



# Economic outlook: Negative expectations

Atradius Economic Research  
Group Risk Management  
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*All views expressed here are those of Atradius Economic Research and represent ongoing research into the determinants of corporate insolvency and the impact of the economic cycle within Atradius. The views do not represent an expression of intent and should not be seen as investment advice.*

# Executive summary

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- n Economic conditions have deteriorated considerably since September.** While the previous baseline scenario was one of a sharp slowdown in economic activity, the current outlook now points towards contraction across a number of major markets – i.e. negative growth.
- n The failure of Lehman Brothers in mid-September launched a wave of panic, leading to a serious crunch in credit markets.** A large number of financial institutions have failed and unprecedented bank bail-out plans by governments in both the US and Europe to escape a full-scale systemic crisis have been implemented.
- n Stock markets plunged across all regions in response to fire-sales of assets and expectations of a steep global recession.** Credit spreads have continued to trail higher, further increasing the cost of credit to households and firms.
- n Prices of oil and other commodities have decreased by approximately 50 % since July.**
- n The impact on real economic activity is now clearly visible.** Economic activity has slowed considerably and unemployment is picking up. Financing difficulties and a sharp drop in demand are taking their toll in terms of corporate failures.
- n The current expectations of falling growth translates into a significantly worsened insolvency environment for the entire global corporate pool.** Insolvencies are predicted to increase steeply across major markets in 2009. Emerging market risk has risen considerably across all regions. The collapse of the Icelandic banking sector has exposed vulnerabilities in various other banking systems, in particular across Eastern European and Commonwealth of Independent States (CIS) countries.

# One step further on a downward path.

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## ECONOMIC INDICATORS

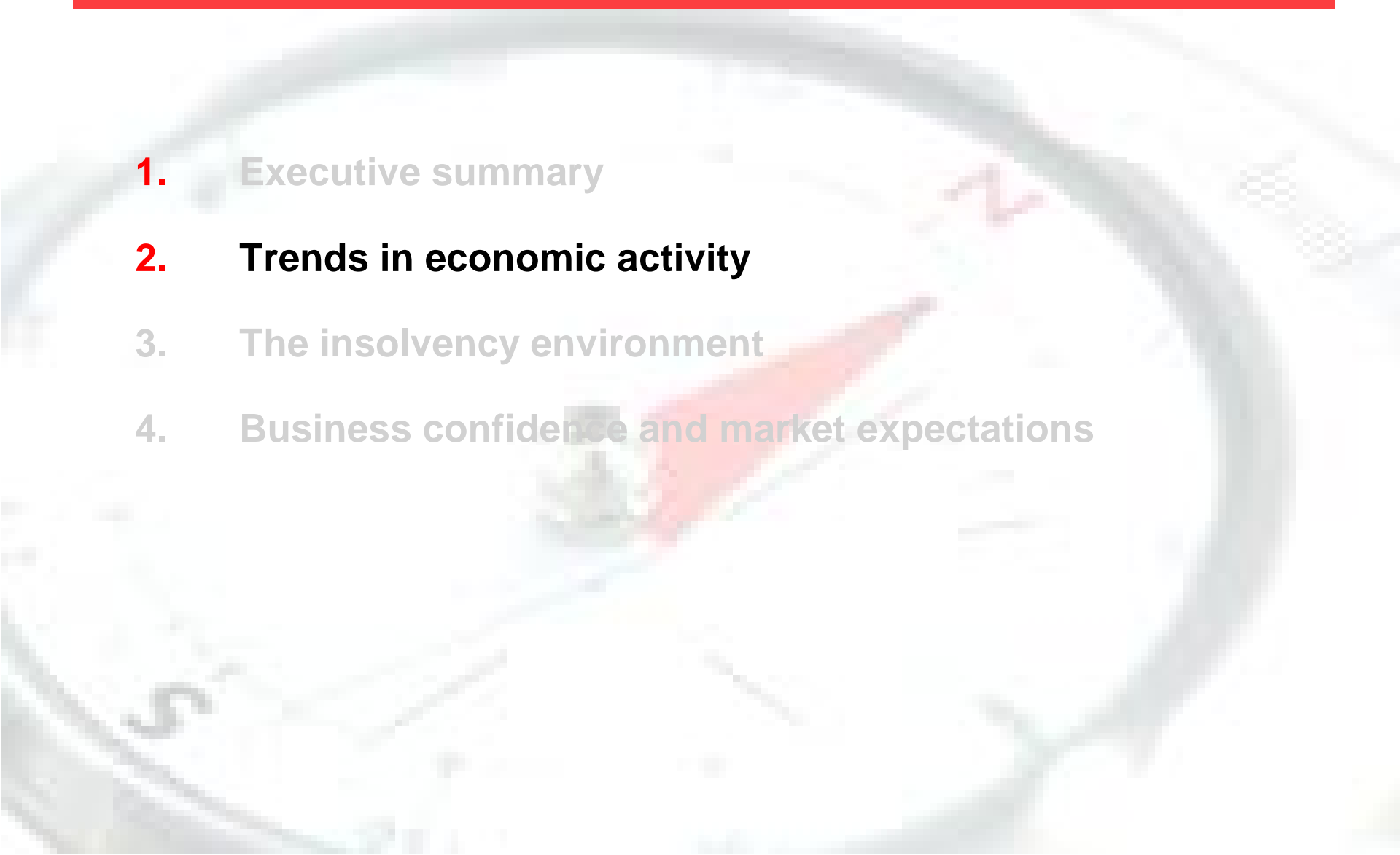
- n The business cycle has turned sharply:** GDP growth has deteriorated across all major markets in 2008, plunging the UK, Euro area and the USA into recession.
- n Consumption is under pressure:** Moderating income expectations and house price declines reduce consumers' spending appetites. The spectre of rising unemployment across major markets increases income uncertainty.
- n Financing for non-financial firms has become increasingly difficult:** Bank lending criteria have been tightened and financial intermediation is hampered by elevated uncertainty.

