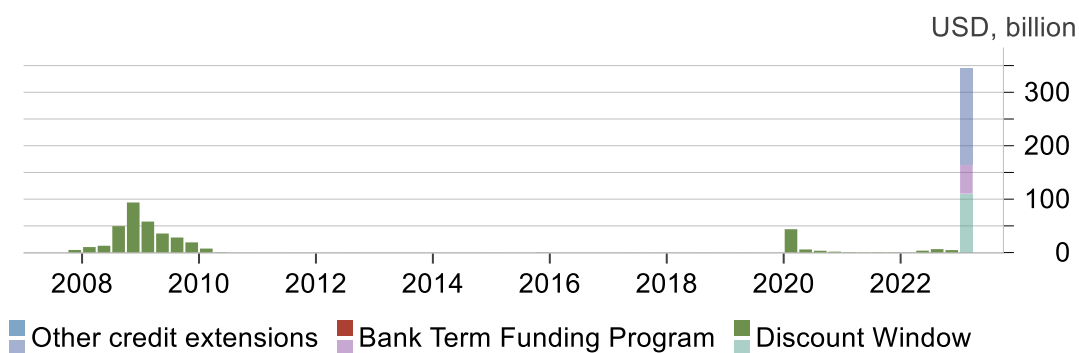
■ Prime Inst. Funds ■ Inst. Gov. funds ■ Prime Retail Funds ■ Retail Gov. funds
■ Small Banks' Deposits ■ Large Banks' Deposits

Regional Banks draw down Federal funding

FHLB advances rise sharply in 2022



Record use of Federal Reserve facilities



■ Other credit extensions ■ Bank Term Funding Program ■ Discount Window

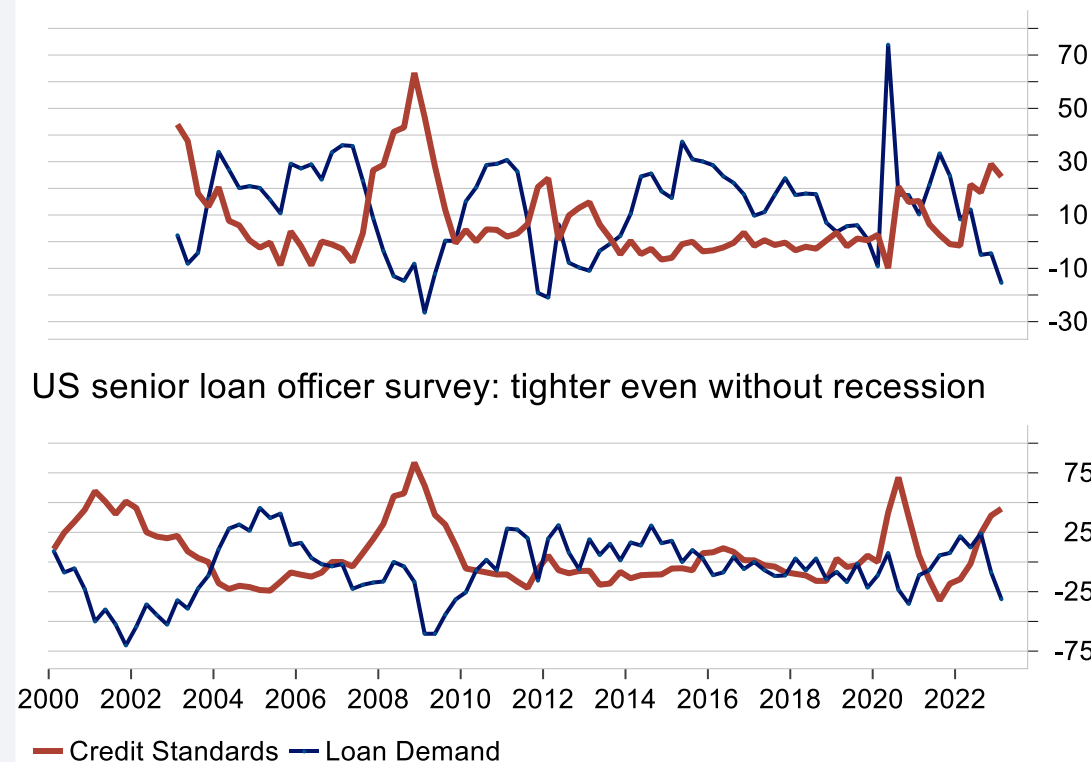
Source: ICI, Federal Reserve,

Euro area banks are tightening their loan underwriting standards

Tighter lending standards and falling loan demand likely to negatively impact GDP growth

