Recent Developments in the European Car Market and Auto ABS Issuance Activity

Annual Report 2018

Financial Research
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Creditreform Rating

Management Summary

1.

The European car market had a tale of two halves in 2018. The stronger first half, which built up on attractive offers pushed by auto players ahead of the implementation of WLTP in September 2018, was followed by a sharp decline in new car sales in the second half. The adverse impact from WLTP-led production bottleneck was exacerbated by continued waning demand for diesel cars in the latter part of the year. Unlike China, the European car market maintained its market share based on new car registrations despite disruptions caused by the WLTP.

2.

Germany seemed less prepared amongst the core markets to deal with the WLTP as evident from sharp declines in both new car sales (-30.5% y-o-y) and production (-10.0% y-o-y) in September 2018. That being said, the country staged a strong recovery in new car sales, posting a leading growth figure within the key markets in February 2019.

3.

The share of diesel car sales in the EU stood at 35.9% in 2018, reflecting a fall of 8.5%, led by Spain and the UK. While the proportion of diesel cars in Germany and the UK is far below the EU level, Italy looks vulnerable as diesel cars sum up to over 50% of its total car sales. Having said that, the prospects of cleaner diesel cars seem to have brightened given the stringent CO_2 target to be achieved by 2021 and concession offered by the EU.

4.

Residual value of cars is eventually displaying signs of stabilization in Germany and the UK. In fact, average residual values of diesel cars (36 months older or 60,000 km) in the UK are improving as customers become cautious preferring used cars.

5.

The European auto ABS market stabilized in 2018, with new issuance volumes topping the tally of 2017 by clocking a growth of 1.3% y-o-y to 24.4bn euros. With the exception of the UK, all other four core markets witnessed higher primary issuance volumes in 2018, led by Spain and Italy. The Netherlands too experienced robust primary activity. Germany returned to growth for the first time since 2015 and maintained its contribution at close to half of the European auto ABS. The other notable trend was the persistent fading of appetite for collaterals originated outside the core markets.

Contact

Dr. Benjamin Mohr
Chief Economist

Creditreform Rating
Hellersbergstrasse 11
41460 Neuss

B.Mohr@creditreform-rating.de

6.

European auto ABS continued to be dominated by captives, with their share further increasing from 73.3% in 2017 to 75.6% in 2018, which was above the long-term average of 68.6%. Volkswagen remained the leader in terms of auto ABS originators, further strengthening its dominance from 22.8% in 2017 to 30.4% of the total auto ABS issuance in Europe last year. Notably, Peugeot sold about 1.9bn euros as compared to 350m euros in 2017 and became the fourth biggest issuer of auto ABS in Europe.

7.

Just over three-fourths of new auto ABS in the EU received an initial AAA rating in 2018, in line with the previous year. However, the share of AAA ratings in new issuances has fallen, especially from 2011, partly reflecting a hunt for higher yielding assets across the lower spectrum of ratings. Issuances spiked sixfold in the BBB- category in 2018, versus 2017.

8.

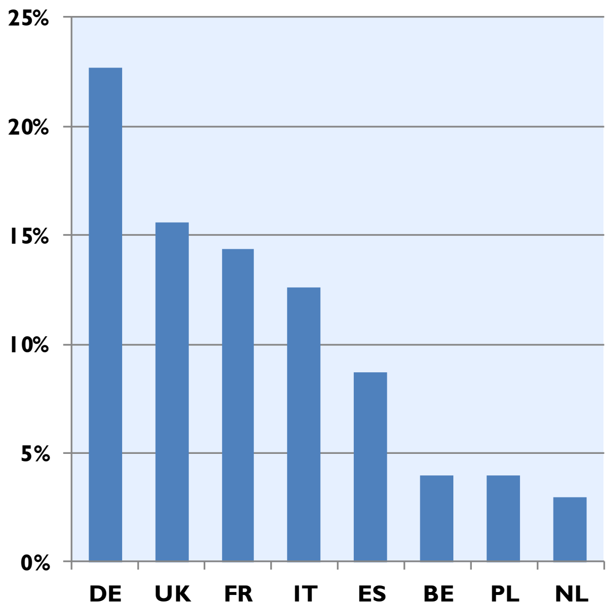
We expect new issuance volumes to remain more or less stable in 2019 although risks pertaining to the outlook are clearly tilted to the downside. New car sales have made a good start to 2019. However, this might not necessarily translate into a healthy securitization as the new regulation of the European securitization became effective on 01 January. Beyond regulatory uncertainty, the auto market faces several headwinds in the form of political risk, and a slowdown in economic growth in the euro area and the UK. Further risks are mainly related to Brexit uncertainty as well as the threat of auto import tariffs by the US.

1. The European Car Market at a Glance

The European Union (EU) maintained its position as the world's second largest car market with a global share of 19.2% in 2018, primarily supported by healthy sales growth in Central and Eastern European markets. This helped to compensate the downturn in key western markets, including Germany, UK, France, Italy, and Spain, which together accounts for 14.0% of the global market share and three-fourths of the EU market (see fig. 1).

Fig. 1: Key car markets in the EU

Percentage of market share in the EU based on new car registrations in 2018



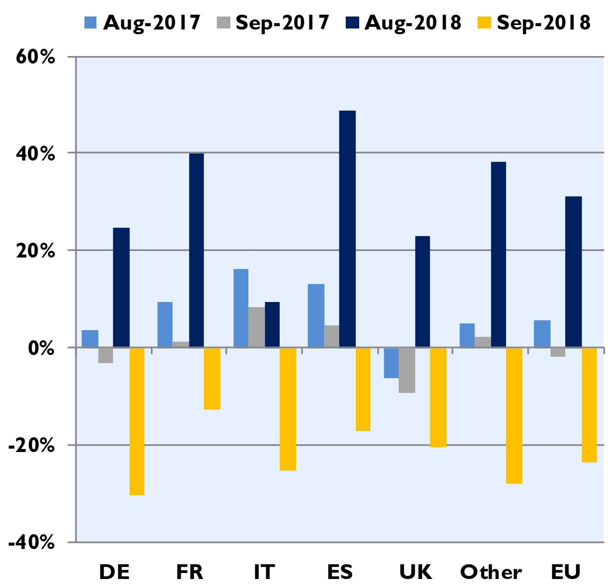
Sources: ACEA, Creditreform Rating

In contrast, China, the world's largest auto market, continued its painful journey, losing 3.5 p.p. of market share to end the year at 29.4% due to its economic slowdown and the effect of the ongoing trade tensions with the US. Meanwhile, the US had a mild bite and maintained its position as the third leading market (17.6%). However, the US has left Europe far behind in terms of electric car sales in 2018 to stand only behind China.

Overall, the European car market remained more or less stable in 2018 as the strong start to the year was spoiled by dwindling demand towards the latter part of the year. This was primarily due to disruptions caused by the implementation of the new emission test, Worldwide Harmonised Light Vehicle Test Procedure (WLTP) in September 2018 and legacy-diesel issues. The WLTP required all new car registrations to undergo an emission test, which is more stringent than the previous one that the New European Driving Cycle (NEDC) introduced back in 1980s.