## CREDIT QUALITY

- n The credit cycle has turned:** Insolvency counts are rising both in the US and in Europe.
- n Credit quality is deteriorating on a broad scale:** Corporate credit ratings demonstrate a negative bias. The number of insolvencies among large rated companies has also increased throughout 2008.

## EXPECTATIONS

- n Expectations have diminished and confidence has declined:** Business and consumer surveys express increasingly negative sentiment, consistent with previous instances of recession.
- n Asset prices have fallen:** Equity prices, which may be taken as a proxy for future revenue and profit expectations, have fallen back sharply.
- n Model-based default indicators suggest accelerating default risk:** Expected Default Frequencies imply increased default risk across all markets and all industry sectors.

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# World economic activity to experience a severe slowdown...

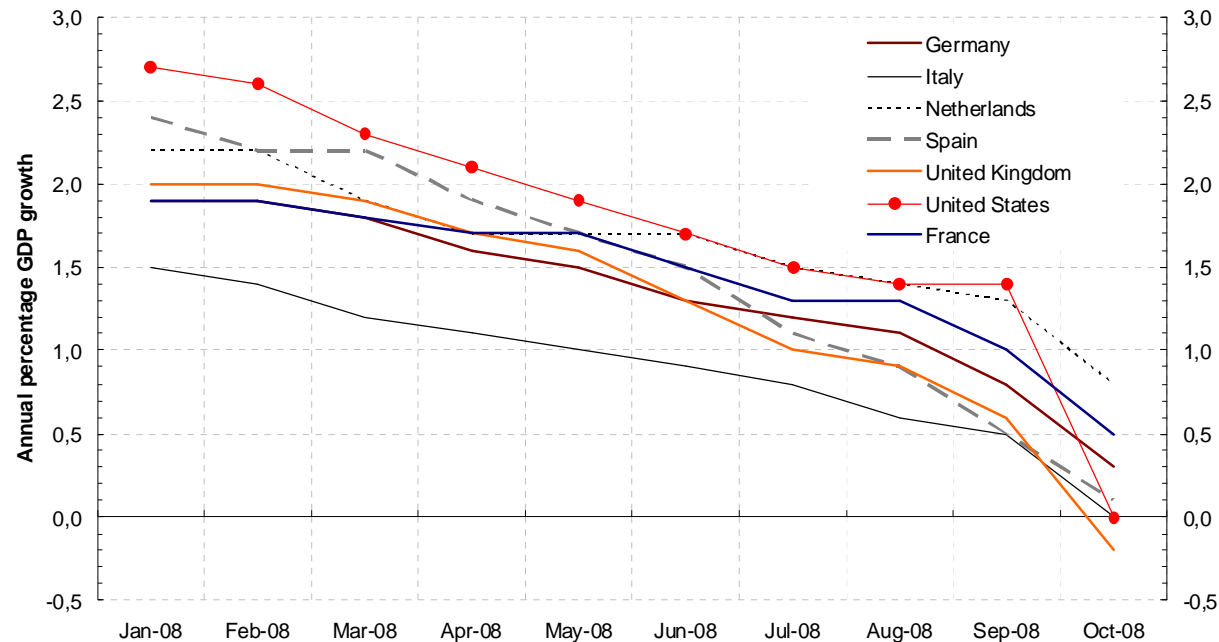
	Consensus Forecast October 2008 Survey	Real GDP % Growth				2008 Trend	2008 M-o-M forecast revision
		2006	2007	2008	2009		
<b>Major Markets</b>	France	2.2	2.1	0.9	0.5	↓	↓
	Germany	2.9	2.5	1.7	0.3	↓	↓
	Italy	1.9	1.4	0.0	0.0	↓	↓
	Netherlands	3.0	3.5	2.1	0.8	↓	↓
	Spain	3.9	3.7	1.3	0.1	↓	↓
	United Kingdom	2.8	3.0	1.1	-0.2	↓	↓
	United States	2.9	2.0	1.4	0.0	↓	↓
<b>Major Regions</b>	Western Europe	2.9	2.8	1.3	0.4	↓	↓
	Eastern Europe	6.8	7.0	6.0	5.4	↓	→
	Euro zone	2.9	2.6	1.2	0.5	↓	↓
	Asia Pacific	5.6	6.2	4.6	4.1	↓	↓
	Latin America	5.3	5.5	4.4	3.6	↓	→
	World	4.0	3.9	2.7	1.9	↓	↓

