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In Europe, more corporate debt would be a good sign

If you fear overleveraged US corporates and believe the credit cycle has peaked, take note of the sharp fall in corporate debt ratios in Europe. This should shield Europe from any possible correction in the US. Low leverage has coincided with low investment ratios, but we expect European corporates to take on more leverage next year. That would be a good sign

We hear your concerns and we're watching US corporate leverage

Noise out of the US points to private credit as an area of stress. There have been some notable casualties in the lending arena already, including Tricolor Holdings and First Brands Group. They may be mostly unrelated, and credit standards have been tightened, but prior extension of credit to weaker names remains a point of vulnerability. It’s also opaque, which makes it hard to analyse. So we understand why some perceive it as ‘late cycle’ and potentially bubbly.

While the market is placing more scrutiny on private lending, US corporate bond spreads remain historically low. This signals that the markets see minimal systemic risk. Low corporate credit spreads imply attractive financing conditions, so our base case is that we will see further credit growth. But, like many, we are monitoring this space.

But Europe's corporate leverage is low and should start to pick up

The question we seek to answer is whether similar risks exist in Europe. Our conclusion is - very out of character for our profession – overleveraged corporates should not be a concern here. Quite the opposite: the corporate sector has been borrowing very little when adjusted for price levels.

Corporates have shifted out of bank loans into bonds, which means these markets look buoyant – issuance records are being broken. We argue this is driven by higher price levels, refinancing of previous issuance, and a change in composition of corporate debt.

In addition to this, European corporates hold more cash, strengthening their balance sheets further. Households, meanwhile, have very high savings ratios. So, investors are chasing relatively low debt issuance. Only very recently has the monetary cycle begun to turn and European corporate loan growth started to pick up. It is still below nominal GDP growth, however.

As such, we believe the credit cycle in Europe will enter a 're-leveraging' phase next year (read our Credit Outlook), with corporates taking on more debt as investment growth gradually picks up. Should credit spreads widen significantly as a result of concerns in the US, European credit markets are likely to experience a less pronounced widening. The underlying foundation of the market should be enough to avoid a severe and longer-lasting credit crunch.

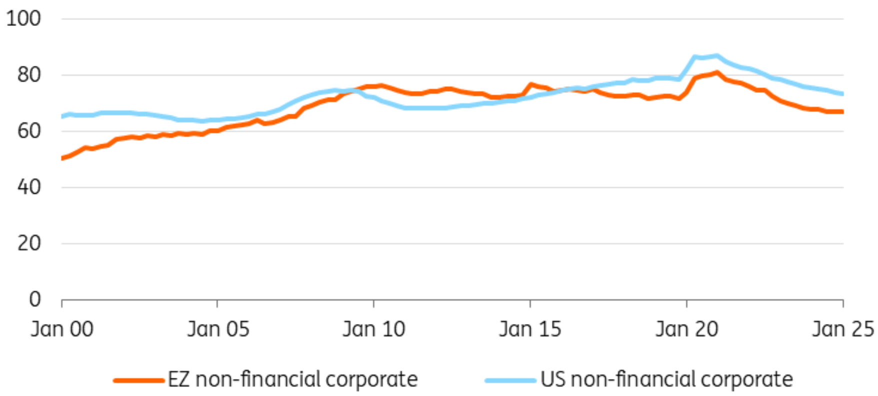
Let us take you through the facts and our thinking.

Fact 1: Existing corporate leverage has been eroded by inflation

Inflation is a curse for lenders and a blessing for debtors. Anyone who believes leverage has grown rapidly in recent years is overlooking the need to adjust for the overall size of the economy, which has been boosted by inflation. A quick reminder: since Covid, nominal GDP in Europe grew by about 30%, while it grew about 40% in the US. Thus, the 'real' value of debt has been deflated away, explaining why the credit to GDP ratio has come down to just below 67% – a level last seen in 2007 for Europe. For the US, the level early this year was comparable to the level last seen in 2015.