Fig. 2: Immediate fallout of WLTP

Data is shown as a change in car sales y-o-y



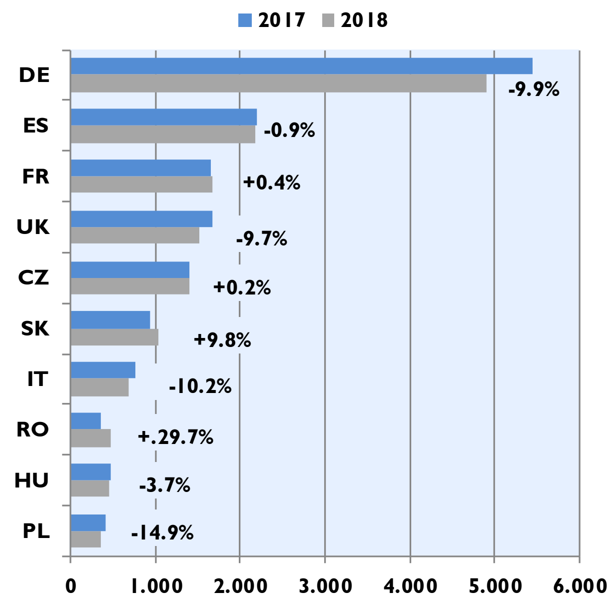
Sources: ACEA, Creditreform Rating

As a result, the second half of 2018 was quite eventful with new car sales spiking in August just ahead of the kick-off of WLTP as carmakers sweetened the deals to reduce their existing inventories (see fig. 2). Otherwise, August tends to be a lean period in terms of car sales. However, euphoric numbers for August were balanced out in the ensuing month as sales plunged by double-digit across the five key markets.

Furthermore, the WLTP has brought a production bottleneck as auto manufacturers had to either slow down production until their cars passed the emission test or register existing inventories before the deadline in order to avoid any retrofit in their cars that entails extra financial burden. Against this backdrop, core markets suffered high single- to double-digit production losses, led by Germany, Italy and the UK (see fig. 3).

Fig. 3: Top 10 car producers in the EU

Data is shown in thousand units and change y-o-y

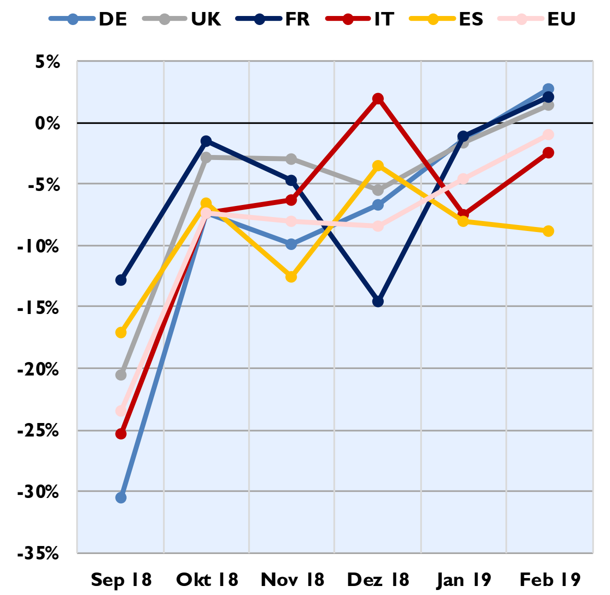


Sources: ACEA, Creditreform Rating

In our view, the effect of WLTP should be transitory and eventually fade as manufacturers adapt the new emission standards. To be sure, it is difficult to precisely assess a timeframe as to when auto makers will be able to fully restore the supply of cars. Yet, all vehicles will have to conform to the WLTP documentation by 2020. Accordingly, auto makers have limited choice but to speed up the production in line with the new emission standards. The underlying demand for cars remained decent showing gradual recovery, but not as strong as before the kick start of WLTP. Germany rebounded strongly to post growth of 3.0% y-o-y in February 2019, supported by the strong uptake of diesel vehicles. Likewise, UK and France also shifted into positive territory.

Fig. 4: Gradual recovery in new car sales post WLTP

Data is shown as the change in car sales y-o-y

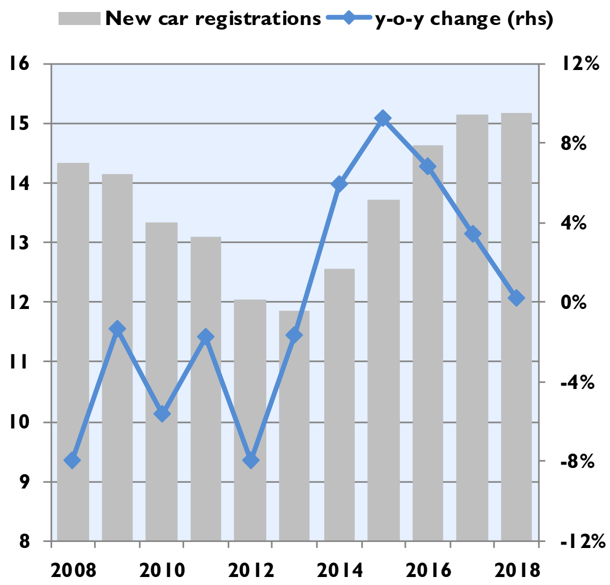


Sources: ACEA, Creditreform Rating

Despite the transitioning challenges related to WLTP, 2018 still marked the fifth consecutive year of growth, albeit marginal at 0.2%, with 15.2m of new car sales being registered across the EU (see fig. 5). The Eastern European countries continued to display strong momentum, offsetting the sluggishness in the key Western markets. Key driving markets were Lithuania (+25.4%), Romania (+23.1%), Croatia (+18.7%), Hungary (+17.5%), and Poland (+9.4%) among others.