Sources: Consensus Forecasts (Survey date 13 October); Atradius Economic Research.

- n Having three quarters of GDP at hand for this year, forecasts for 2008 start to stabilise. From these figures it is clear that economic activity has slowed across all major regions compared to last year. In some markets the slowdown has been very sharp (e.g. Spain and the UK).
- n Following the failure of Lehman Bros, expectations have been severely revised downwards. Forecasts suggest that economic growth will be close to zero, or negative, across major markets in 2009.

## ...and we are likely to see GDP growth forecasts fall further.

Consensus GDP growth forecasts for 2009

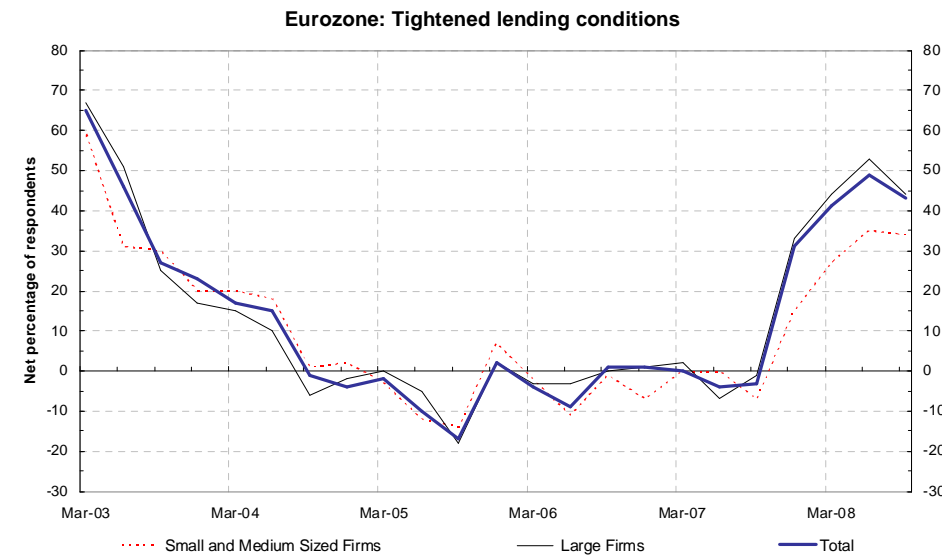
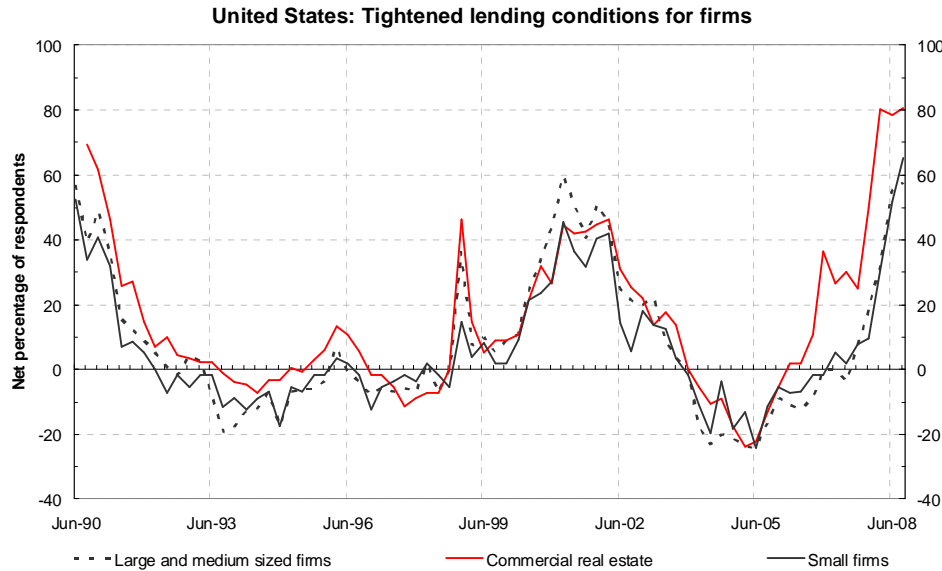


Sources: Consensus Forecasts; Atradius Economic Research.

