Is Europe Heading for Recession?

Prospects for the Eurozone economy and corporate debt sustainability

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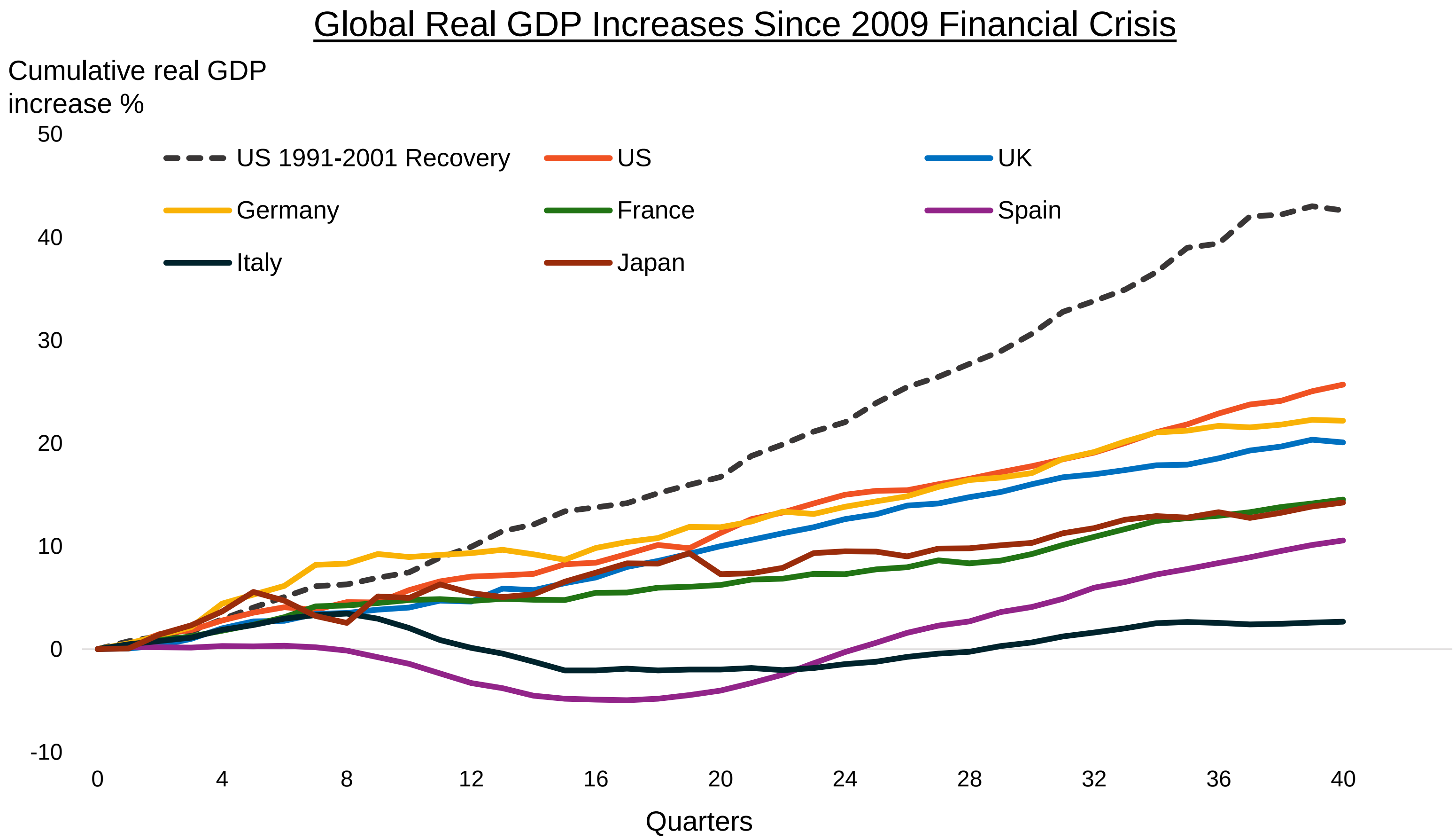
The macro context:
Where are we in the cycle?

The current recovery in perspective

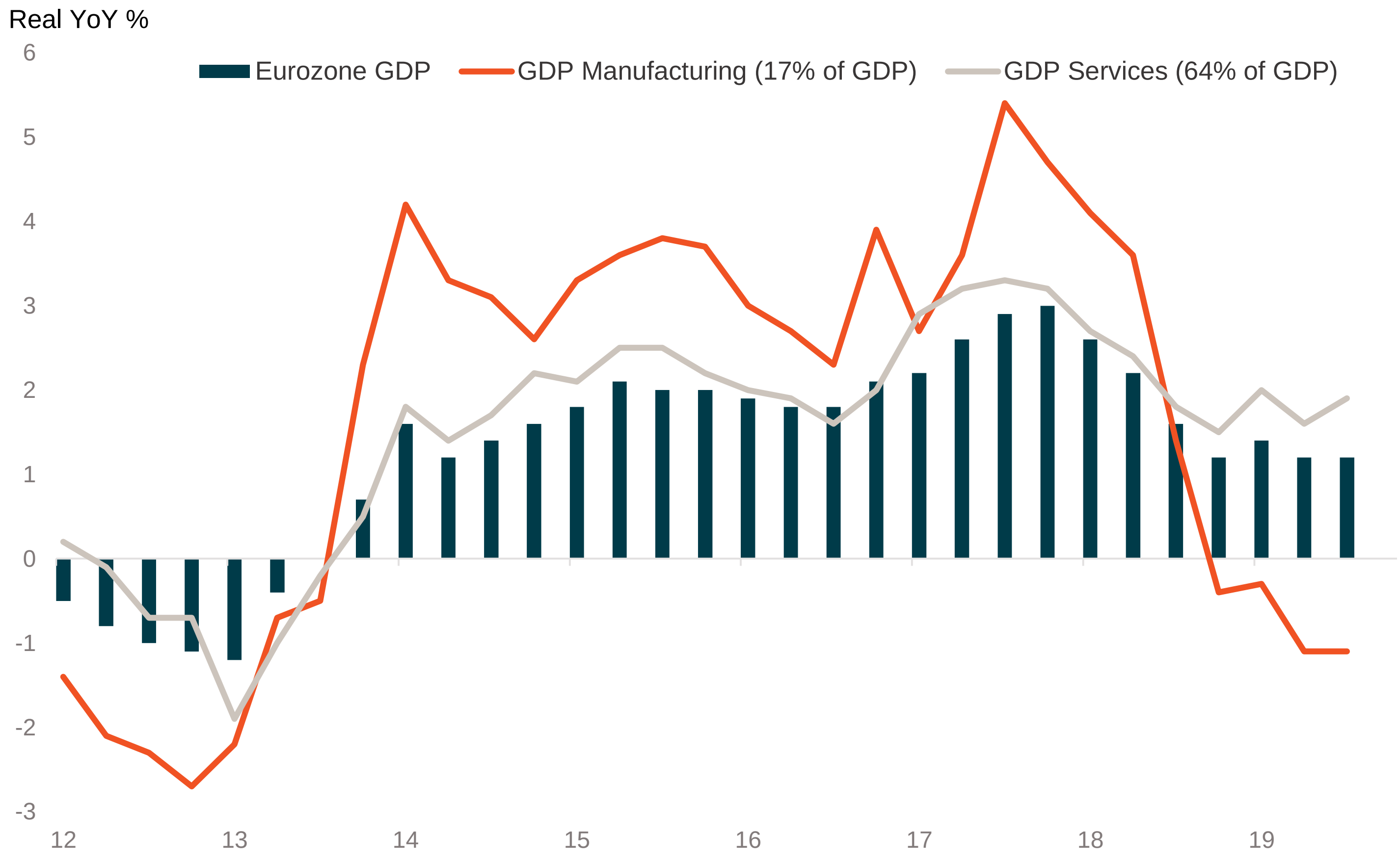
- The longest, but also the most moderate, economic recovery since WWII. Recessions are not inevitable. Australia, for example, has not had a recession in 28 years.