Fig. 5: Registration of new cars in the EU

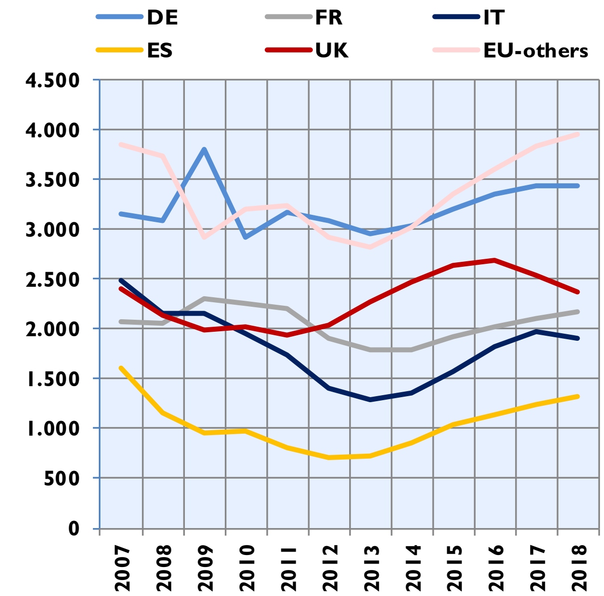
Data is shown in million units



Sources: ACEA, Creditreform Rating

Fig. 6: Car sales in European core markets

Data is shown in thousand units



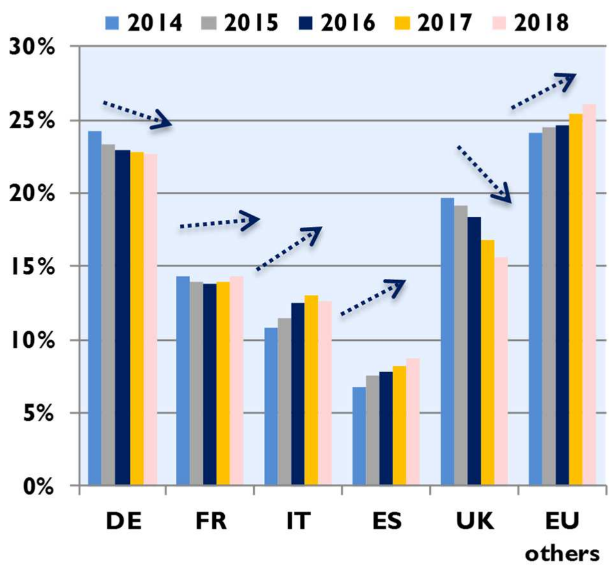
Sources: ACEA, Creditreform Rating

These countries benefitted from the continued and robust economic growth as well as increasing disposal income. On the other hand, core markets such as the UK remained under pressure, dragged down by prolonged uncertainty related to Brexit and a weak economic outlook (see fig. 6). Italy also experienced a tough time, with sales declining 2.9% y-o-y, reflecting political uncertainty and economic woes as it slipped into recession in Q4-18. Germany also saw marginal pressure (-0.2% y-o-y) as macro data softened, especially in the second half of 2018. Sales in France grew 3.0% y-o-y despite 'yellow vests protests' that lasted for several weeks. Spain continued to witness a solid momentum with its market expanding by 7.0%, witnessing the fifth consecutive year of strong growth.

Over the last five years, Spain and Italy gained market share by 2 percentage points each to 9.0% and 13.0% of the EU respectively (see fig. 7), largely driven by favorable credit conditions resulting from the ECB's easing monetary policy and the pent-up demand following the European debt crisis. While political risks in Spain and Italy remained relatively high, the economic recovery especially in the former was robust enough to keep boosting household spending. In addition, Eastern European markets keep garnering their share as the UK unabatedly keeps losing its market position amidst Brexit uncertainty. The UK is now on the cusp of losing its second largest position (16.0%) in Europe to France (14.0%), which has maintained its share at the same level since 2014. Germany has kept its market share intact at 23.0% over the past three years, yet it gives up 1 percentage point versus 2014.

Fig. 7: Development of market shares

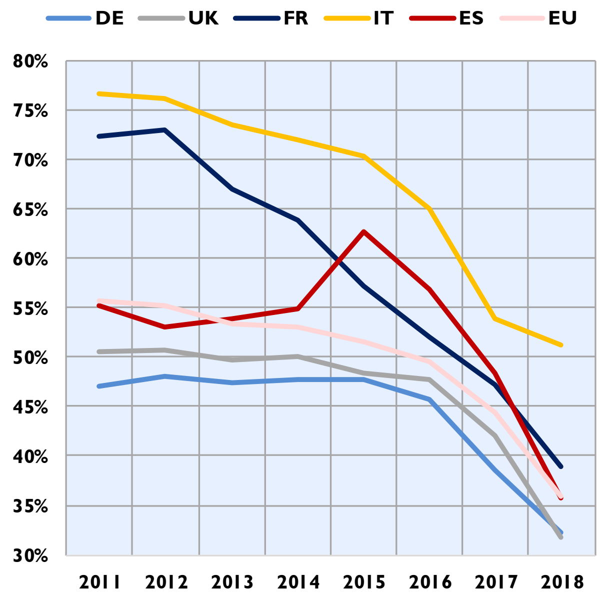
Data is shown in % of European car market



Sources: ACEA, Creditreform Rating

Fig. 8: Share of diesel cars in total sales

Data is shown in %



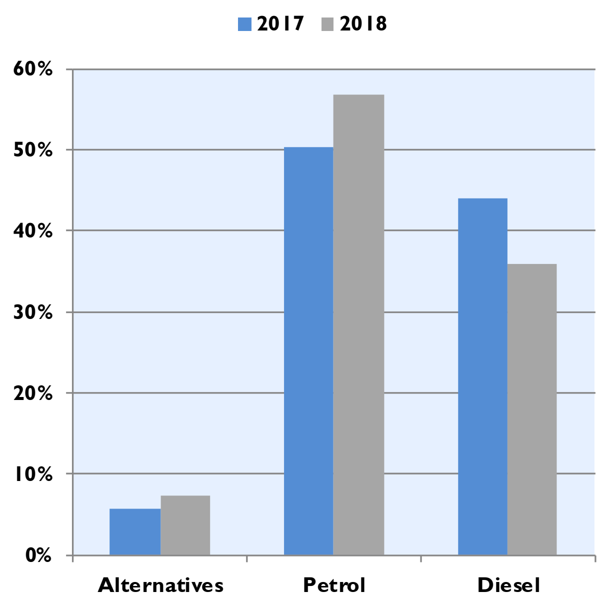
Sources: ACEA, Creditreform Rating

The key trend in the regional markets remained well intact in the form of marginalisation of diesel cars, which took a further hit in 2018 after WLTP came into effect (see fig. 8). The share of diesel car sales in the EU declined by 8.5% y-o-y to 35.9%, led by Spain (-20.5%) and the UK (-10.3%). With this, Spain is now in line with the EU average diesel fuel mix of approx. 36.0%. However, France and Italy still float above the EU average, with the latter appearing quite vulnerable as the diesel car mix makes up as high as 51.2% at the end of 2018. At the latest count, the UK and Germany were already running below the EU average at around 32.0%.

However, the ongoing positive uptake in vehicles powered by petrol and alternatives, more than offset the faltering demand for diesel cars. The growth in alternatives continued to be exponential at about 30.0% y-o-y in 2018; yet they still account for a small share of total car sales. Petrol car sales kept growing at low double-digit, while diesel car sales remained pervasively out of favor declining at high-single digit in 2018 (see fig. 9).

Fig. 9: New car registrations in EU

Data is shown as percentage of total sales based on the fuel mix



Sources: ACEA, Creditreform Rating

As diesel car sales face secular pressure, automakers are considering an alternative path to counter losses amidst several headwinds such as regulatory uncertainty, a tepid economic outlook, concerns over US auto tariffs, and Brexit. Yet, major auto players have a more benign view for the industry in 2019. However, the cost of vehicles is likely to head north as auto manufacturers intensify innovation that requires higher investment, in an effort to substitute diesel-powered cars.

Furthermore, WLTP will put the industry sector under additional cost pressure as it warrants updating existing and future cars with new technologies, components, etc. Given the rigorous emission test involved that includes both lab and real driving test under the new regulation regime, the measured CO_2 emission is expected to inflate as compared to the test under NEDC. The increase in emission will vary not only from car to car, but also from model to model and specification to specification. Early indicators signal that CO_2 emission will be 20.0 to 25.0% higher under the new regime. This will have a significant bearing in countries where vehicle registration taxes are based on emissions. About half of the EU members are using taxes based on either wholly or in part on CO_2 levels and fuel consumption. If the members continue with the existing framework, it would lead to an increase in taxes and put burden on end-consumers. In such a case, the demand for cars would decrease, especially for older used cars.

Moreover, the key challenge for European auto manufacturers is to meet the CO_2 target of 95g/km by 2021. With a ubiquitous decline in the demand for diesel cars, auto manufacturers are struggling to reduce emission levels (119g/km in 2017). Manufacturers require new technologies to reduce emission levels from the petrol version and heavy investments to launch alternatively powered vehicles. This will feed into higher cost for new cars until economies of scale for such cars are being realised. That being said, manufacturers are still strongly considering to bring clean diesel vehicles while conforming to the pollution levels under the EU norms.