Note: Consensus GDP-growth forecasts for 2009 from 10 consecutive surveys (between January and October 2008).

- n Throughout 2008, growth forecasts for 2009 have been adjusted downwards. In January 2008, the consensus expectation for annual US growth in 2009 was 2.7 percent. By September 2008, this figure had been revised down to 1.4 percent.
- n After the September survey was conducted, and the credit crunch that followed, the outlook for growth deteriorated dramatically. In October, the consensus expectation for US growth in 2009 was reduced to 0%. In the case of the UK, growth is now expected to be negative in 2009.
- n Given the most recent revisions from major forecasters (e.g. the IMF), further downward movements are to be expected. Several major markets, including the UK, now face the prospect of contraction in 2009.

# Credit conditions are alarmingly tight in the current climate...

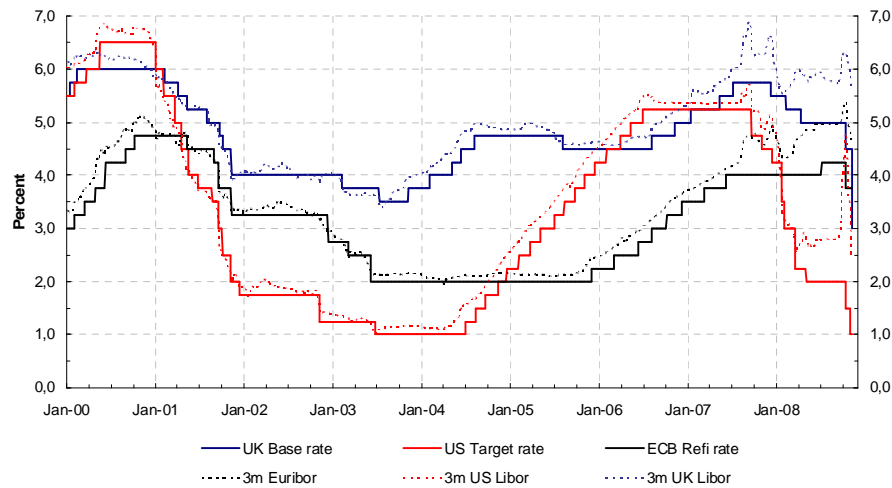
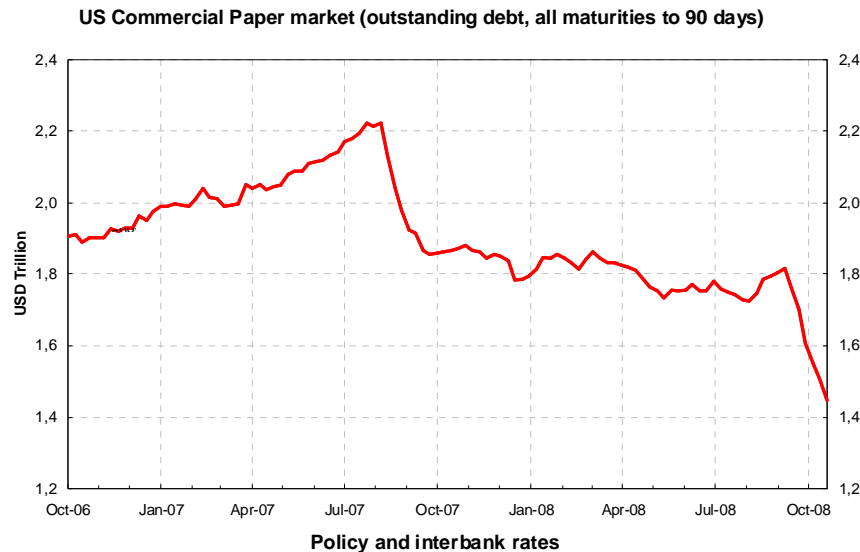


- n The corporate sector faces tighter credit conditions as evident from bank lending surveys.
- n The marginal effect appears to have been roughly the same for large firms and SMEs. In the US, lending standards for commercial real estate have tightened even more forcefully.
- n The Eurozone, the UK and the US are facing similarly tight credit conditions. The time series for the UK is too short to be conclusive, yet displays a clear negative trend.
- n The tightening process in the Eurozone has been in evidence for a shorter period, and has been less forceful than that of the US. In Q3 there was even a tendency towards moderation.
- n Given the extreme level of uncertainty that prevails concerning the solvency situation of financial institutions and creditworthiness of firms, we can expect the tightening to continue.