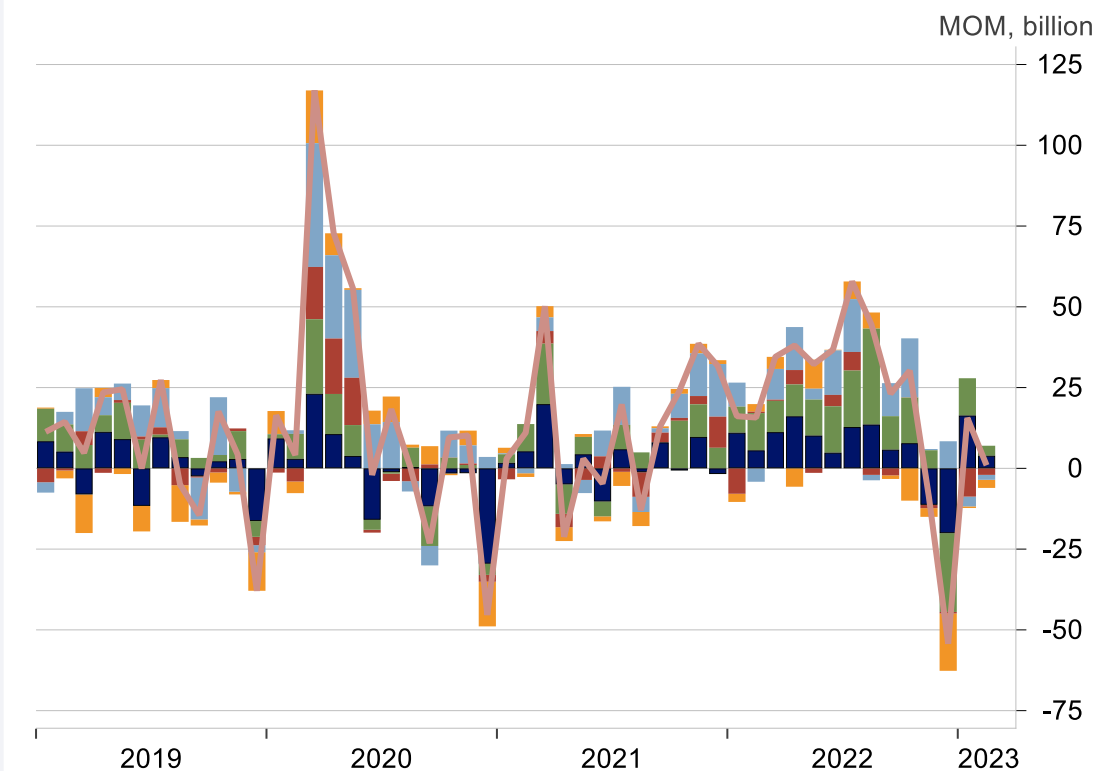
Banks are tightening lending standards

ECB bank lending survey: loan demand falls as banks tighten



Corporate loan volume declines

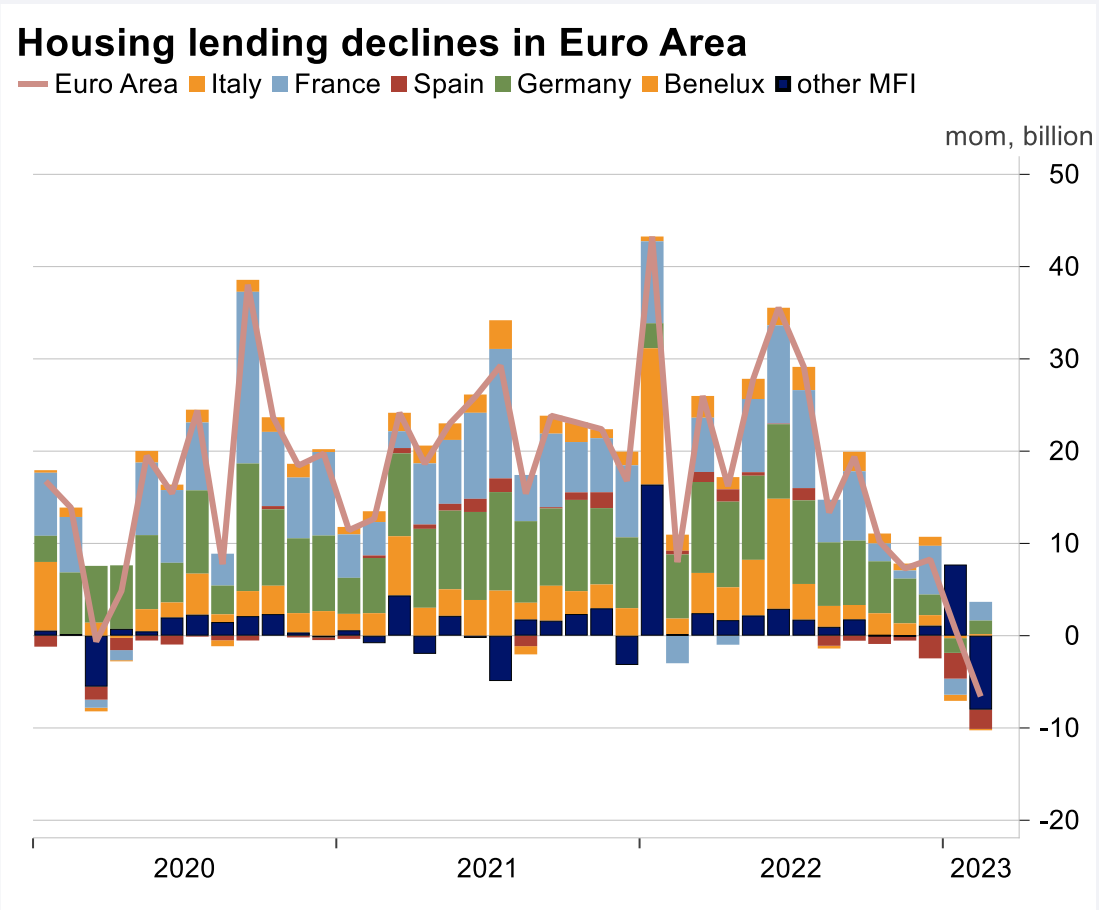
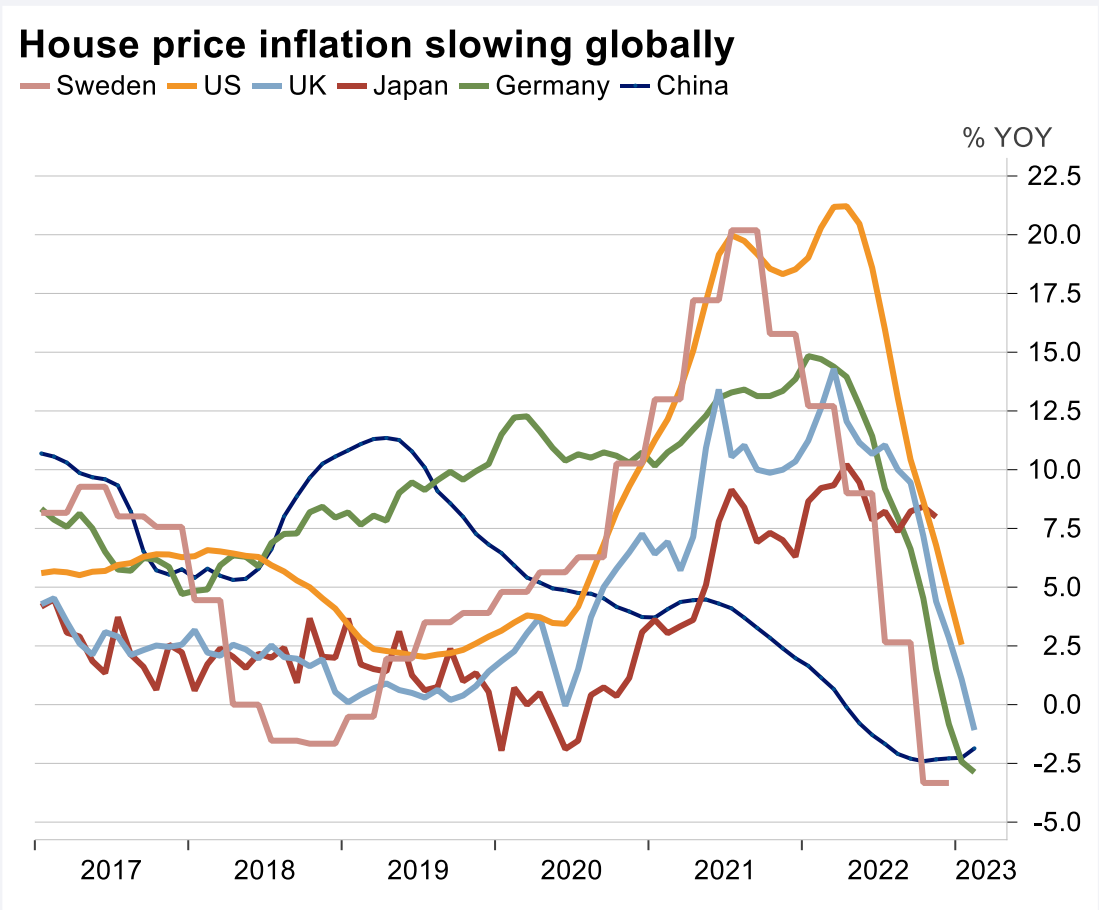
— Euro Area — Italy — France — Spain — Germany — Other MFIs



Source: ECB, Federal Reserve

Real estate price declines put added pressure on households

Headline housing indexes are in decline as bank lending shrinks after years of expansion

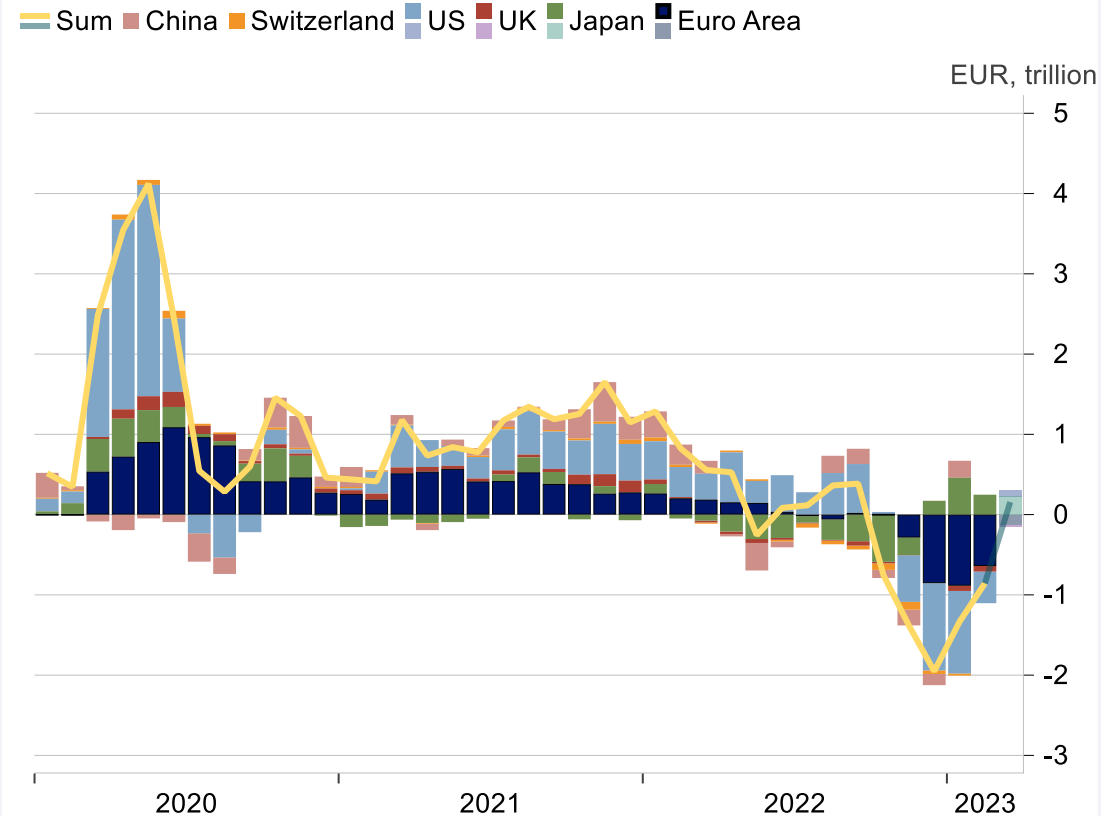


Source: National statistics offices, Nationwide, Europace, Ministry of Land, Infrastructure, Transport and Tourism (Japan), Case-Shiller Index, ECB