Nevertheless, expectations of higher car prices and supply constraints brought by the new regulation are likely to help residual value of used cars to some extent. Furthermore, the German government seems to increasingly eschew enacting law to ban older diesel cars. This might be due to mixed experiences following the fallout from banning older diesel cars in Stuttgart since the beginning of 2019, which led to the German style of French yellow vests protests.

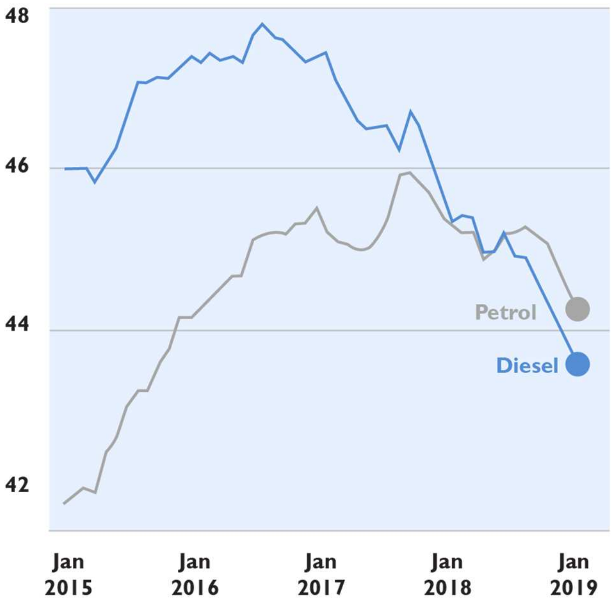
There are several other German cities bracing for imposing bans, but the implementation now looks challenging as the ongoing protest could put political pressure on the ruling government. The diesel ban planned for Frankfurt has been halted by the court on the grounds of 'insufficient' reasons to implement it. Furthermore, several other cities might get a relief as the European Commission has approved the German government's plans to impose bans only in cities that exceeded pollution limits of an average 50mg of nitrogen oxide. This implies that cities such as Berlin, Frankfurt and Hanover may circumvent diesel bans. The above backdrop alongside efforts by auto players to bring cleaner diesel cars could act as a silver lining.

The decline in residual values for diesel cars has started slowing since late 2018, following three years of sharply falling values, exacerbated by Volkswagen's diesel issues. Indeed, diesel residual values have been stabilising in key markets, including Germany and the UK.

According to Autovista, the performance of diesel residual values in Germany was better than petrol in 2019 so far. Average residual values of diesel cars that are 36 months older and have run 60,000km are now retaining almost as much of their value as petrol cars, at 43.6% and 44.3% respectively (see fig. 10). That said, petrol residual values continued to command premium over diesel in Germany since the second half of 2018, and the trend may continue until the end of this year.

Fig. 10: Residual values in Germany

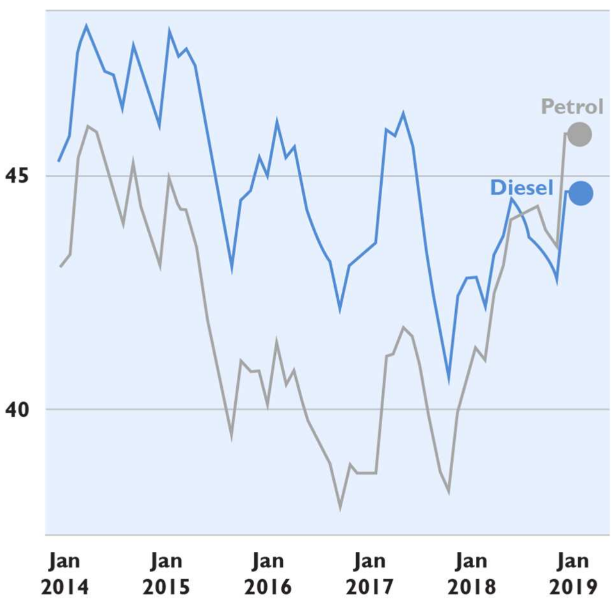
Petrol and diesel RVs as % of original list price for 36 months older cars/60,000km



Sources: Autovista

Fig. 11: Residual values in the UK

Petrol and diesel RVs as % of original list price for 36 months older cars/60,000km



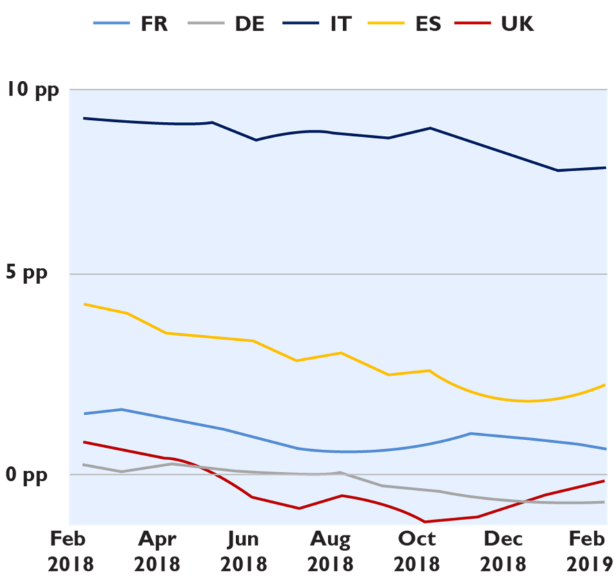
Sources: Autovista

By the same token, in the UK, residual values are improving for both diesel and petrol used cars (see fig. 11). Until May 2018, diesel used cars commanded higher premium, but this trend has reversed with petrol used cars now offering 100bps premium over diesel. Average residual values of petrol and diesel cars were 46.0% and 45.0% of the original list prices as of January 2019, respectively.

As shown in figure 12, France, Italy and Spain remained resilient as compared to Germany and the UK. Amongst them, Italy stood out, with diesel residual values commanding 7.0% premium over petrol. Diesel residuals currently retained 45.0% of their original value after 36 months and 60,000km, versus 37.0% for petrol-powered cars. Similarly, in Spain, diesel cars have persistently held better value than petrol cars, even though the spread between them has narrowed from 5.0% in August 2015 to 2.0% in February 2019, with the deterioration being pronounced since the start of 2018. More recently, diesel cars retained 51.0% of the original list price.

Fig. 12: Diesel residual values eventually appear to be stabilising in core auto markets

Residual value advantage of Diesel over Petrol in percentage points



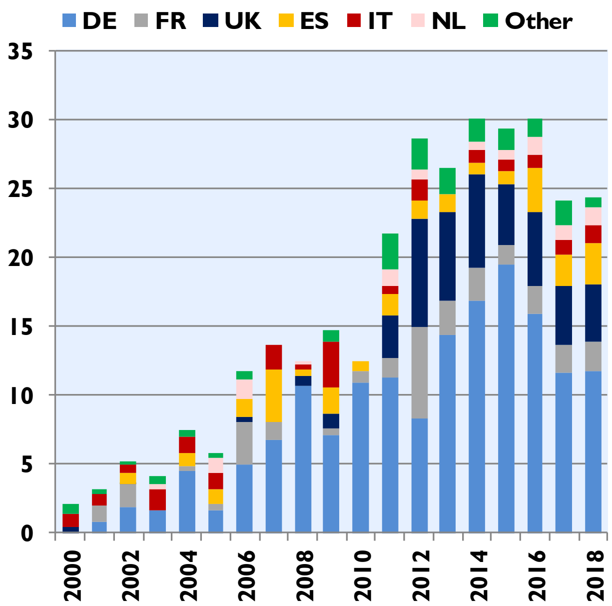
Sources: Autovista

2. The Auto ABS Markets in Europe

In 2018, the new issuance volumes in the European auto ABS market slighly surpassed the tally of 2017. This was despite the dullness being witnessed in the second half, thanks to a good start to the year. After attaining their record run in 2016, new issuance volumes plunged by roughly 6bn euros to 24.1bn euros in 2017. However, with an increase of 1.3% y-o-y to 24.4bn euros in 2018, a new normal seemed to have established in the primary ABS market with an upward bias (see fig. 13).