The corporate debt-to-GDP ratio has come down strongly in Europe

Consolidated non-financial corporate debt-to-GDP ratio (%)



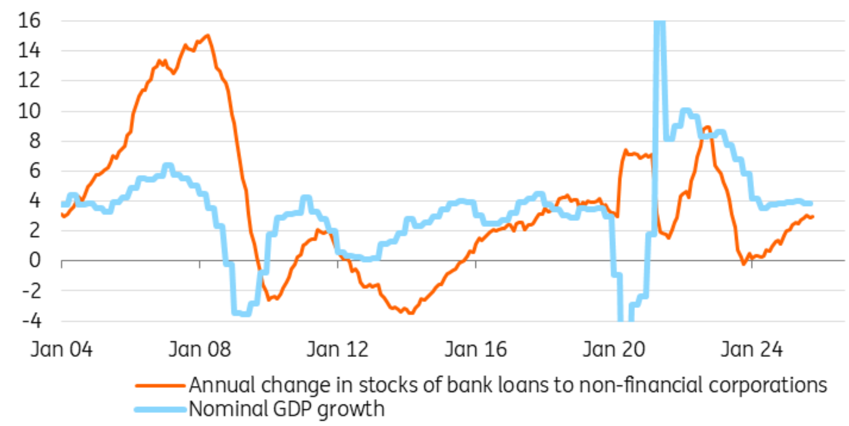
Source: BIS (US) and ECB (Euro Area 20), ING

Fact 2: Weak net bank lending growth

The erosion in the value of debt relative to GDP is not due to inflation alone. Corporates' net new borrowing has not kept pace with GDP growth since the 2020 peak. Only recently have signs of a turnaround emerged, with corporate loan stocks expanding more quickly. In October, total outstanding bank loans were up 2.9% year-on-year. However, this growth is still below nominal GDP growth, which stood at about 4% in the third quarter.

Growth of bank loans to corporates is well below nominal GDP growth

Annual growth (%)



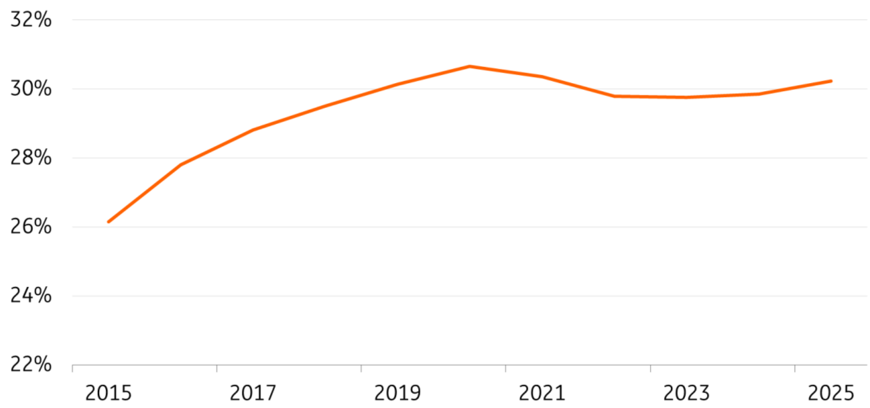
Source: ECB, Eurostat, ING

Fact 3: Corporates have shifted from banks to bonds

But what about the solid growth in corporate bond issuance and private credit? To start with bonds: the ECB's monetary policy has certainly provided a boost. Since 2015 we've seen an increasing share of corporate funding coming from bonds (see graph). Over the last 12 months, net growth in outstanding bonds has picked up to about 3.5% per year, just above bank loan growth (at 2.9%). Such an increase may well feel significant, but it still falls short of GDP growth. Issuance may be at record levels and debt capital markets are experiencing a strong surge, but that's also because previous issuance peaks lead to refinancing needs now, while some maturing bank loans may also be supportive.