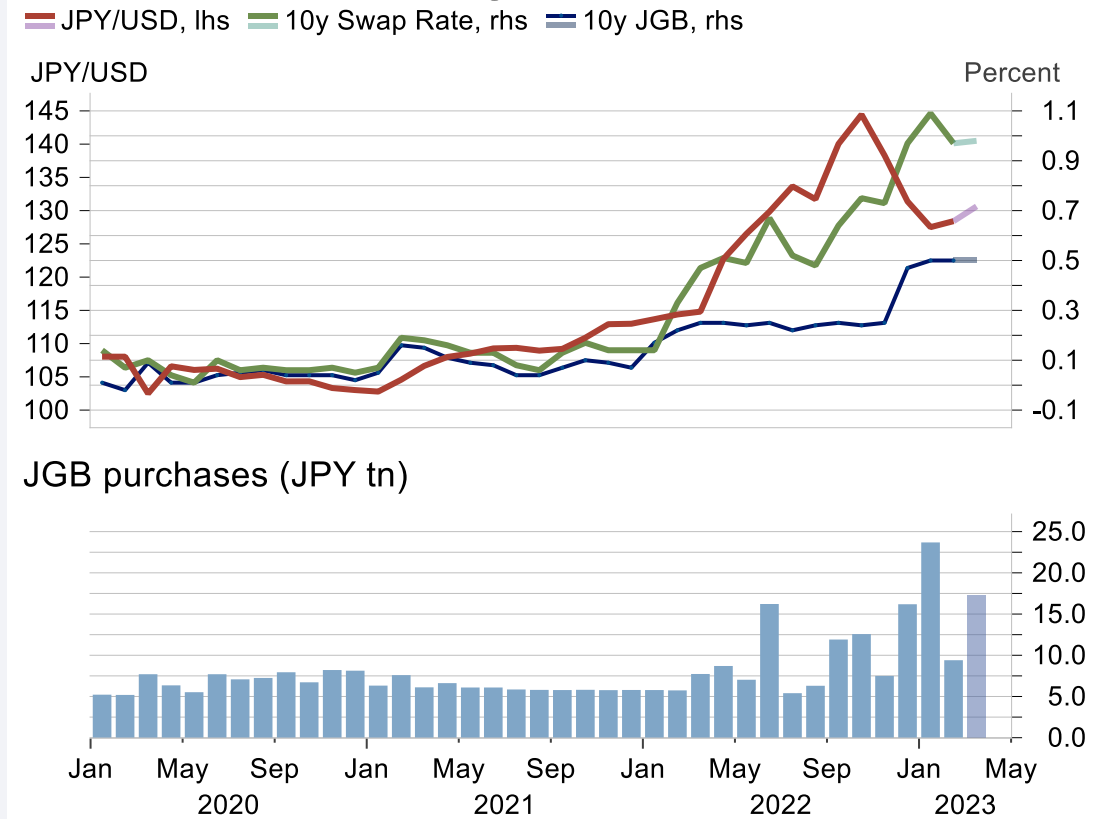
Financial crisis is calling quantitative tightening into question

Central banks' balance sheets rise again as liquidity needs increase and BOJ defends JGB yield target

Liquidity shortage reverses quantitative tightening



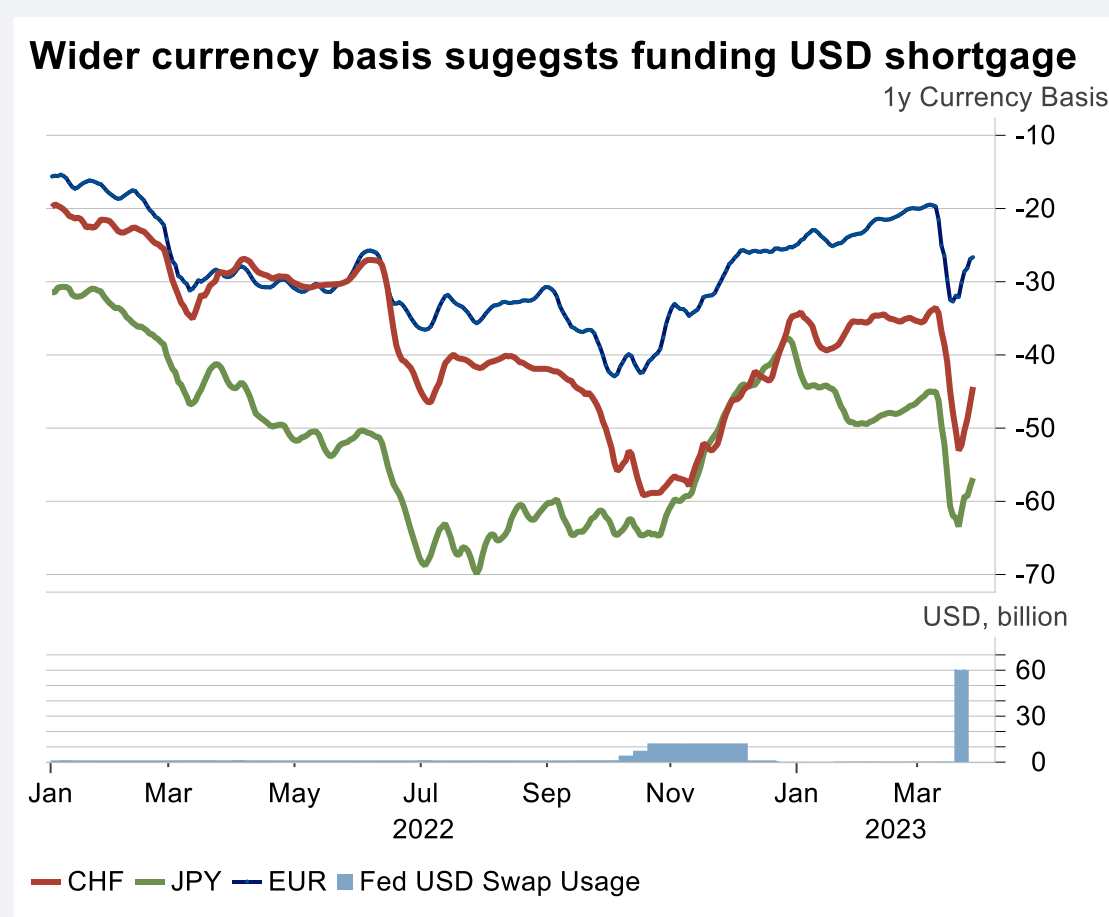
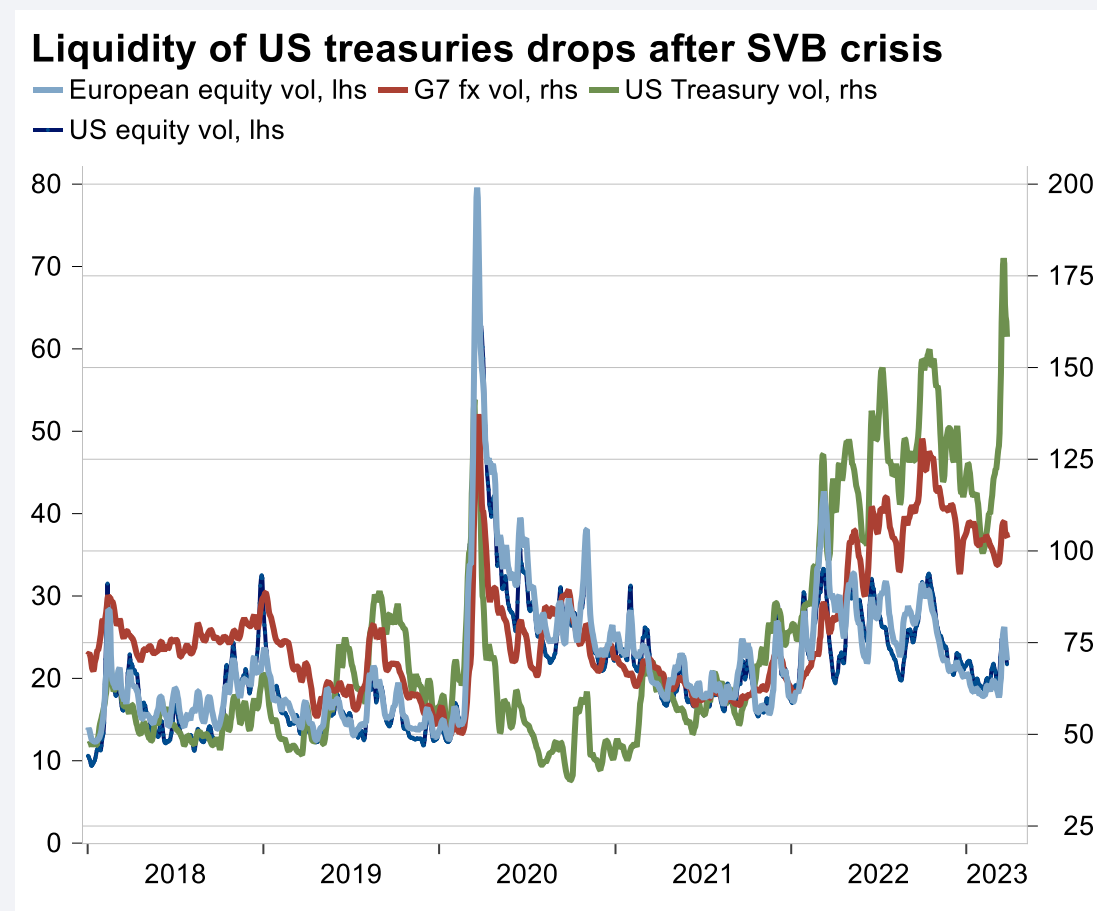
Bank of Japan has emerged as another wild card