Source: NBER, Bloomberg. Note: Cumulative real GDP growth from Q2 2009 to Q2 2019.

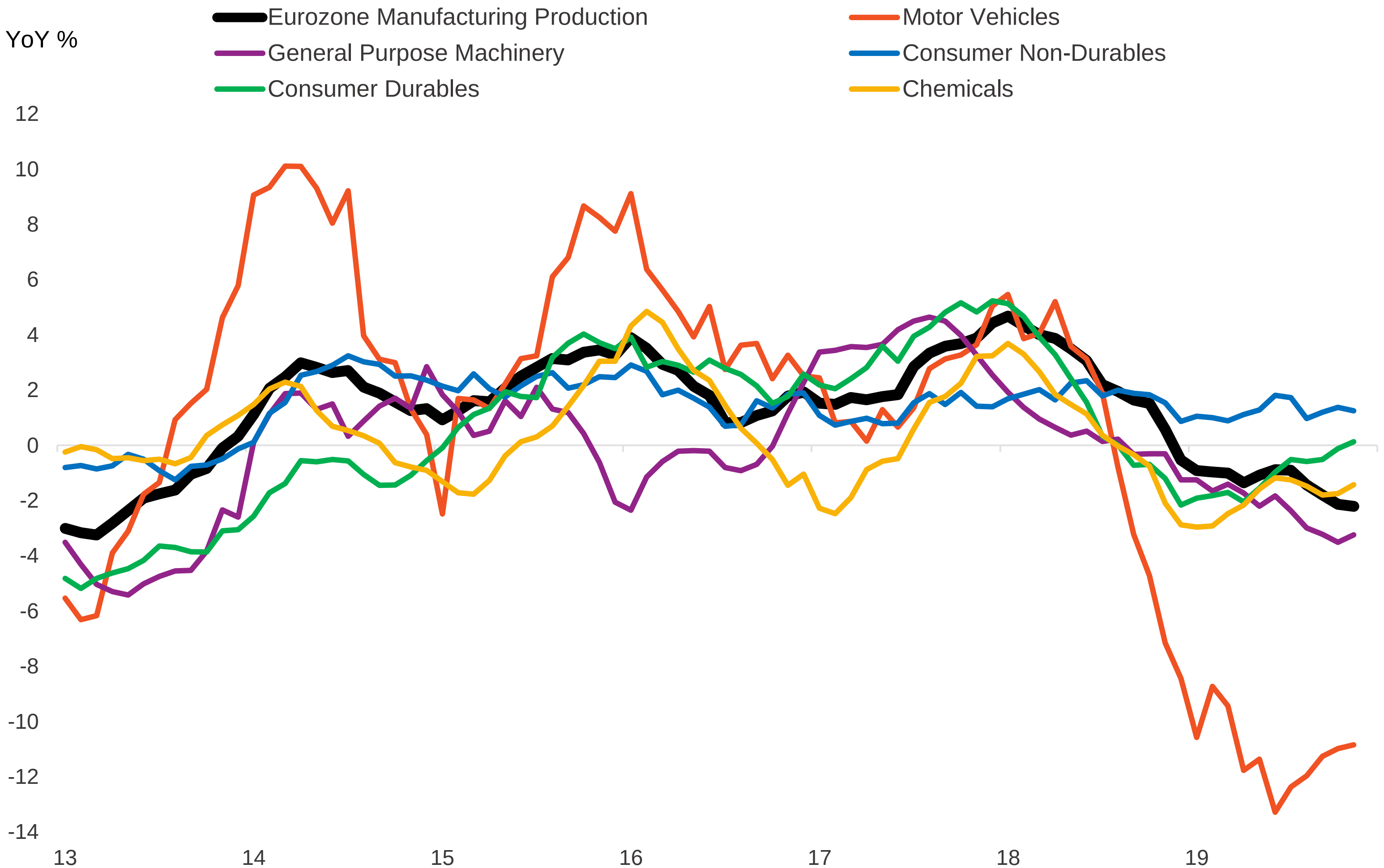
Where does Europe stand today?

- So far the slowdown has been moderate and heavily focused in the manufacturing sector. Services have generally been holding up well.