Fig. 13: Development of the auto ABS issuance activity in Europe

Volume of new auto ABS issuances in billion euros, by origin of collateral, until the end of 2018

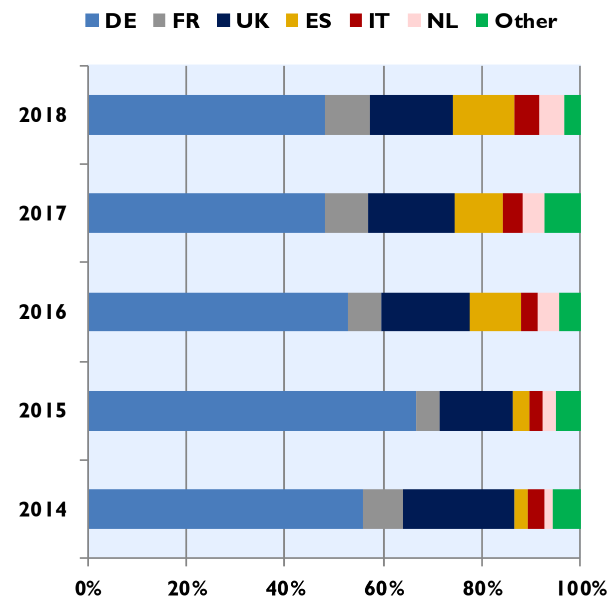


Sources: Thomson Reuters, Creditreform Rating

Barring the UK, all other four core markets witnessed higher primary issuance volumes in 2018. The activity in the UK was almost in line with 2017 (4.2bn vs. 4.3bn euros of issuance in 2017). Unsurprisingly, auto issuance volumes in Spain kept their pace in 2018 (+0.7bn to 3.0bn euros), mirroring a positive development in the domestic new car market. Italy and the Netherlands too followed on the heels of Spain, with issuance volumes rising 0.2bn euros each, to 1.2bn and 1.3bn euros, respectively. Germany, the biggest European market for auto ABS, returned to growth for the first time since 2015 when domestic issuance volumes reached record 19.5bn euros. German new issuance volumes grew 1.6% y-o-y to 11.7bn euros in 2018, primarily driven by Volkswagen, reversing its downside trend that started since 2015. This also reflects greater conviction on Volkswagen post its emission debacle. France saw a 3.1% growth to 2.2bn euros, supported by issuance from Peugeot and Renault.

Fig. 14: Country of origin for the underlyings of European Auto ABS

Share in annual issuance volume of auto ABS deals by origin of collateral



Sources: Thomson Reuters, Creditreform Rating

German collateral thus continued to dominate the European auto ABS market in 2018, followed by the UK and Spain. The share of auto ABS issuances for all the key markets has eventually stabilized in 2018, with UK being an exception (see fig. 14). This was a significant improvement – especially for Germany, where the decline was more intense than in other four key markets in 2016 and 2017. The share of German auto ABS deals grew marginally in 2018 and maintained its contribution at close to half of the European auto ABS.

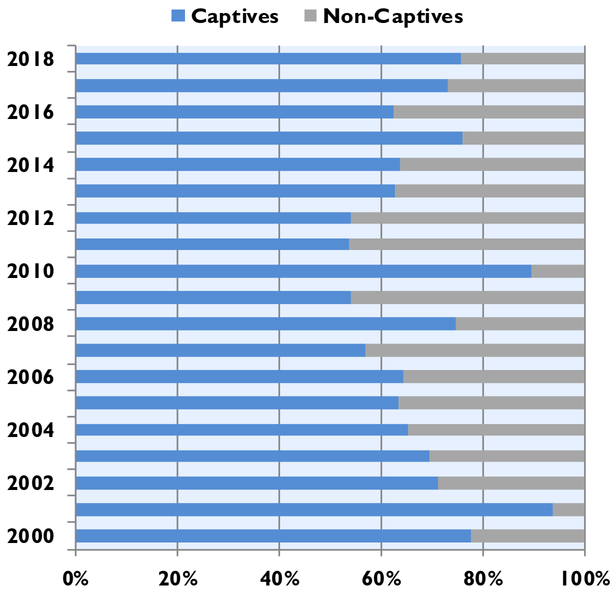
However, Germany's market share in the European annual issuance volume was still far below in comparison to two-thirds in 2015. While we acknowledge that the total volume of German deals shrunk between 2015 and 2018, other key markets displayed resilience and are indeed growing, with Spain and France leading the pack during the same period. Spain held 12.2% of the European auto securitization deals in 2018, rising 8.6 and 2.7 percentage points over 2015 and 2017, respectively. France gained about 4.1 percentage points to 8.8% in 2015-18. The UK volume has also increased by 2.4 percentage points to 17.2% since 2015. The other notable trend was the persistent fading of appetite for collateral originated outside the core markets (-1.0bn to 0.8bn euros in 2018), which somewhat offset the increases in European core markets.

3. Originators of Auto ABS

The major European issuers of auto ABS continued to be banks affiliated with automobile manufacturers (so-called captives). Of the new issues in 2018, approx. 18.4bn euros, equivalent to three-fourths, were issued by banks affiliated with auto manufacturers. Thus, the share of new auto ABS issuances by captives increased from 73.3% in 2017 to 75.6% in 2018 (see fig. 15). The long-term average share of captives in new issuances is 66.2%, clearly reflecting the persistent dominance of captive auto finance companies linked to various manufacturers in Europe.

Fig. 15: Captives and non-captives in the European ABS market

Share in volume of new issues by originator, in %



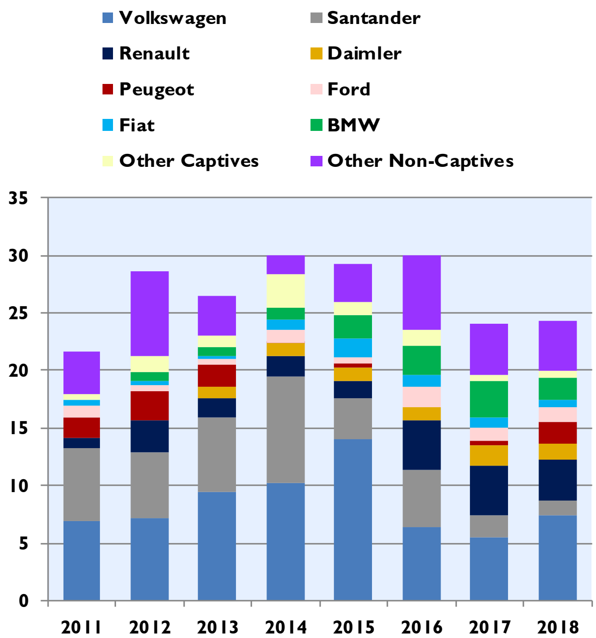
Sources: Thomson Reuters, Creditreform Rating

Volkswagen remained the leader in terms of auto ABS originators, further strengthening its dominance from 22.8% in 2017 to 30.4% of the total auto ABS issuance in Europe last year. The company eventually showed increased issuance activity in 2018 after witnessing a declining trend since 2015 to post a seven-year trough at 5.5bn euros in 2017 (see fig. 16). Volkswagen raised 7.4bn euros in new auto ABS in 2018, reflecting a rise of 1.9bn euros despite witnessing a moderate issuance volume of 2.3bn euros in the second half of the year.