Source: National central banks

Persistent concerns over market liquidity

Bid/ask spreads widen again after SVB intervention and FX basis rises after Credit Suisse debacle



Source: ICE, Deutsche Boerse, CME, JP Morgan, Bloomberg

Ratings

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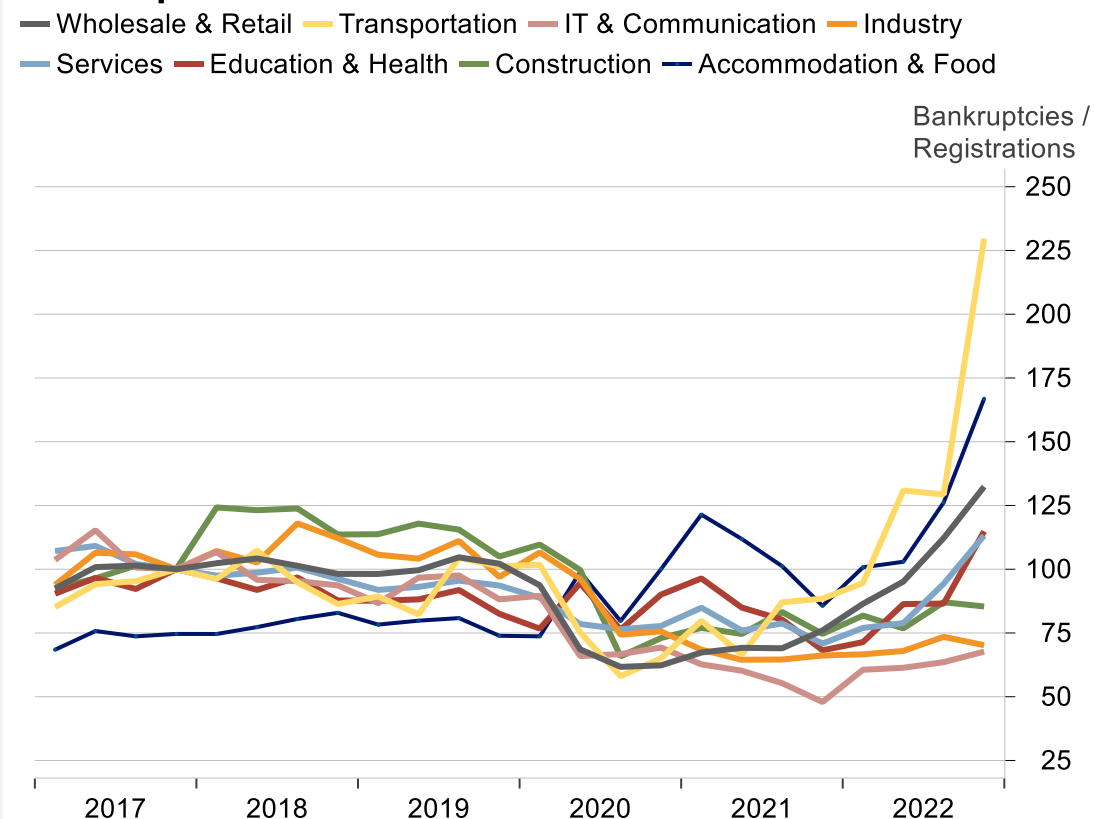
- Latest Economic Trends
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- **Credit Markets**



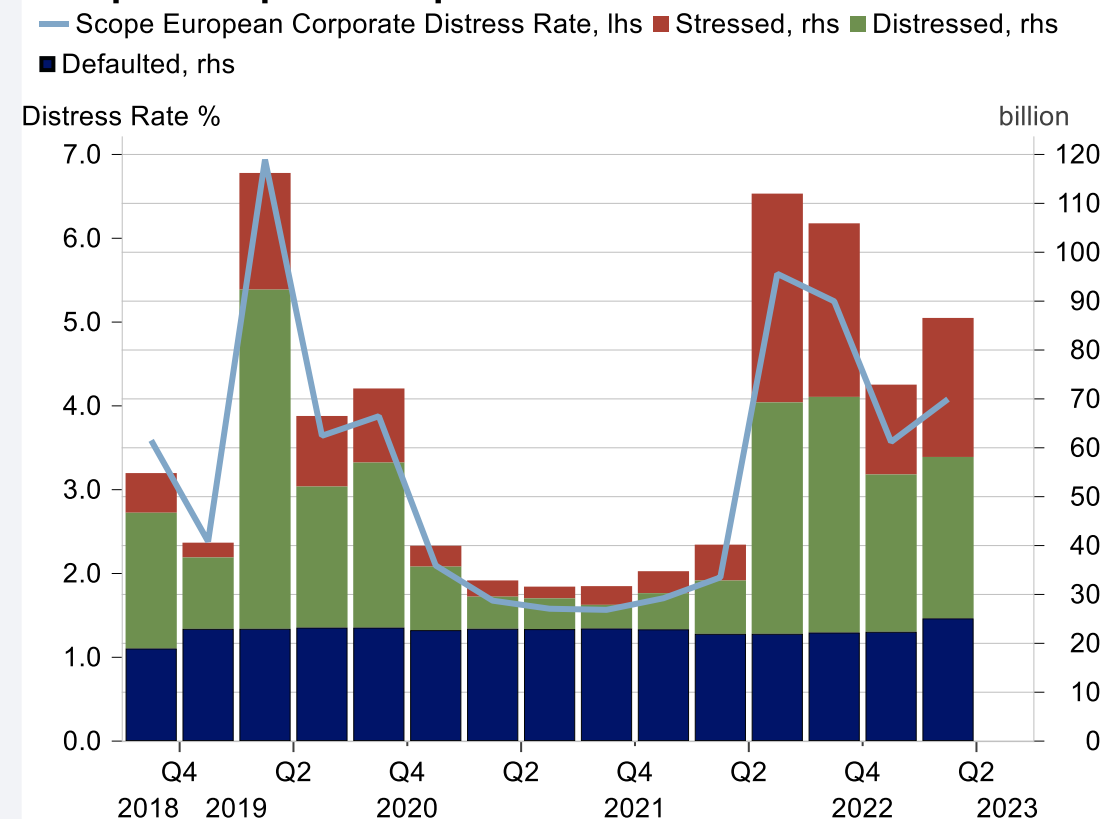
Corporate defaults pick up

Bankruptcy statistics pick up in certain sectors and Scope distress rate rises to 4% at the end of Q1