Sources: Federal Reserve; European Central Bank; Global Insight; Atradius Economic Research.

Note: The bank lending surveys of credit market conditions based on responses of banks give a view of whether credit market conditions are getting tighter or easier. Tightening credit conditions are reflected by higher positive net percentage in the charts. Last: 2008 Q3.

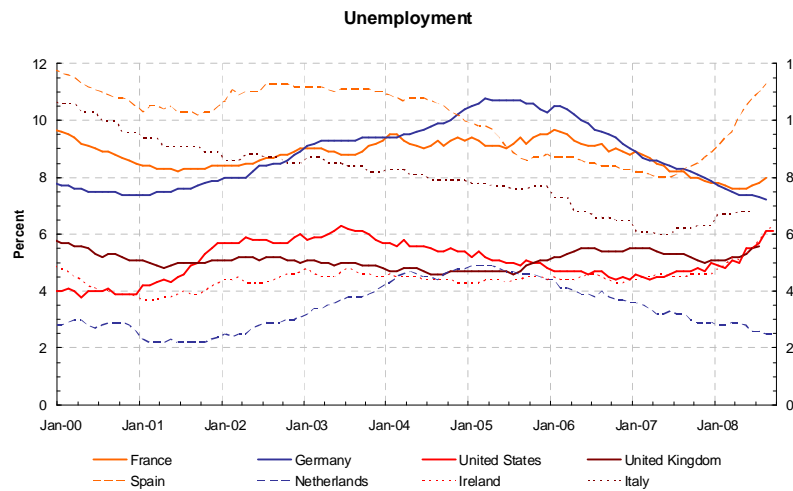
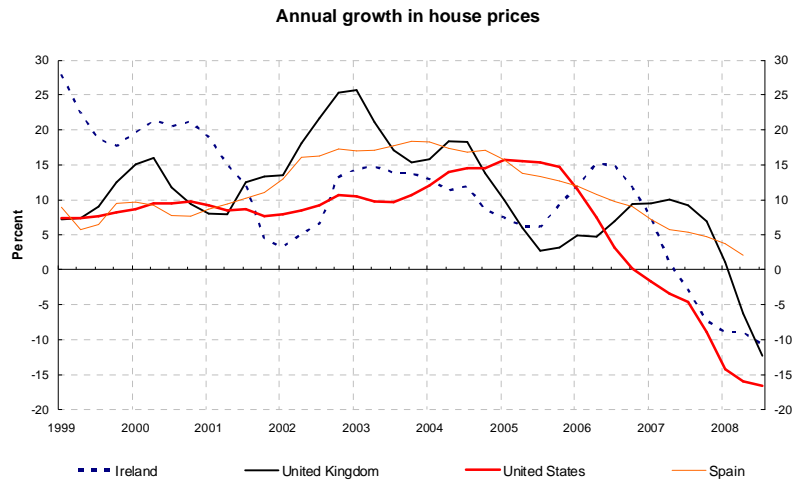
# ...implying that firms are being squeezed on two fronts.



Sources: Global Insight; Atradius Economic Research.

- n The slump in economic activity, as evidenced by a contraction in consumption, falling asset values and slower rates of credit growth affects firms on several fronts.
- n It affects profits through revenues and costs. Revenues fall as households retrench while costs remain downwardly inflexible, at least in the short run. In a global recession, no support can be expected from export markets.
- n It affects firms' ability to raise additional debt and their ability to service their current debt burden. Corporate debt has increased in parallel with household debt in several countries.
- n The inability of large firms to raise liquidity through the commercial paper market and loss of appetite for corporate debt issuance implies that they will also have to seek recourse to more traditional bank finance. This might in turn crowd out financing for smaller firms.
- n Funding costs remain elevated for banks despite aggressive monetary easing. Furthermore, the interest reductions are not passed on one-to-one to firms as the perception of credit risk has changed.
- n Increasing credit risk premiums are putting pressure on the lending rates facing non-financial corporates.