On the other hand, BMW's issuance volumes slowed from 3.1bn to 2.0bn euros in 2018, after experiencing four consecutive years of growth until 2017. BMW embarked 2018 on a strong note, tapping 1.5bn euros in the first half itself. However, the latter part of 2018 turned out to be relatively modest, as weakness in the broader car market had built up along the way, ending the year with a primary supply of 2.0bn euros. Another major player, Renault's issuance volume was 731m euros less than in 2017 to 3.5bn euros; yet it remained the second biggest issuer (after Volkswagen) for the third consecutive year while accounting for 14.6% of total auto ABS issuance volumes (see fig. 17). Last year, the major surprise came from Peugeot, which sold about 1.9bn euros as compared to 350m euros in 2017. Consequently, Peugeot became the fourth biggest issuer of auto ABS in Europe in 2018. The other two key players were Daimler and Ford, both of which raised 1.4bn and 1.2bn euros in 2018, respectively. These figures correspond to about mid-single digit share in the total new issuance volumes in Europe.

Fig. 16: European auto ABS issuances by originator

Volume of new auto ABS issuances in billion euros

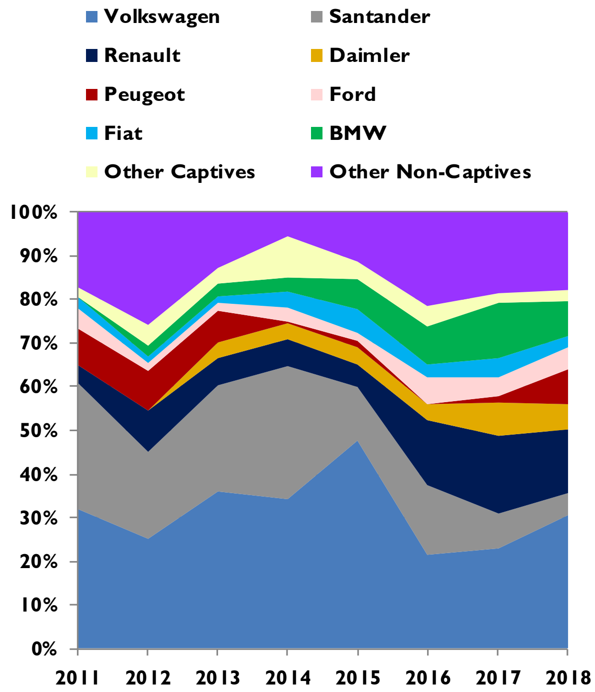


Sources: Thomson Reuters, Creditreform Rating

Among the non-captives, Santander continued to lead in the category, though issuance volumes continued to decline in 2018, with the bank issuing 0.7bn euros less at 1.3bn euros. This represented 5.2% of the entire European new auto ABS issuance volumes and just over one-fifth of the total non-captives supply. The non-captives issuance continued to decline over the past three years to about one-fourth of total auto ABS volumes in 2018 from close to half in 2011.

Fig. 17: Originators in the European auto ABS market

Share in annual issuance volume of new auto ABS issues by originator



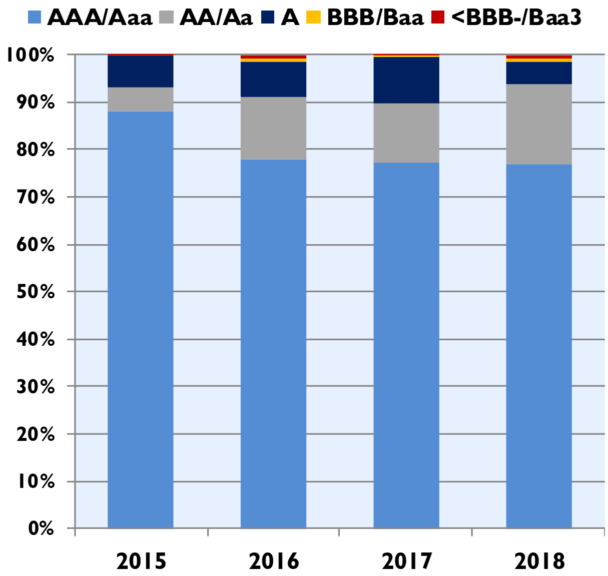
Sources: Thomson Reuters, Creditreform Rating

4. Rating Profile of Auto ABS in Europe

Auto ABS remains a high-quality asset class as evident from underlying credit ratings. The largest majority of new auto ABS issuances continued to receive an initial rating of AAA. In 2018, just over three-fourths of new auto ABS tranches (77.0%) were assigned AAA ratings, which was almost in line with 2017 (77.3%).

Fig. 18: Recent development in European auto ABS ratings

Initial ratings (S&P, Moody's, Fitch) include class A and subordinate tranches, per year of issue in %, measured by the issue volume of all rated notes



Sources: Thomson Reuters, Creditreform Rating

However, the share of AAA rating in new issuances has been falling persistently, especially from 2011. The coveted AAA rating once comprised 95.0% of all European new auto issuances in 2011. This figure came down to 87.5% in 2015 and further down to 77.0% in 2018, partly reflecting a hunt for higher yielding assets across the lower spectrum of rating in an otherwise low interest rate environment. The AAA rated issuance volumes fell from 23.2bn euros in 2015 to 17.6bn in 2018, underscoring almost one-fourth of decline. That being said, for 2018, AAA rated volumes rose 2.6% y-o-y, ending the year on a positive note.We believe that this development is not a great cause of concern, given the still excellent overall rating profile of auto ABS in Europe.

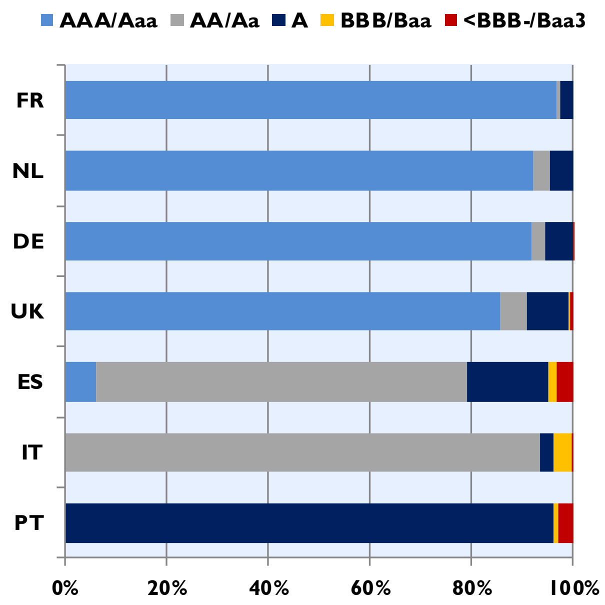
However, the share of AA rating increased over the recent years from 5.1% in 2015 to 12.6% in 2017 and further to 16.8% in 2018, underscoring the growing appetite for auto deals even down the way through capital structure. Issuance volumes for the AA category rose from 2.8bn euros in 2017 to 3.8bn euros in 2018, with a threefold increase from 2015. Concurrently, the share of the A rating category reversed its trend, closing 2018 at just 4.9%. Issuance volumes at the lower end of the investment grade category (BBB-) turned out to be robust in 2018, spiking sixfold to 193m euros from 2017. In 2015, BBB- raised just 6.6m euros.