Bankruptcies rise across Euro-area and UK



Scope European Corporate Distress Rate falls



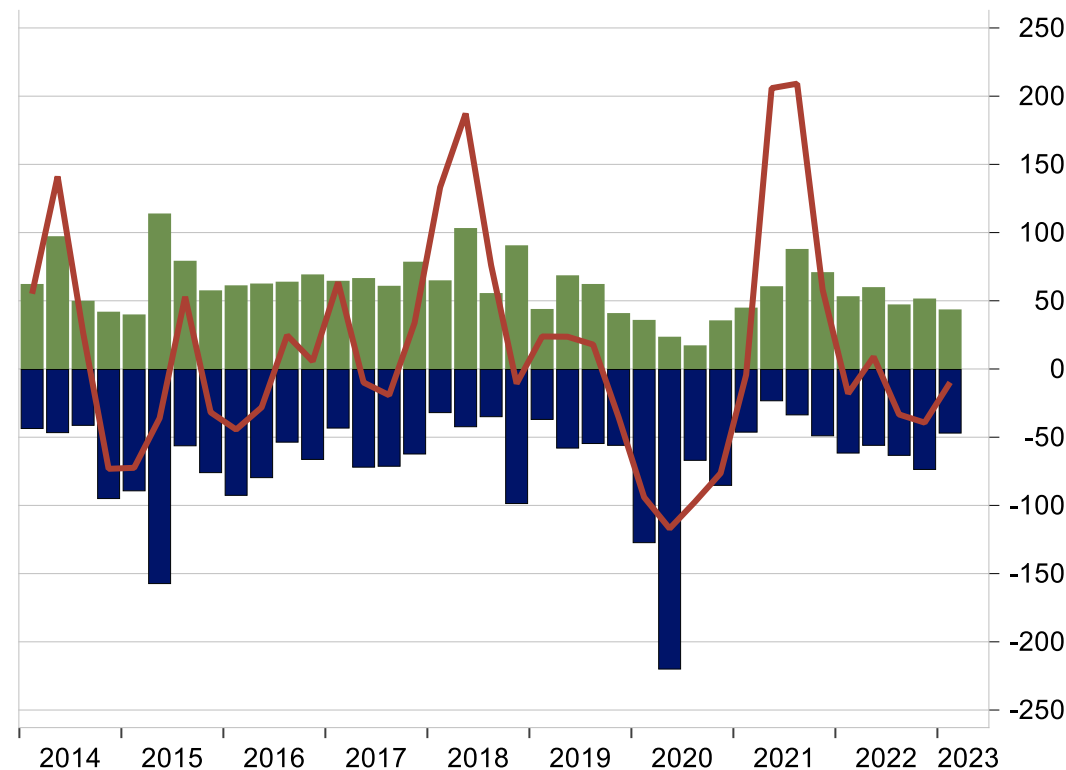
Source: Scope, Eurostat, Bloomberg. Distressed debt >10% spread, stressed debt >8% spread