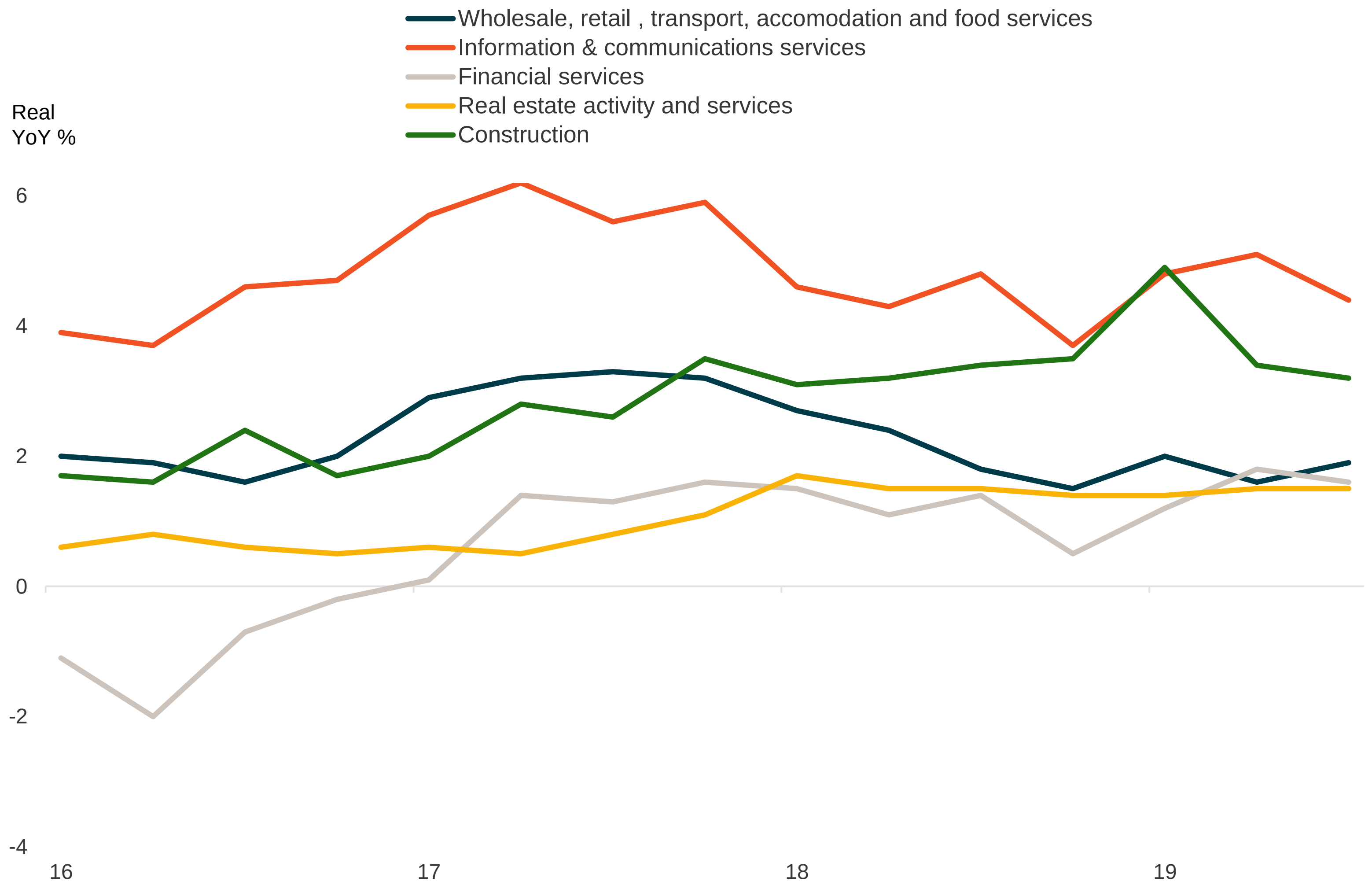
Source: Bloomberg. Data to Q3 2019.

Manufacturing slowdown concentrated in a few sectors



Source: Bloomberg. Data to November 2019.

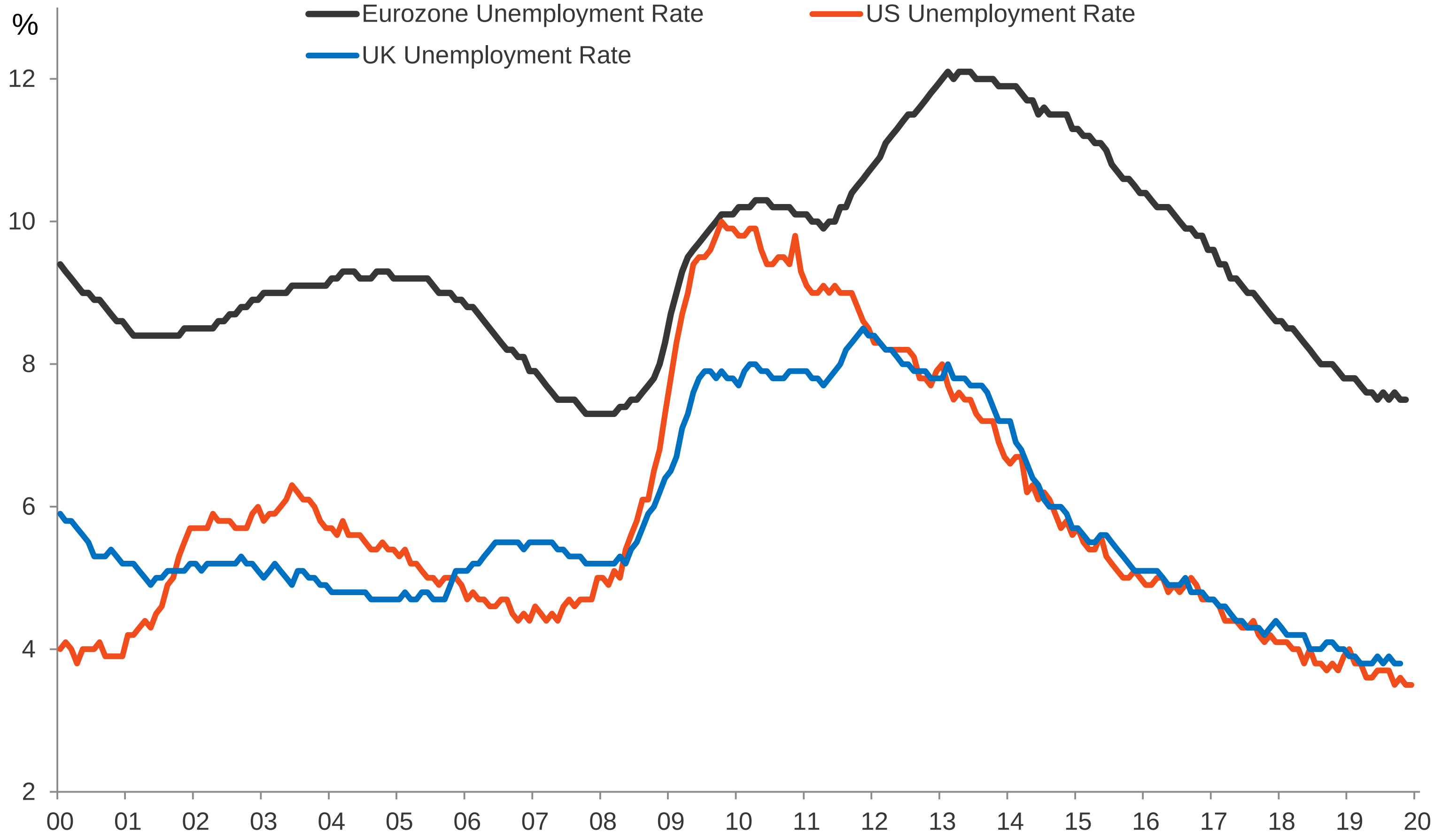
Most of Europe's services businesses performing well



Source: Bloomberg. Data to Q3 2019.

Strong labour markets support private consumption

- Private consumption makes up 60-80% of most developed economies GDP. With unemployment at or near all-time lows and wages rising, private consumption is expected to remain firm.