Thus, over the past few years, more auto ABS tranches with an AA/Aa rating and below were issued, seemingly attracting investors seeking relatively higher yields in addition to the protection offered by asset-backed securities. Historically, European ABS are characterized by strong underlying asset quality. According to ESMA CEREP data, default rates posted below 0.5% between July 2001 and June 2018, which compares very low to default rates of roughly 7% in the US over the same period. Meanwhile, supply of auto ABS, which constitute about one-fifth of the European ABS market, has risen driven by increasing vehicle sales, and strengthening demand for alternative fixed income instruments.

It is evident from figure 19 that the rating profile varies depending on the origin of collateral. Between 2015 and 2018, auto ABS with French underlyings held the largest percentage of notes with the highest credit quality (96.7%). Following closely are auto ABS tranches from the Netherlands (92.1%) and Germany (92.0%), while the UK held 85.6%. Meanwhile, deals originating from peripheral countries are mainly concentrated in the AA rating category, with Spain and Italy holding 73.0% and 93.6% during 2015–2018, respectively. Italy did not print any deal in the AAA category during the same period, while Spain tapped 540m euros, reflecting 6.1% of total issuances in the country. Portugal held 97.2% of the deals rated at the BBB category during the same period.

Fig. 19: Auto ABS ratings by origin of collateral

Initial ratings (S&P, Moody's, Fitch) include class A and subordinate tranches, measured by the issue volume of all rated notes between 2015 and 2018



Sources: Thomson Reuters, Creditreform Rating

5. Perspectives for the Issuance of European Auto ABS

We expect new issuance volumes to remain more or less stable in 2019 although risks pertaining to the outlook are clearly tilted to the downside. In general, we assume captives to remain the key driver in the auto ABS primary market.

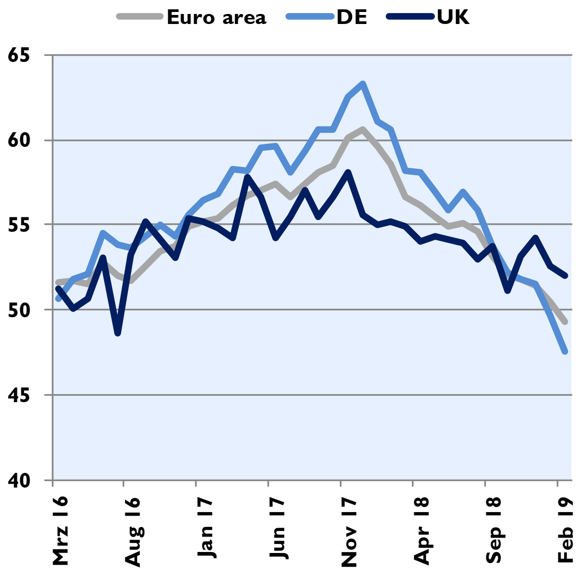
New car sales have made a good start to 2019, at least in Germany, France, and the UK, with all of them returning to growth in February. However, this might not necessarily translate into a healthy securitization as the new regulation of the European securitization became effective from 01 January 2019. While the new regulation is designed to revitalise the securitization activity, some of the underlying technical framework to designate simple, transparent and standardised (STS) securitizations is yet to be finalized. This has created uncertainties amongst potential issuers, resulting in negligible ABS issuance in Q1-19. As a result, the first half of 2019 may turn out to be rather modest in terms of new issuance volumes, though we could see a busy second half as issuers try to catch up. To be sure, we view auto ABS as high-quality assets and their demand could remain intact even if they may not be labelled as STS.

Beyond regulatory uncertainty, the regional auto market admittedly faces several headwinds in the form of political risk (e.g. EU parliamentary election in May), a slowdown in economic growth in the euro area, Brexit uncertainty as well as the threat of auto import tariffs by the US.

The euro area's GDP growth halved from 0.4% (average quarterly basis) in the first half to 0.2% in H2-18, with noticeable divergence being witnessed amongst the largest economies. Germany and Italy underperformed, with former growth coming to a standstill in the second half and the latter falling into recession. Germany was hit by the warm and dry summer, lower production of cars, and weaker external demand. Italy went through significant financial volatility, worsening business confidence, and uncertainty, leading to the suppression in the economic activity. However, France and Spain saw better GDP growth in the second half. The weakness in manufacturing activities remained a drag in the economic performance of the major European economies. PMI data are thus on the declining trend since past several months due to waning new export orders and inventory stocks (see fig. 20). This along with other recent indicators as well as global headwinds points to a continued moderation in economic growth in the near term. At this stage, we project the euro area to post growth rates of 1.2 and 1.4% in 2019 and 2020 respectively

Fig. 20: Manufacturing PMIs

Purchasing Manager Index, values higher than 50 indicating growth since previous month



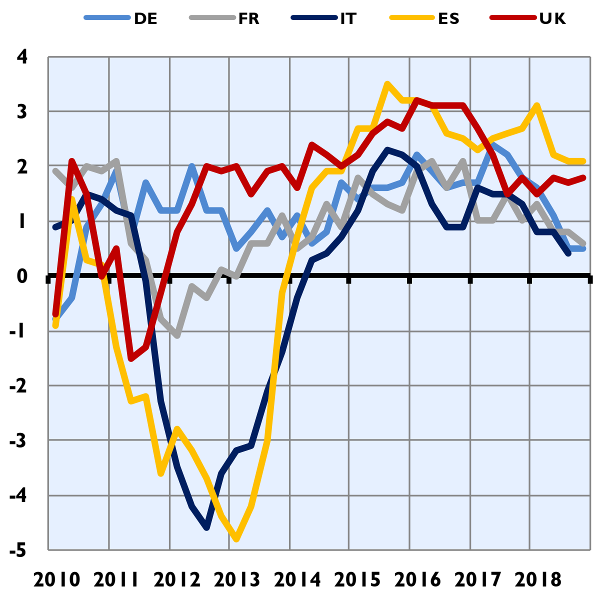
Sources: Thomson Reuters, Creditreform Rating

Nonetheless, the outlook remains constructive over the medium term. We believe external risks should gradually wane going forward, and supporting economic factors such as rising wages, some loosening in the fiscal policy, accommodative monetary policy and a gradual recovery in external demand should come into play to support moderate economic expansion. The ECB is again likely to play a key role in supplementing consumer and market sentiments, even though its firepower appears to subside. Labor markets remain healthy and real disposable income should stay solid, which bode well for consumer discretionary goods, including cars. On the whole, we expect private consumption to be the main growth engine in most of the European economies, though uncertainty has weighed on its growth dynamics more recently (see fig. 21).