Ratings activity slowed in Q1 as volume of downgrades declined

Negative ratings drift subsides as downgrades match upgrades in Europe during Q1

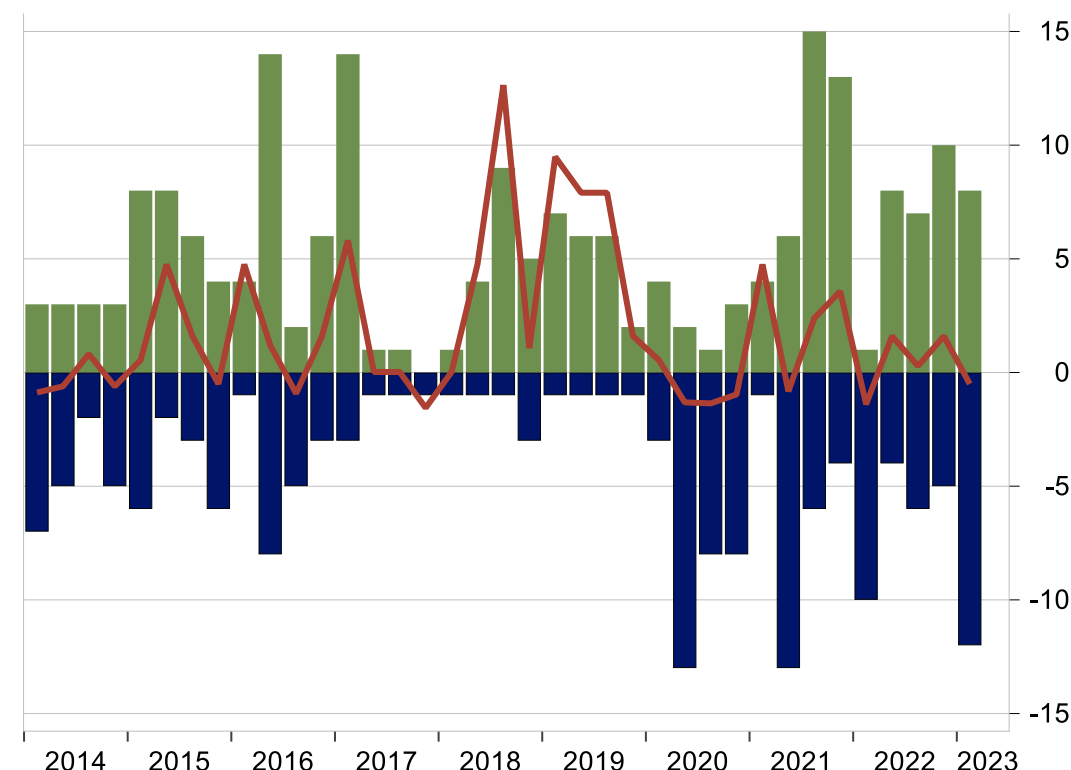
Ratings stabilise across Western Europe

— Up/Down Ratio, lhs ■ Upgrades, rhs ■ Downgrades, rhs



Scope's ratings drift remains stable

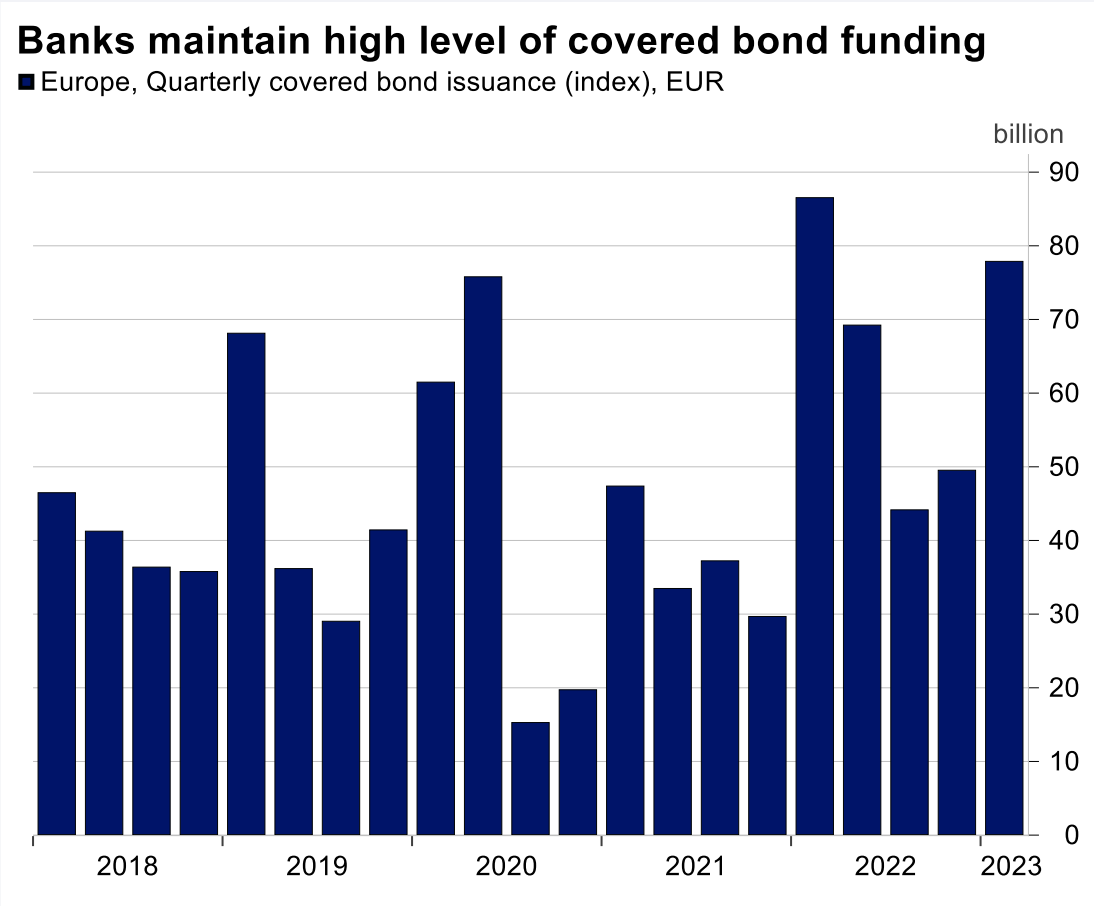
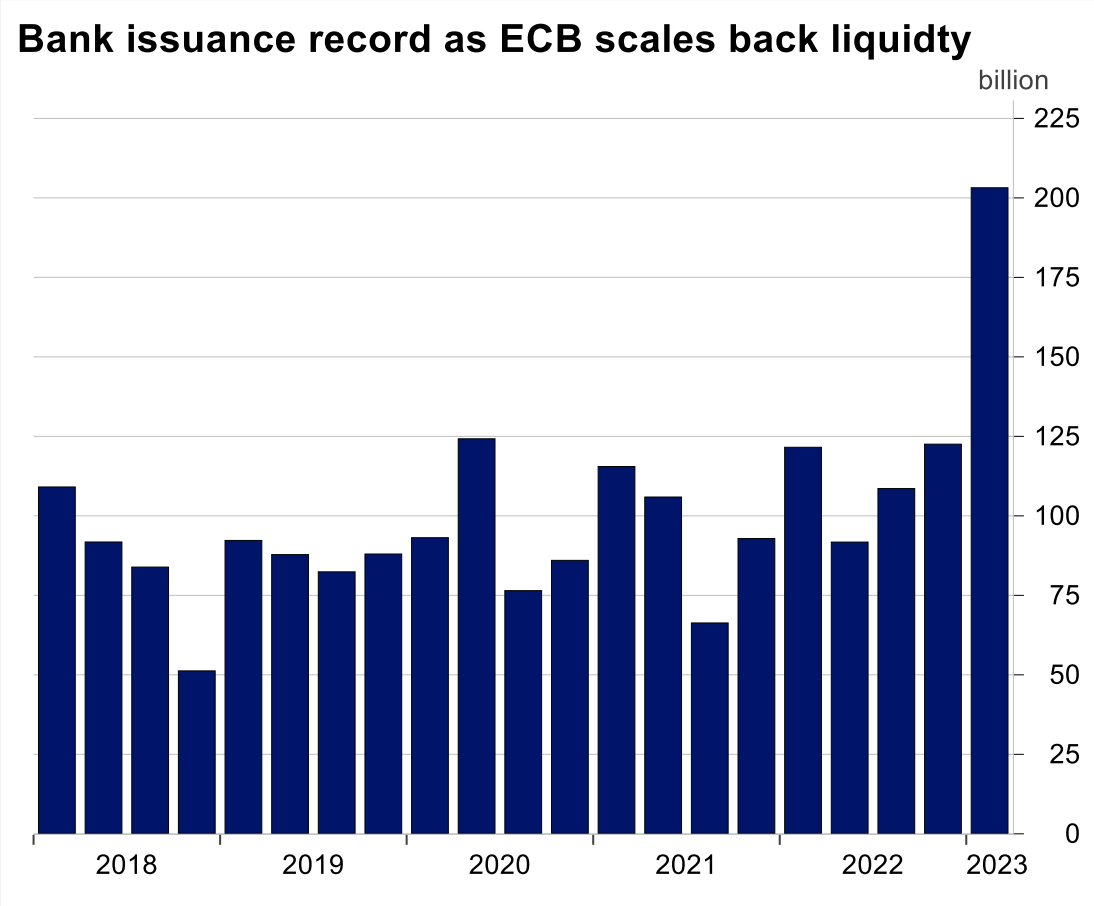
— Up/Down Ratio, lhs ■ Upgrades, rhs ■ Downgrades, rhs



Source: Scope Ratings, Bloomberg. Ratings actions on European corporate, financial, and public-sector issuers by four major ratings agencies, incl. Scope subscription ratings.

Banks facing higher funding costs due to renewed concerns about systemic risk

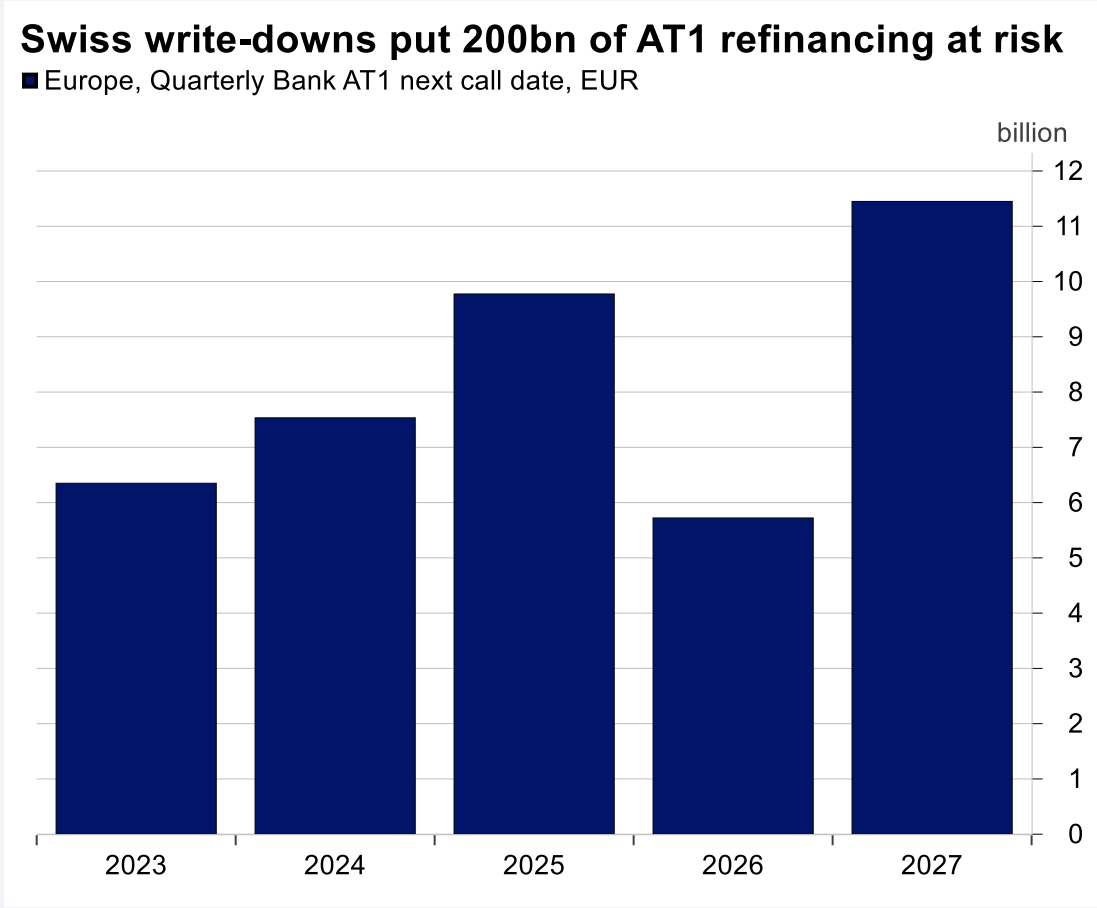
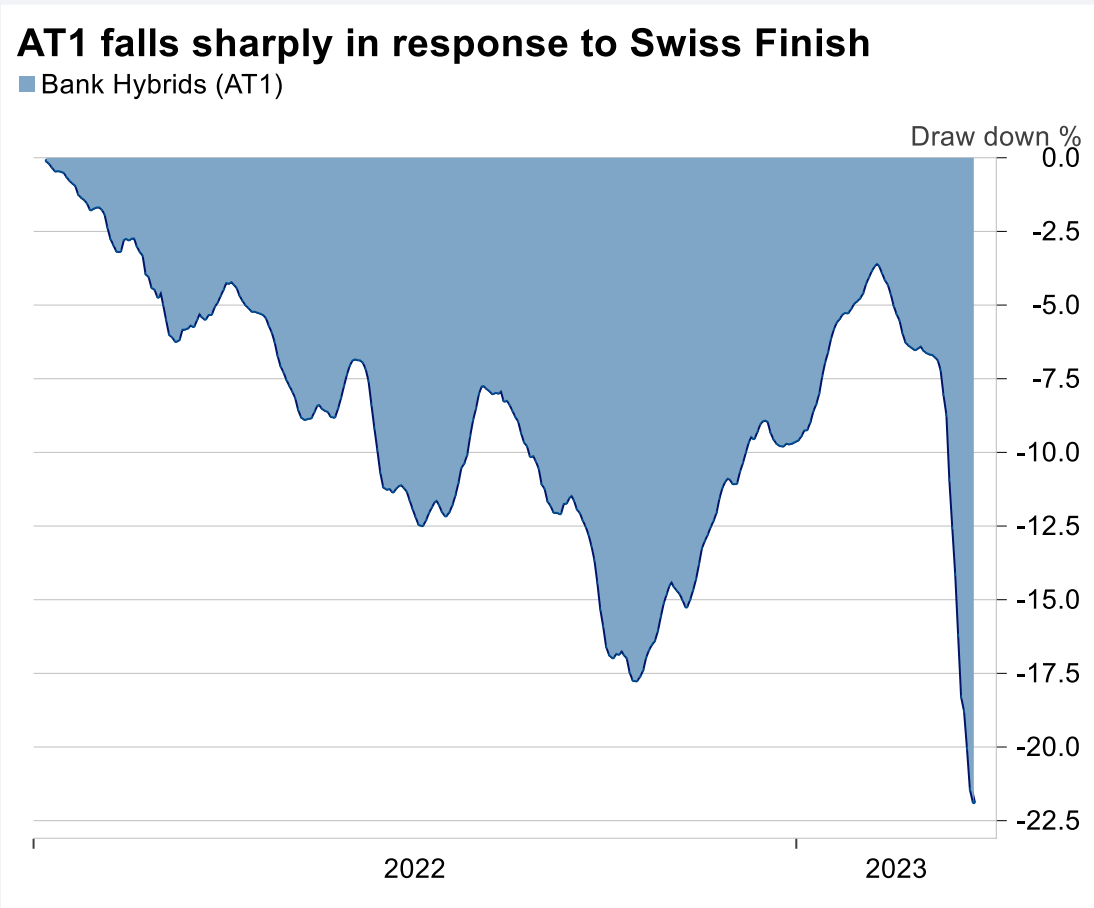
European banks prepare for heavy TLTRO repayment schedule in June