Source: Bloomberg

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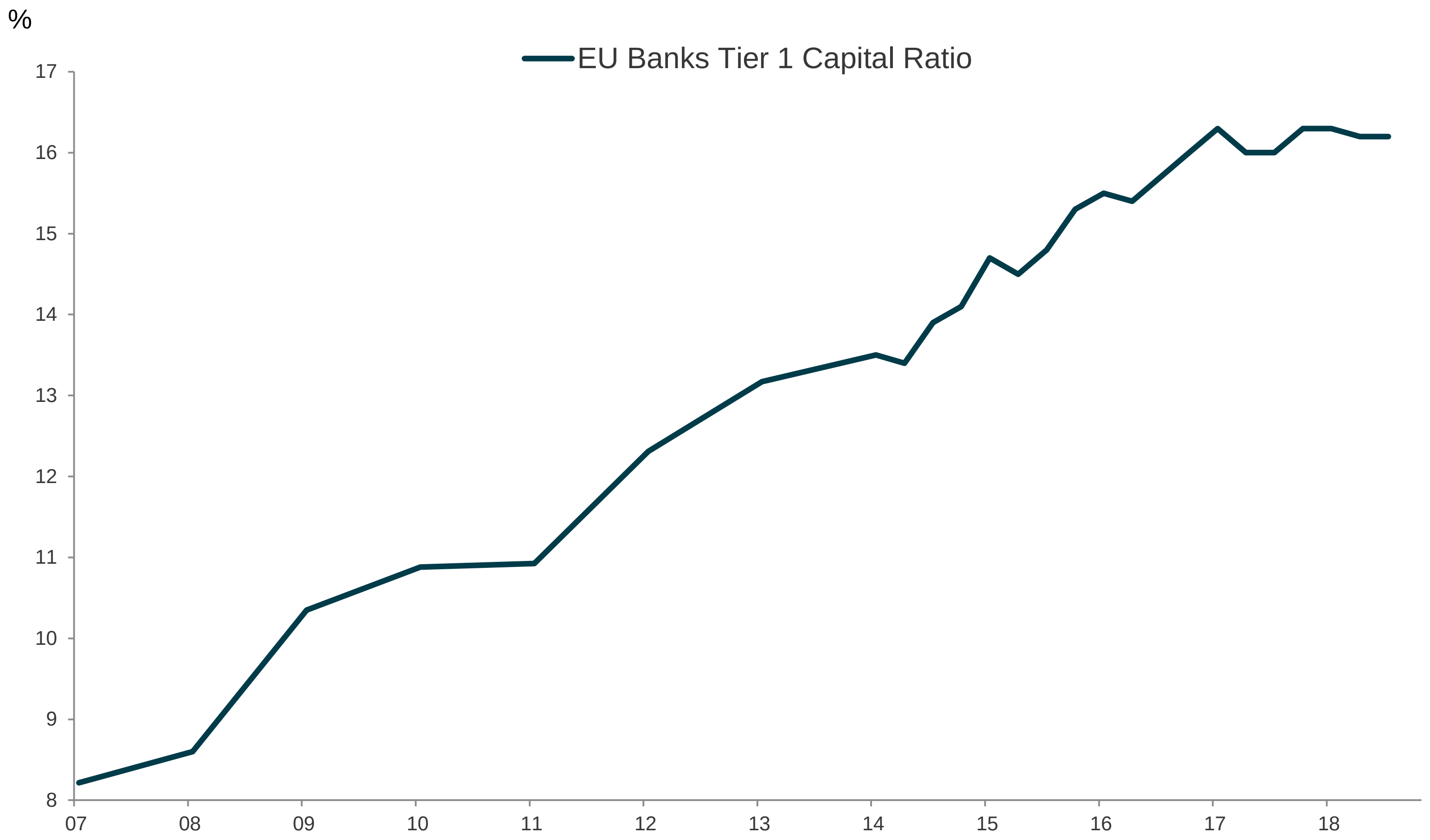
Strong bank balance sheets have reduced systemic risk

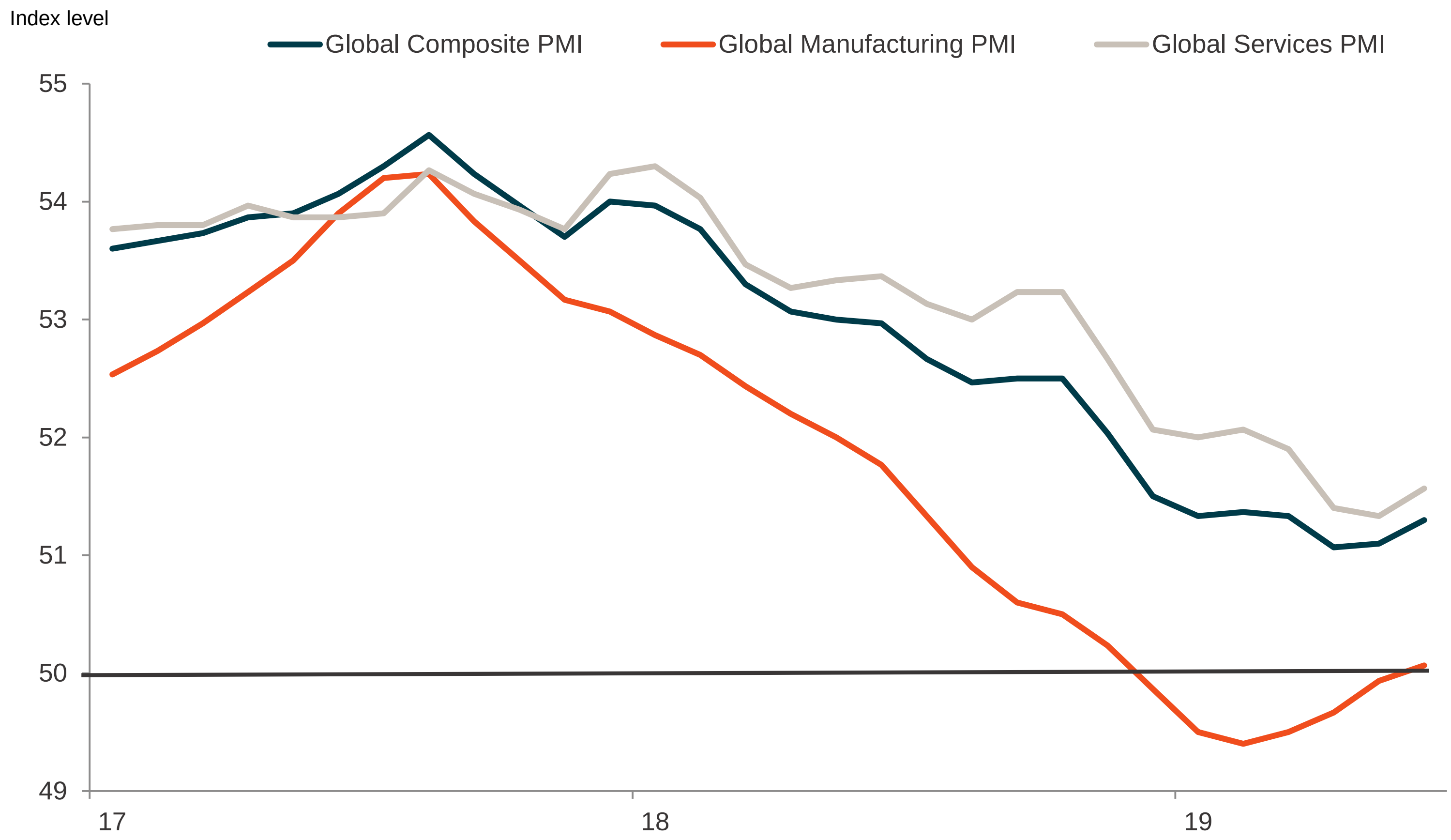


Source: EBA, data to June 2019.