# Consumption is coming under pressure as consumers retrench.



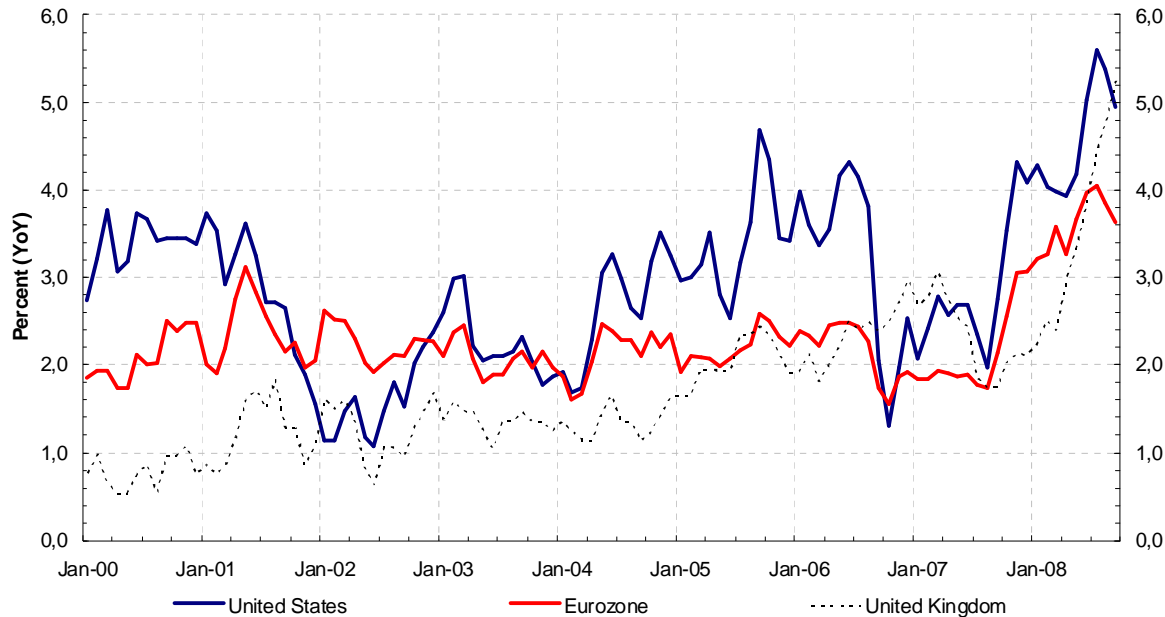
Sources: Global Insight; National Statistical Agencies.

Note: House price developments as described by S&P Schiller-Case (US), Nationwide (UK), Permanent/tsb (IRE) and National average (ESP).

- n Households, in several countries, have been rapidly accumulating debt in recent years. The drivers behind this behaviour – low interest rates, lax credit conditions and boosted income expectations – are now in reverse. Falling collateral values now affect the ability of households to finance consumption through borrowing.
- n In response to a weak economic climate unemployment is increasing. This translates into reduced income expectations which, combined with tighter credit conditions, means eroding purchasing power.
- n Deteriorating mortgage borrower payment capacity is now also evident across Europe. In the US, house prices are still falling after eight quarters of steady decline.
- n There is a similar (albeit lagging) development in Europe. House prices are falling in the UK, Ireland and Denmark. Sharp price deceleration is experienced across virtually all European markets.
- n With consumption falling, the revenue growth of firms is under threat. Firms’ adjustments to a weaker environment will continue to fuel unemployment, leading to further contraction.

# Price inflation is still running high but shows signs of moderation...

Inflation is high above targets



Sources: Global Insight; Atradius Economic Research.

Note: The inflation targets in the Eurozone, the United Kingdom and the United States are defined as to keep inflation close to 2 percent or slightly above.

- n Inflation accelerated in several markets during 2008, driven by sharp increases in the cost of oil and other commodities. Some moderation has occurred in recent months but inflation is still above targets.
- n High input costs have been putting pressure on producer margins. The ability of producers and retailers to further raise prices and protect margins is constrained by the nascent slowdown in consumer demand.
- n Consumer disposable income is still strained by the rise in the cost of essentials such as food and energy. The current fall in prices will take a few quarters to feed through.
- n However, as it does, inflation will fall sharply. Inflation expectations are also coming down and this has given room for monetary policy easing.

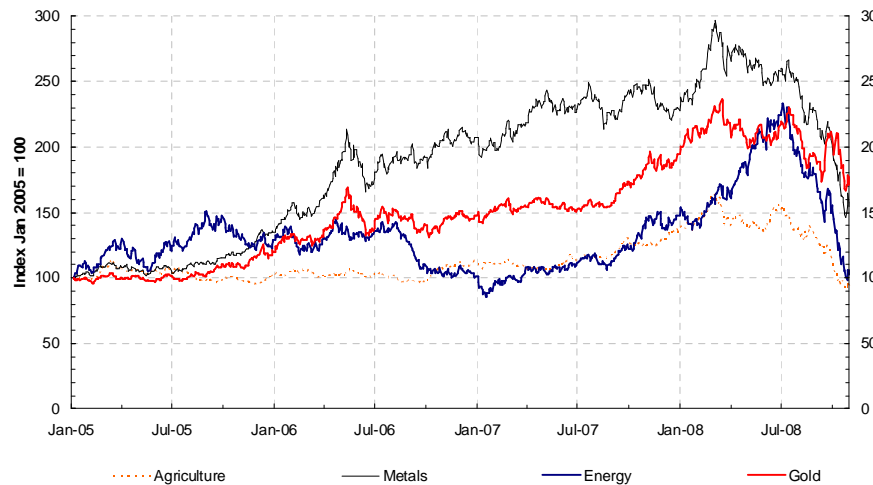
# ...as the price of oil and other commodities continues to plummet.