Source: Scope Ratings, Bloomberg. Unsecured issuance includes dated bonds by banks domiciled in Western Europe EUR >200mn issued in EUR, USD, GBP. Covered bonds incl. public issuance of EUR >500

Bank AT1 market heavily impacted by Swiss decision to bail-in AT1 holders

Swiss authorities ignore capital waterfall by giving preferential treatment to equity over AT1 investors

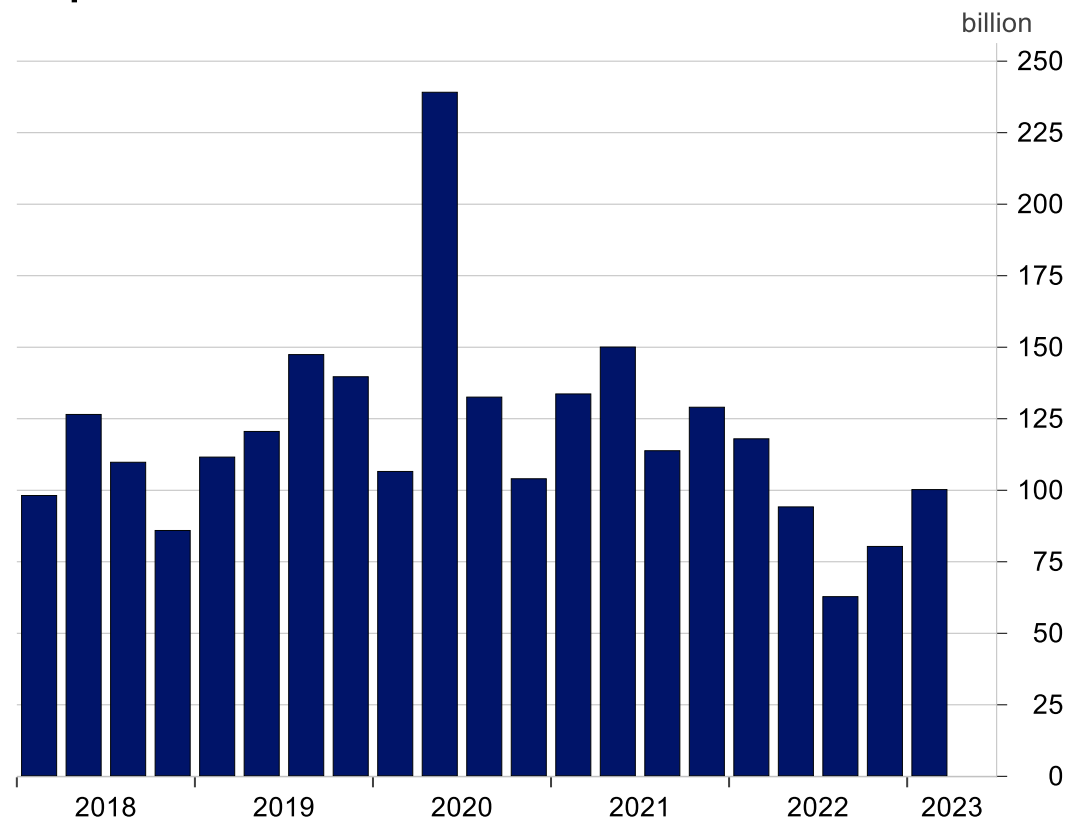


Source: Scope Ratings, Invesco, Bloomberg. Includes bonds issued by EU domiciled issuers, denominated in EUR, USD, or GBP.

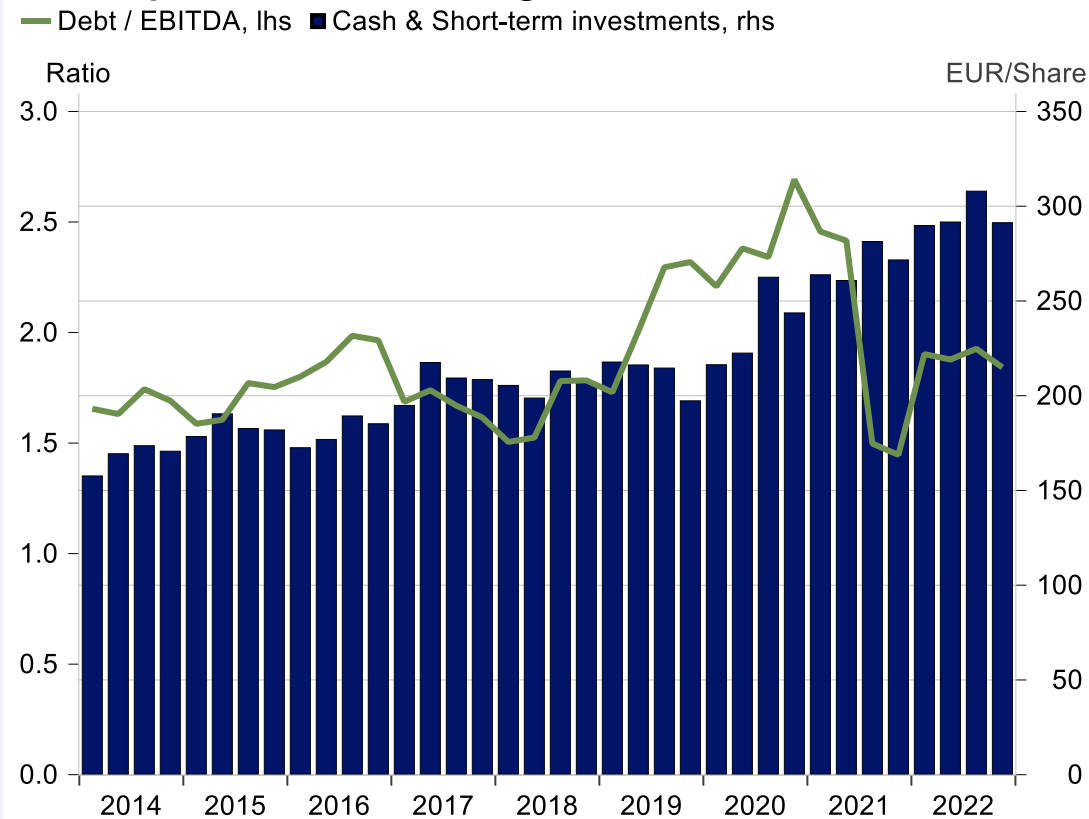
Corporate issuance stabilises in Q1 as companies maintain elevated cash balances