Source: Bloomberg

Some early signs growth may be stabilising

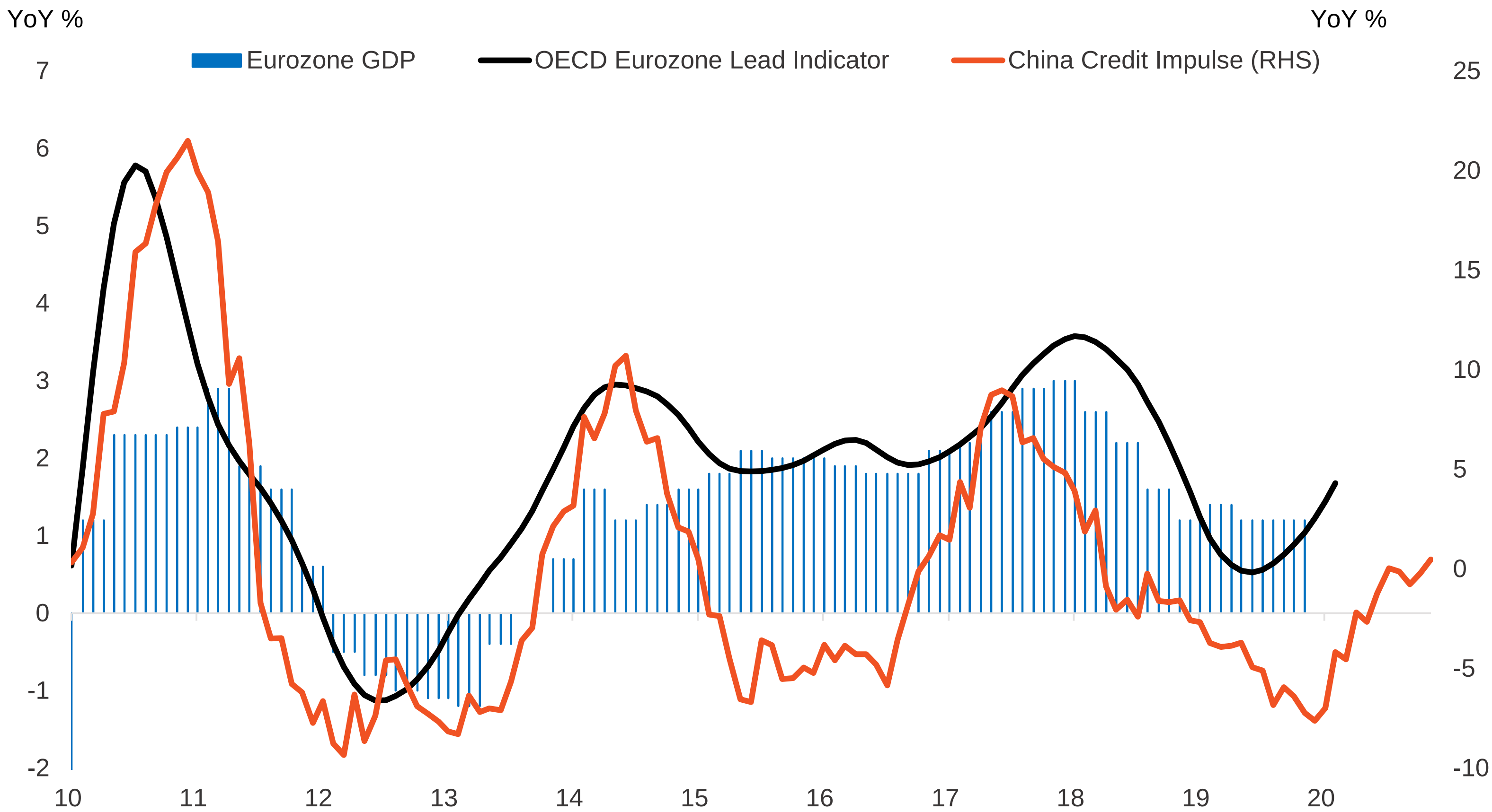
- Purchasing manager indexes indicate the services sector is still seeing healthy growth and there are early indications the worst of the manufacturing slump may be behind us.



Source: Bloomberg. Data to December 2019. >50=Expansion.

Lead indicators point to a pick-up in growth in 2020

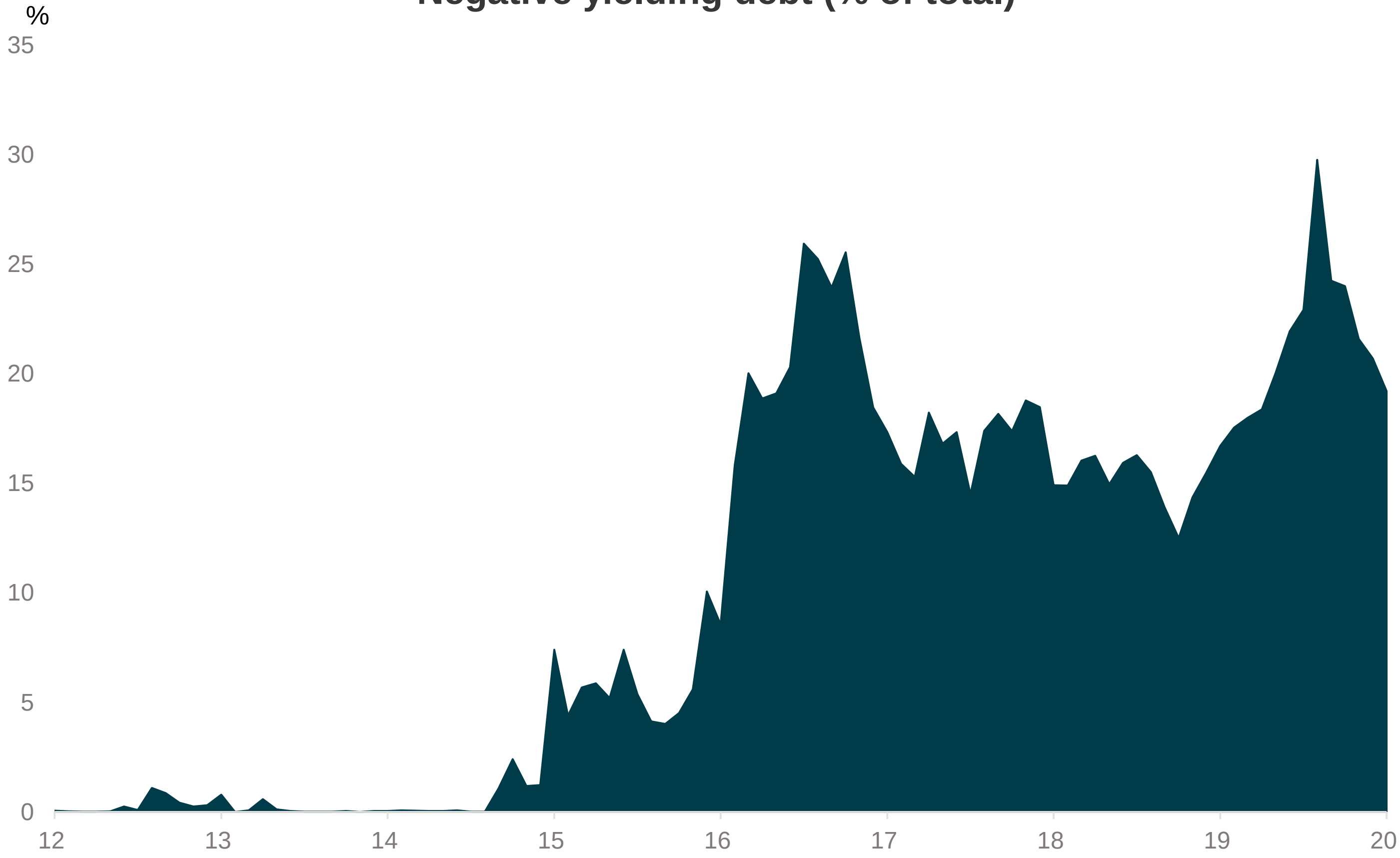
- China easing playing a larger role in driving the industrial cycle than is widely recognised. Further China credit is expected in 2020, supporting moderate global industrial recovery.