Oil and broad commodity price developments



- n The dramatic increase in the price of oil and other commodities that started at the beginning of 2007 came to a halt in July this year.
- n After reaching a peak of more than 140 USD per barrel in July, the price of oil has fallen back to a level of around 60 USD per barrel (and declining).
- n The prices of other commodities, e.g. metals, have witnessed similar price developments. Prices have fallen more than 50% over the last few months.

Commodity price developments

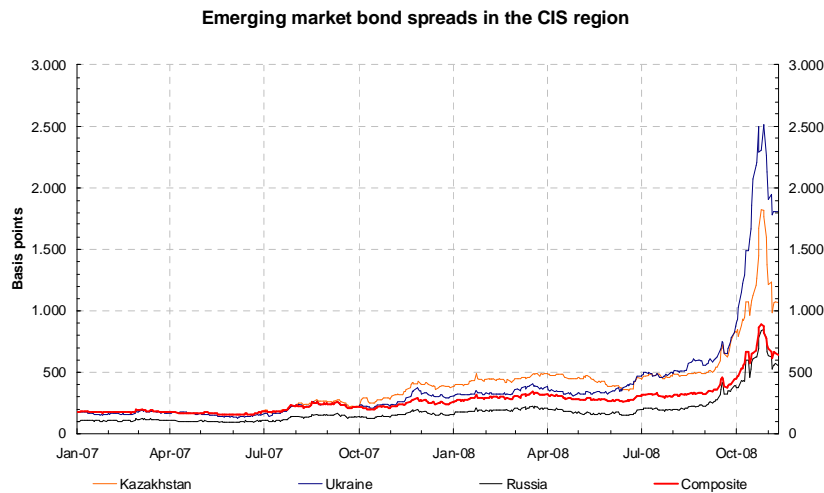


- n The recent strength of the USD against other major currencies is one factor behind these developments (since the commodities generally are priced in USD), but it also reflects the general slowdown in economic activity.
- n While reducing inflationary pressures across markets (easing price pressures in the energy and food segments), such abrupt developments create other vulnerabilities (e.g. among commodity producing emerging markets and firms).

Sources: Global Insight; Euronext; Atradius Economic Research.

Note: Rogers International Commodity Indices (World).

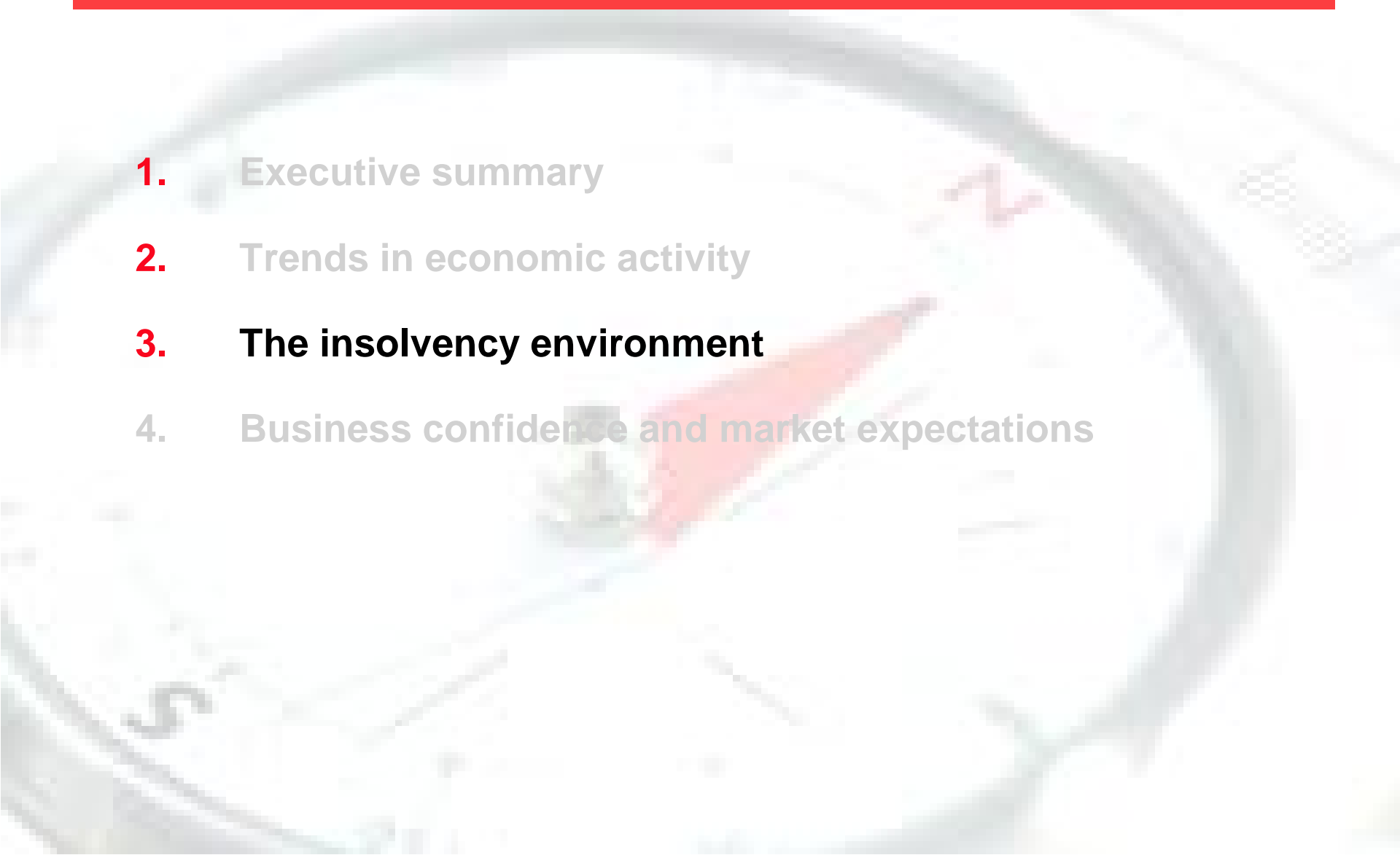
# These conditions have global implications.