Corporate bond issuance below boom years but IG remains supported by low leverage and strong cash flows

Corporate bond issuance remains below 2022 level



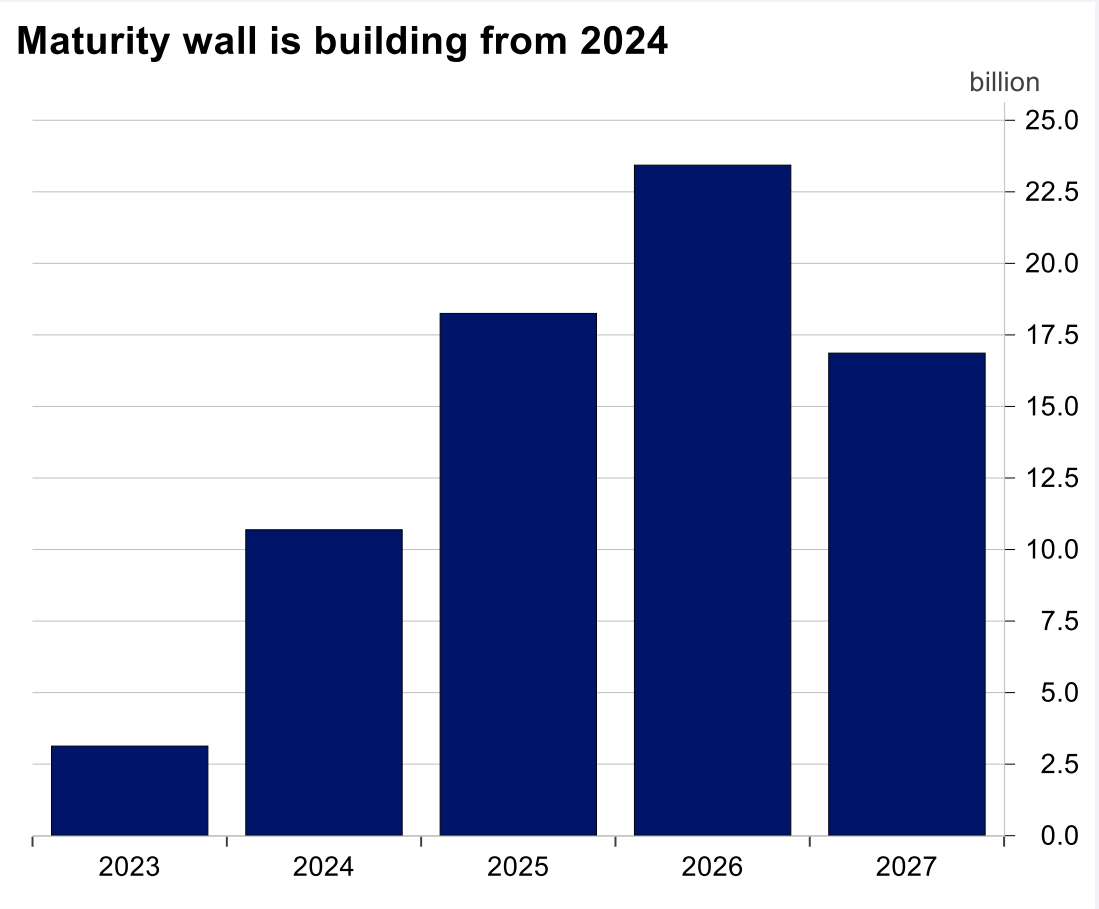
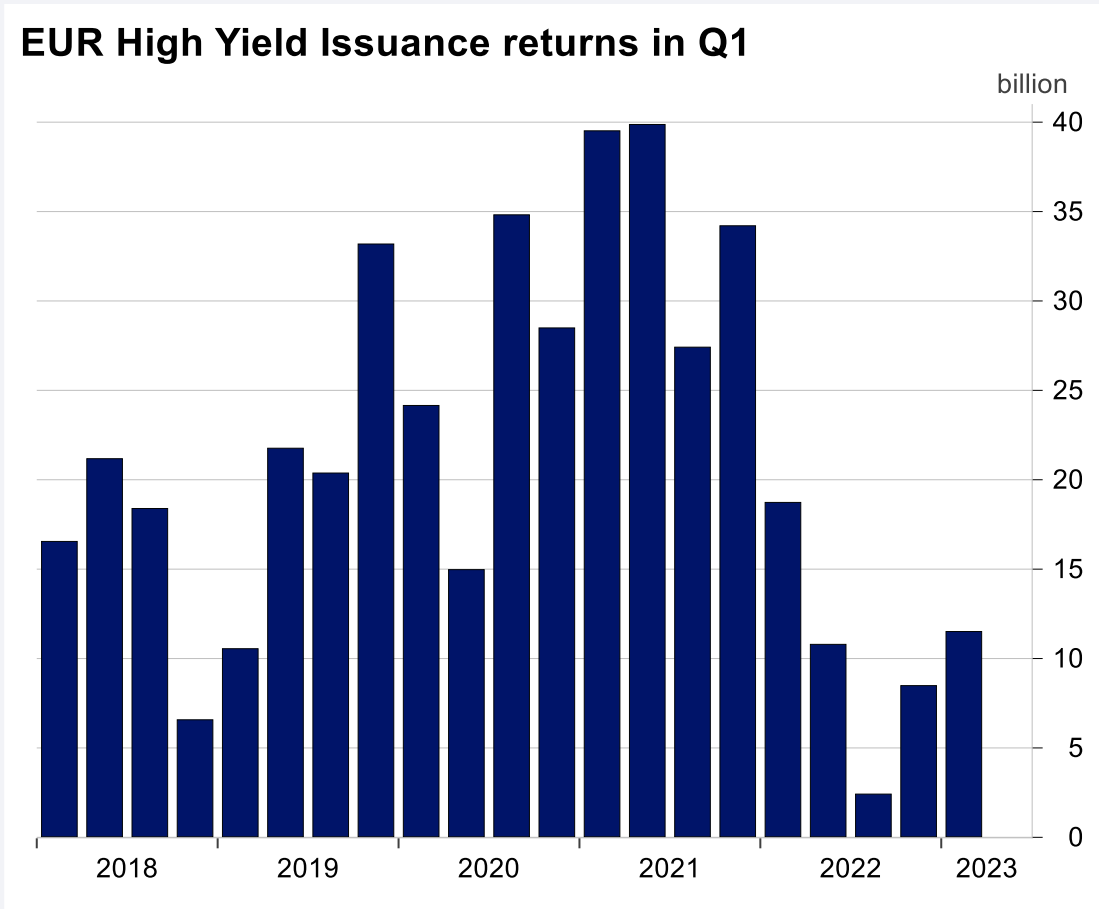
EU corporates maintain high cash buffers



Source: Scope Ratings, Bloomberg. Left-hand chart: Public bonds & loans (>EUR 10mn) issued by European non-financial corporations. Right-hand chart: Cash held by listed large cap non-financial corporates.

Junk-rated companies are borrowing again

High-yield issuers have scaled back their activities as maturities remain light for now



Source: Scope Ratings, Bloomberg. Index-eligible high-yield bonds issued by European non-financial corporations.



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