Source: Bloomberg

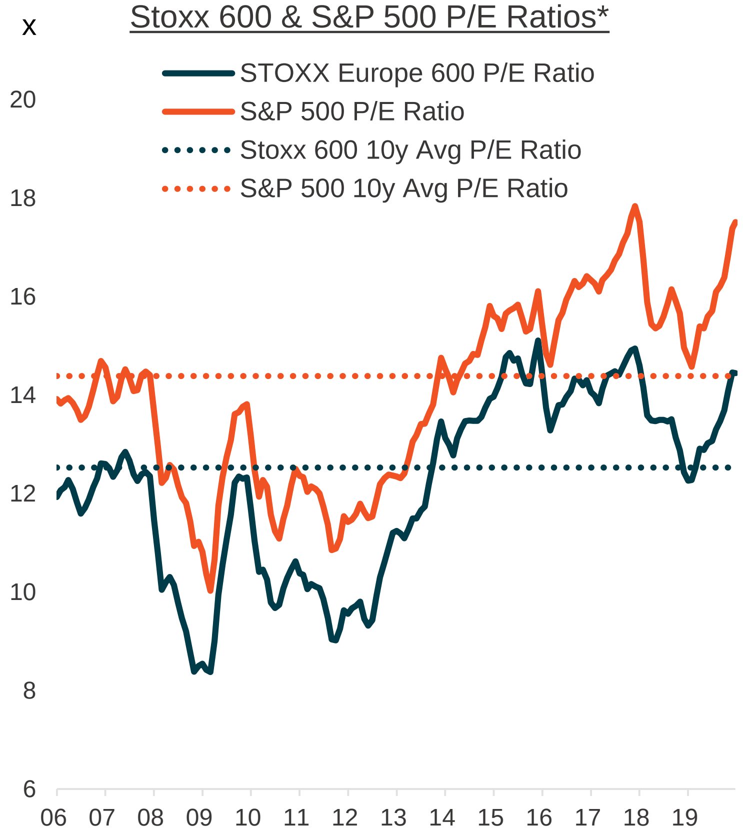
Central bank policy expected to remain easy and should keep risk free rates low and bid for yield strong

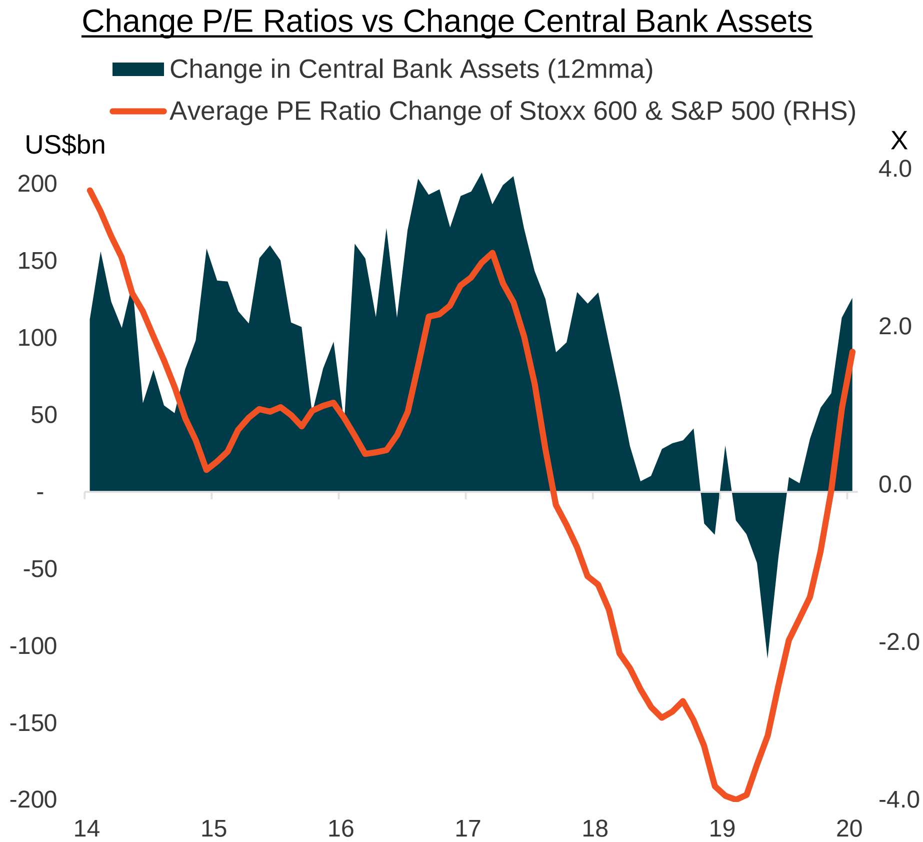
Negative yielding debt (% of total)



Source: Bloomberg

The question is how much positive macro news and monetary easing is already priced in?





*Based on 1yr forward EPS

Source: Bloomberg.