European corporates increasingly finance themselves via bonds

Ratio of Euro area non-financial corporate's outstanding bonds to the total of outstanding bank loans plus bonds



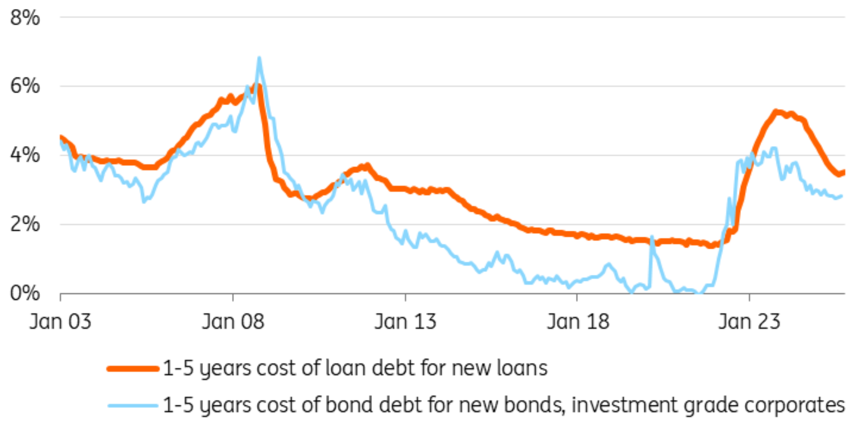
Source: Bloomberg, ECB, ING

In Europe, private credit remains marginal compared to other forms of debt. Estimates vary, but the IMF puts it at 1.6% of corporate credit in 2023. For comparison, the share in the US was 7% at that time. According to the ECB and PitchBook Data Inc., private credit funds domiciled in the euro area held total assets of €106 billion (versus €1.2 trillion in the US) in the second quarter of 2024, which is about 1.5% of outstanding loans and bonds combined. Given the limited size, we do not view a surge in private credit as a significant development for European corporates.

For European corporates, the most significant development has been the switch from banks to bonds. The relative pricing of bank loans versus other forms of funding helps to explain this trend (see graph). Regulatory changes since the Global Financial Crisis have influenced the cost differential between loans and bonds, as have the European Central Bank's corporate asset purchase programmes. We expect disintermediation of corporate credit to continue.

The cost of financing via bonds has come down relative to bank loans

Yield on investment grade corporate bonds (average of all outstanding at 1-5 years maturity) and cost of borrowing from banks, new business for 1-5 years maturity



Source: IHS Markit, ECB, ING

Fact 4: Debt service costs are manageable

To judge the financial sustainability of these loans, we should also look at the debt service ratio. Different measures paint a slightly different picture. The BIS uses the interest payments plus amortisations to income ratio, which stands below the eurozone's average level seen over the last two decades. In the US, the share of income used to service debt for corporates is at one of the lowest points in the last two decades.

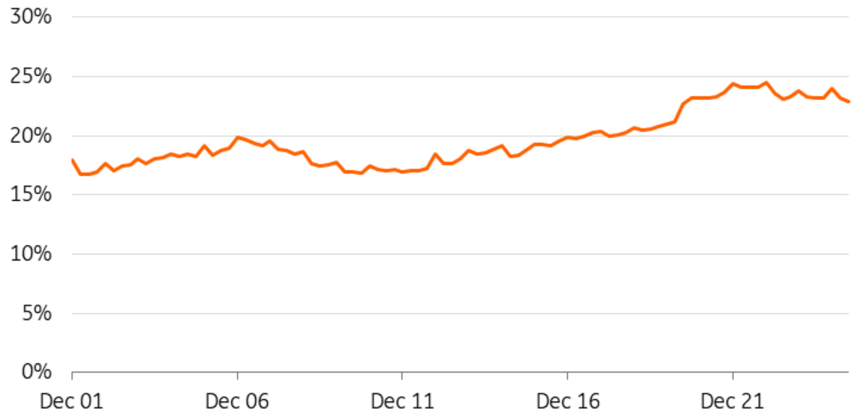
The ECB uses the sum of the interest paid versus net operating surplus and property income. This ratio is currently high compared to 2022, but that year marked a historical low and the ECB shows the ratio stabilising at a level below the 2024 peak. That makes sense, as most bank loans have now been repriced and interest rates for outstanding corporate bank loans have stabilised below their peak, according to ECB data. Rates on bonds outstanding may be creeping up further, as the average duration of bonds is longer than bank credit, and bonds issued in 2015-2022 will be maturing, but we expect that to be a slow process.