Financial conditions in the euro area remain favorable as the ECB becomes more dovish, while pushing back rate hike expectations to 2020 or until inflation reaches closer to its target level of 2.0%, which is expected to reach only 1.6% in 2021. Although the ECB ended its asset purchasing programme (APP) in December 2018, it continues to reinvest the maturing principal amount purchased under the APP for an extended period of time. Furthermore, the ECB has announced its third targeted long-term refinancing operations that begin in September 2019 and end in March 2021. All these measures are likely to keep lending resilient to the private sector, including households. Meanwhile, the consumer credit take-up is likely to remain favorable, backed by rising wages amidst the tight labor market. The unemployment rate stood at 7.9% in Q4-18, the lowest since Q3-08.

Fig. 21: Private consumption growth in key auto markets

Year-on-year, in %

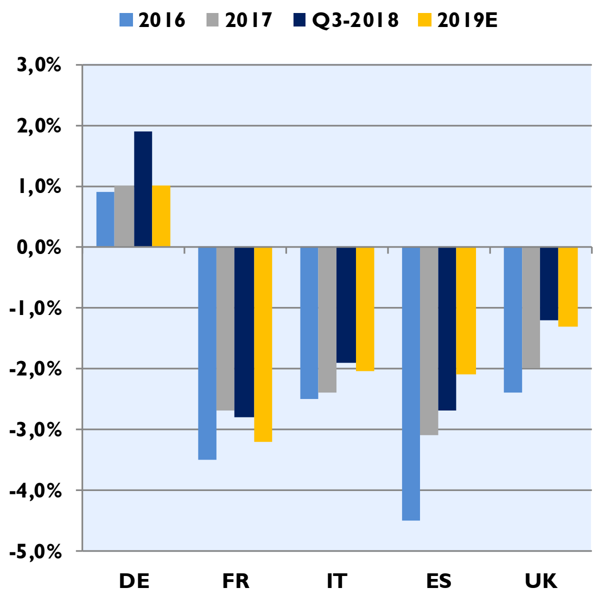


Sources: Eurostat, Creditreform Rating

Moreover, the fiscal policy for the euro area may be expected to ease in 2019 (see fig. 22). The major boost is likely to stem from cuts in direct taxes, social security contributions and higher government expenditure in some countries. However, the magnitude of fiscal loosing is projected to be small in 2019, led by France and Italy. Germany plans for a smaller surplus and the UK is also expected to increase spending.

Fig. 22: Fiscal policy to ease ahead

Budget balance as % of GDP



Sources: Eurostat, EU COM, ONS, Creditreform Rating

Likewise, the economic growth in the UK has slowed markedly in late 2018. The GDP grew 0.2% in Q4-18 with the pullback majorly taking place in December when GDP contracted by 0.4%. There was broad-based weakness in the economy, with construction, production and services output falling in the month. While monthly GDP figure could be volatile, a more stable quarterly number also suggests a slowdown in the underlying economic fundamentals. Services growth (80% of the private sector economy) eased to 0.4% in Q4-18, following strong summer. Production output fell 1.1%, stifled by the manufacturing activity (-0.9%). The weakness in manufacturing reflected the decline in transport equipment (-2.7%), owing to a partial shutdown of several car manufacturing plants. The Brexit uncertainty continued to take a toll on the UK business investment that continued to shrink for the fourth consecutive quarter, the first such instance since 2009. Household consumption remained benign, increasing just 0.4% in Q4-18. However, government consumption had been healthy at +1.4%, reflecting primarily spending on general public services and defence.

Looking ahead, we expect the British economy to further lose steam, anticipating GDP growth of 1.2 and 1.3% in 2019 and 2020 respectively, with domestic demand remaining the main driver. To be sure, this forecast is contingent on the materialization of our base-line scenario, implying an orderly Brexit

A sustained weakness in industrial and construction output at the beginning of the year underpins our view that a rebound in investment is rather unlikely until we see greater clarity on the terms of the UK's EU departure. External demand should remain muted over the coming two years, as uncertainty about the UK's future trade relationship with the EU is likely to persist beyond March 2019 and economic growth in the country's main trading partners should lose momentum. Alongside sluggish growth in headline investment and external demand, we anticipate only moderately rising private consumption over the next two years. With the deadline for the UK's departure from the EU ticking closer, there are signs that Brexit-related uncertainty is increasingly spreading to private households.

In Nov-18, PM May and the EU concluded on a draft withdrawal agreement, including a post-Brexit transition period until December 2020. However, several cabinet members and the parliament rebuffed the negotiated proposal. More importantly, PM May failed to secure a parliamentary majority for the deal, as the House of Commons rejected it three times.

In the meantime, the House had spoken out against the UK leaving the EU without an agreement.

While the exit from the EU was initially scheduled for 29 March, UK authorities will have to provide clarity on the withdrawal agreement by 12 April. Previously, the European Council had agreed to an extension until 22 May 2019, provided the withdrawal agreement is approved by the House by 29 March, which was eventually not the case, or to 12 April otherwise.

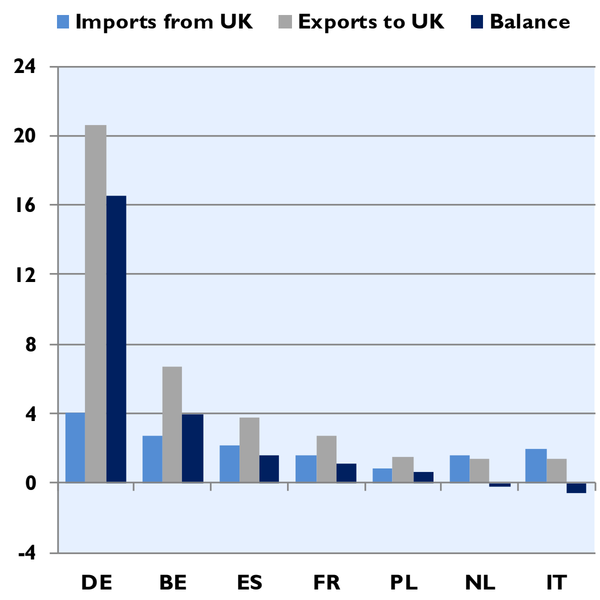
On 02.April, the Prime Minister announced that she wanted to request a new postponement of Brexit in the EU to allow more time for reaching a cross-party consensus. The extension should be 'as short as possible', but give the British parliament the time to approve an agreement to withdraw from the EU after all.

Our baseline scenario continues to be that of a delayed Brexit deal, i.e. a conclusion on May's deal or a similar deal, followed by a transition period, which ensures greater continuity for corporates, consumers, and policy-makers alike – thereby cushioning cliff effects and enabling a relatively smooth adjustment to a post-Brexit world. We believe that a 'short-term solution' may still be feasible, a 'longer-term delay', which could happen if the House cannot agree on a way forward before 12 April, appears not unlikely – probably implying a participation in the election of EU Parliament. Even a new referendum or snap elections may not be ruled out in that case.

A hard Brexit remains a key risk (as hard Brexit could result in 10% WTO import tariffs on both sides), especially for German auto carmakers within the EU, given the size of transactions between Germany and the UK (see fig. 23). The UK car industry has almost halved its investment to just 588.3m pounds and car production fell 9.1% y-o-y to 1.5m in 2018, the second consecutive annual decline.

Fig. 23: Trade value of motor vehicles, automotive parts and accessories

Data shown in billion euros, in 2018



Sources: ACEA, Creditreform Rating

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