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The corporate context:

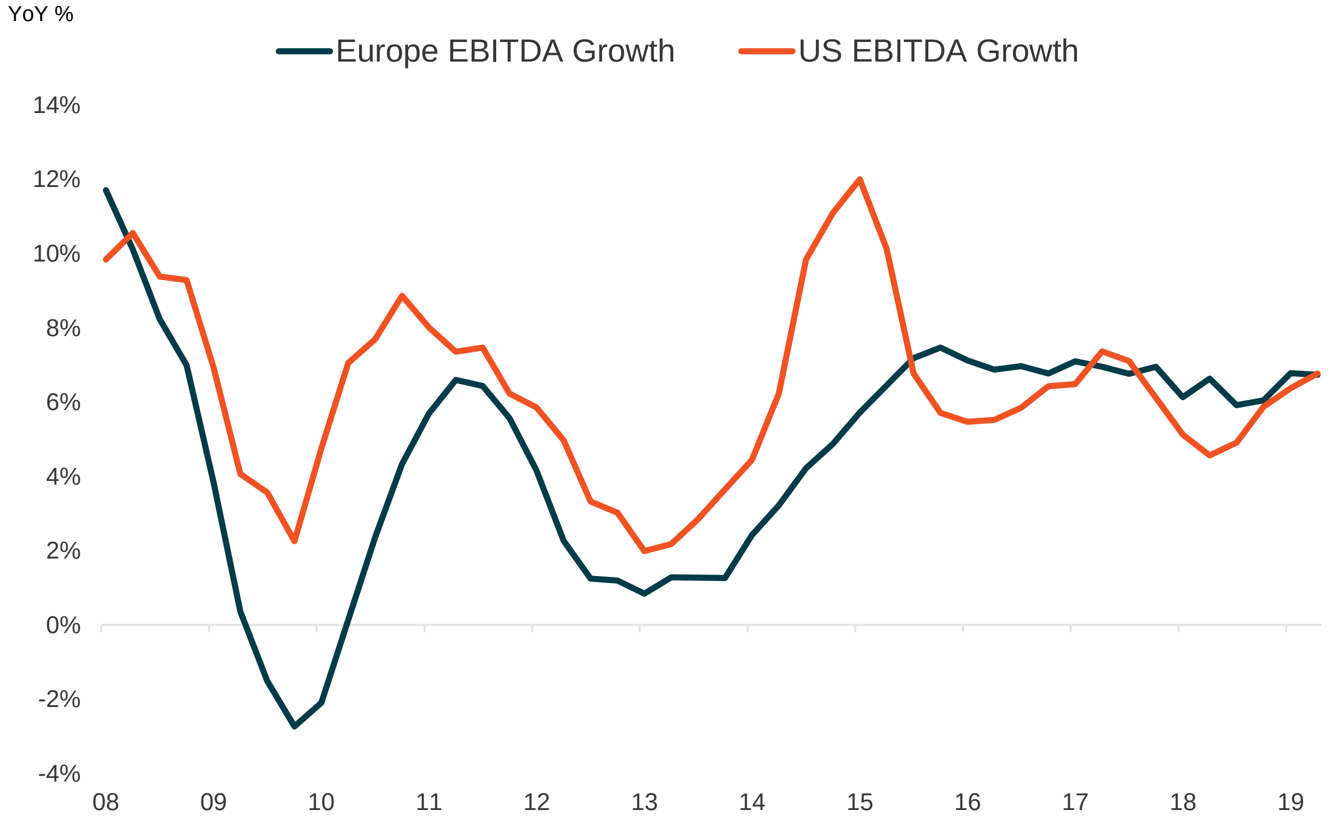
What does private company data tell us about company fundamentals?

ICG Private Company Database

- **Provides insights into fundamental trends** in Europe and US unlisted company sector.
- **Over 1400 private companies** covered by the database
- **An average of nearly 500 companies under coverage** every quarter
- **11 years of detailed private company financial data** – EBITDA, Revenue, Leverage, Interest and Margin trends broken down by sector, sub-sector and country
- **8 major sectors and 25 sub-sectors** covered
- **24 countries** covered

US and Europe private company EBITDA growth has held up well despite slowdown in economic growth