Fact 5: Corporate cash levels are high

When thinking about future debt servicing costs, it is important to look at the other side of the balance sheet, too. Part of the increase in debt around Covid went hand in hand with higher cash levels. At European corporates, cash currently amounts to almost 23% of total debt, compared to about 18% in the two decades preceding Covid. It is still attractive to hold on to these cash levels, but should debt or bonds have to be refinanced at higher rates, corporates will likely use some of this cash. If cash-to-debt ratios normalised to 18% (the average for the two decades prior to Covid), debt levels would decline by more than 5%. This also suggests that the corporate credit-to-GDP ratio is overstated by more than five percentage points compared to historical norms, serving as an important mitigant against higher interest costs on maturing bonds.

European corporates still hold high levels of cash

Closing balance sheet positions of Euro area corporates, ratio of stocks of currency and deposits to debt securities and loans, current prices



Source: ECB

Fact 6: No signs of debt-fuelled growth

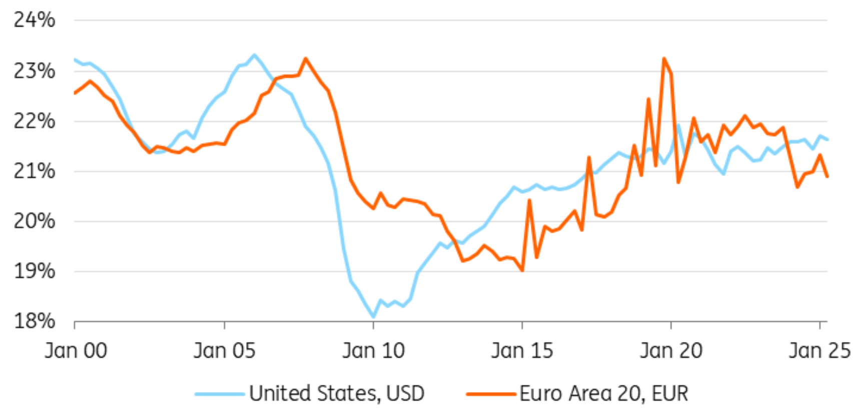
Over the last couple of years, low corporate borrowing by European corporates has gone hand in hand with limited investment. Nominal investment growth has been lower than nominal GDP growth since 2023 (see graph). Prior to Covid, corporate investments did pick up relative to GDP from historically low levels. The growth was not funded via a relative pickup in debt, as the ratio of corporate debt to GDP broadly stabilised over that period. Corporate investments were funded out of cash flows. Recently, the ratio came down strongly, reflecting uncertainty as well as a sudden surge in financing costs.

A brief sidestep to the US. We've noticed before that the same can be said about US big tech investments in data centres. For the most part, these investments have been funded by very strong operational cash flows. The US investment to GDP ratio has only picked up marginally over the last six years. Before that, it was also recovering from very low post-GFC levels.

Comparing with previous bubbles: Neither the US nor Europe currently show investment-to-GDP ratios anywhere near the levels seen before the dotcom bust or the Global Financial Crisis. Back then, surging investment was accompanied by a very strong surge in corporate borrowing. This suggests it is unlikely we will need to see a reversal of unhealthy corporate investment levels. This is especially true for Europe, where the risk of investors suddenly pulling the plug on corporate funding appears low. In fact, for Europe, a pickup in corporate investment and borrowing from current levels would be a positive sign.

Corporate capital expenditure is low versus GDP in Europe

Gross fixed capital formation to GDP in current prices



Source: OECD, ING

Rising European corporate debt levels would be a good thing

Inflation has eroded the real value of eurozone corporate debt, and corporates also hold substantial cash reserves. We do not view European corporate debt levels as a major concern. Even if US private credit issues spill over, solid European fundamentals should limit any potential credit crunch and prevent a long period of deleveraging.

Looking ahead, we expect an increase in corporate borrowing to fund capital expenditure. There are multiple drivers for this: the delayed impact of monetary easing, supportive government spending, and easing of uncertainties such as high energy prices and trade tensions. While debt always carries risk, a pickup in borrowing during 2026 would be a positive sign for Europe.

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