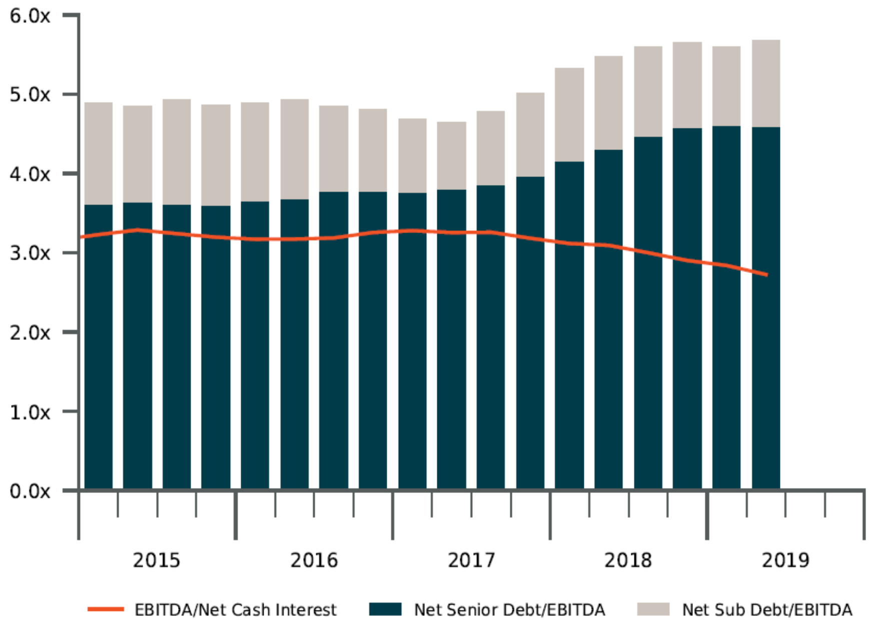
US & Europe EBITDA Growth



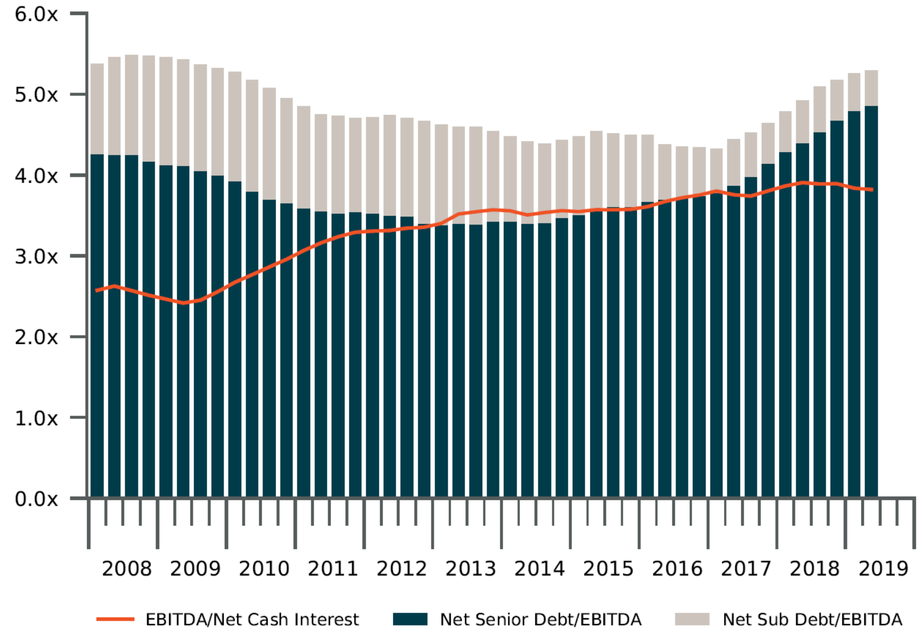
Source: ICG Private Company Database

Leverage has increased but interest coverage is still high

US Leverage and Interest Cover



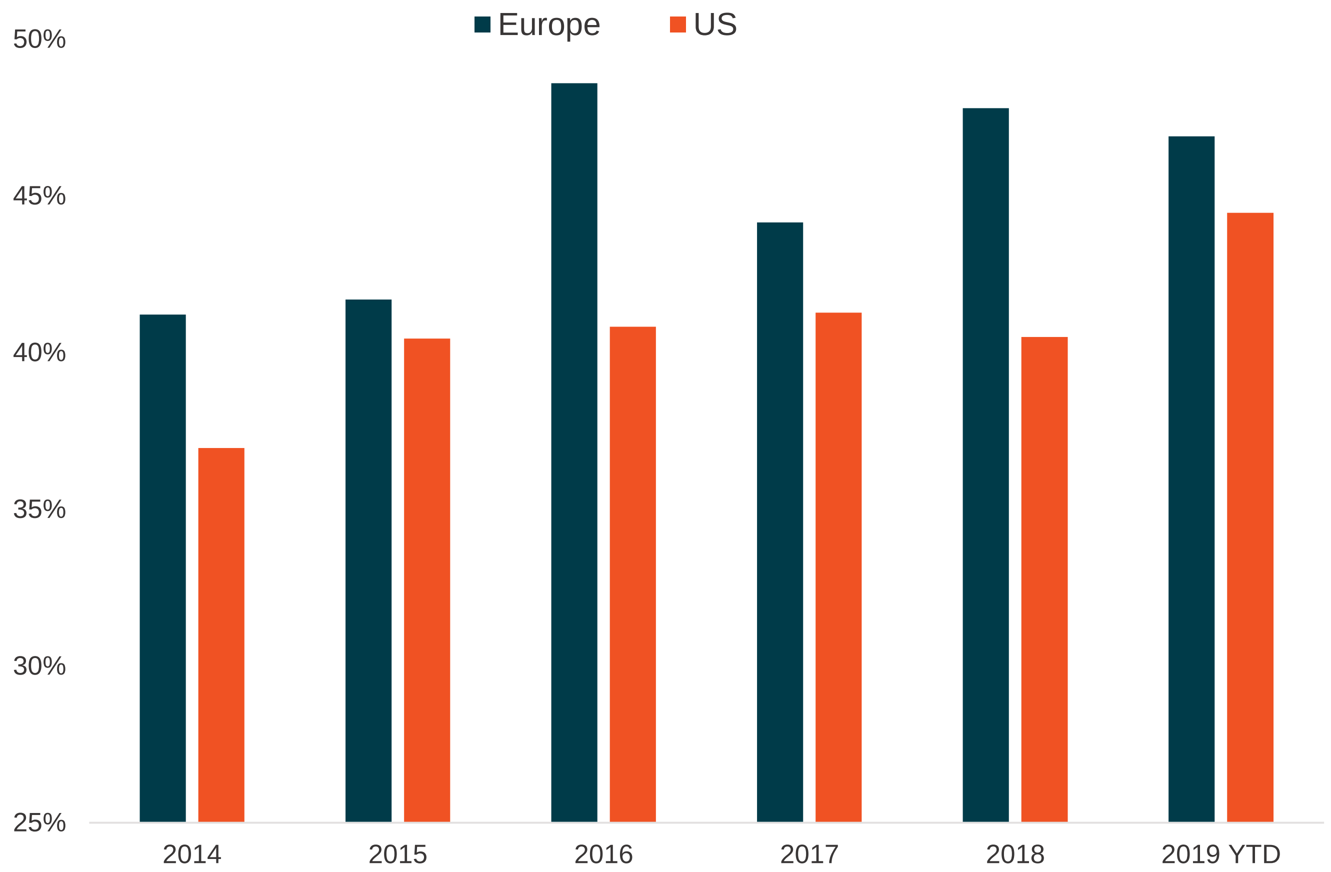
Europe Leverage and Interest Cover



Source: ICG Private Company Database

Equity buffers remain near record highs

US & Europe Equity Cushions



Source: S&P LCD, EV/EBITDA - Net Debt/EBITDA

What could go wrong?

Key Risks	Potential Offsets
US-China and/or US-EU trade wars escalate and damage global trade and growth	Trump can de-escalate trade tensions quickly and unilaterally and likely will if the US economy or markets appear at risk of an extended slump given his focus on popularity ratings and 2020 re-election prospects.
Tightening financial conditions causes a self-reinforcing downward market-growth spiral	The ECB has re-started its QE program and eased TLTRO bank loan terms. The Fed is on hold and can - if necessary- re-start its QE program. Middle East conflict driven oil price spikes a risk but increased non-OPEC supply reduces risk of sustained rise.
China growth slowdown accelerates and causes a global industrial recession	China has gradually been stepping up fiscal and monetary easing. Credit growth is picking up and, with a lag, should support the real economy. Policy-makers have substantial capacity to ease more aggressively if necessary.
Worst case hard Brexit/Italy financial risks occur and spread through the world economy	The ECB and BoE will maintain low rate policies and have made clear they will intervene strongly if systemic financial risks rise or growth slows sharply. Weak Europe data mostly focused in a few industrial sectors. Although reluctant to use it, in worst case scenario Germany has substantial capacity to use fiscal policy to boost growth.

Conclusions

- **Market volatility likely to remain high in 2020.** Weak growth, earnings downgrades, high valuations and geopolitical event risk will likely provide headwinds in 2020.

- **However, Europe (and global) recession risks are low in our view**. Well-supported private consumption and services sectors, a bottoming of the global industrial cycle, moderate fiscal expansion and pro-active central banks should allow the expansion to extend into its 11th year.

- **Europe and US private company fundamentals appear healthy**, with EBITDA and debt sustainability measures still sound.

- **Broad market default rates will likely remain low**, but performance dispersion at a country, sector and company level will likely increase, putting a larger than usual premium on rigorous bottom-up credit, structure and strategy selection.

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