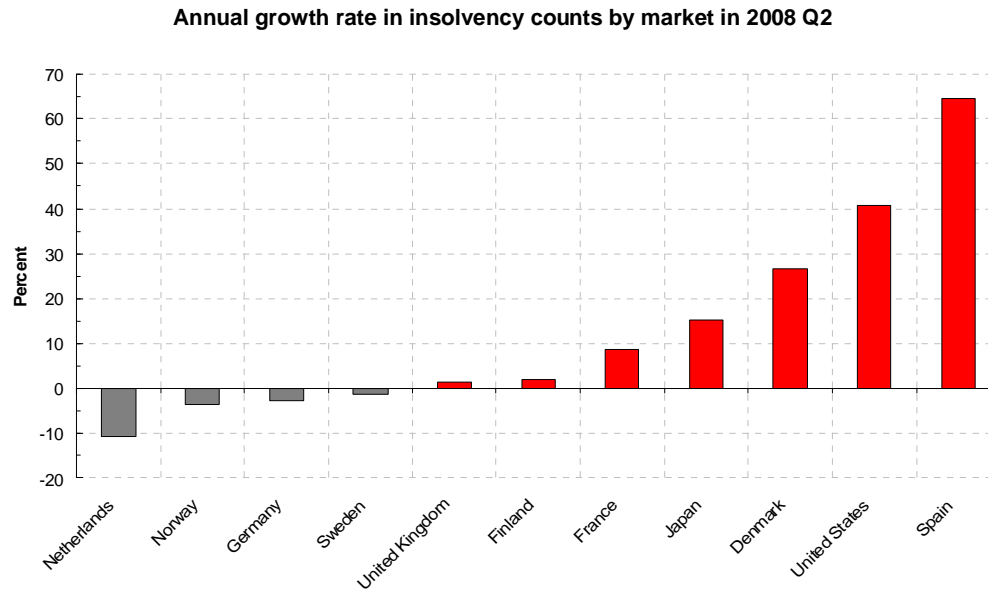
- n There are a number of emerging markets facing very testing times ahead, particularly in Eastern Europe.
- n This is reflected in a broad-based increase in emerging market bond spreads. The weaker the country fundamentals, as reflected in sovereign ratings, the sharper the increase in risk level.
- n Many countries have experienced excessive credit creation over the past few years, relying on international bank linkages to make domestic loans. These countries now face severe macroeconomic adjustment.
- n Commodity exporting countries (e.g. the CIS) are adversely affected by the sudden drop in commodity prices. This situation further accelerates net outflows of capital.
- n A sudden outflow of capital, speculative pressure, collapse of the banking system (even in the presence of state-sponsored and/or international bailouts) will lead to a significant increase in corporate defaults.

Sources: Global Insight; JP Morgan; Atradius Economic Research.

Note: Emerging market bond indices (EMBI) track total returns (or yields) on foreign currency denominated bonds issued by sovereign governments. They are graphed here as the yield spread over US treasury bonds. Only sufficiently liquid bonds are included in the indices. Daily observations (last: 11 November 2008).

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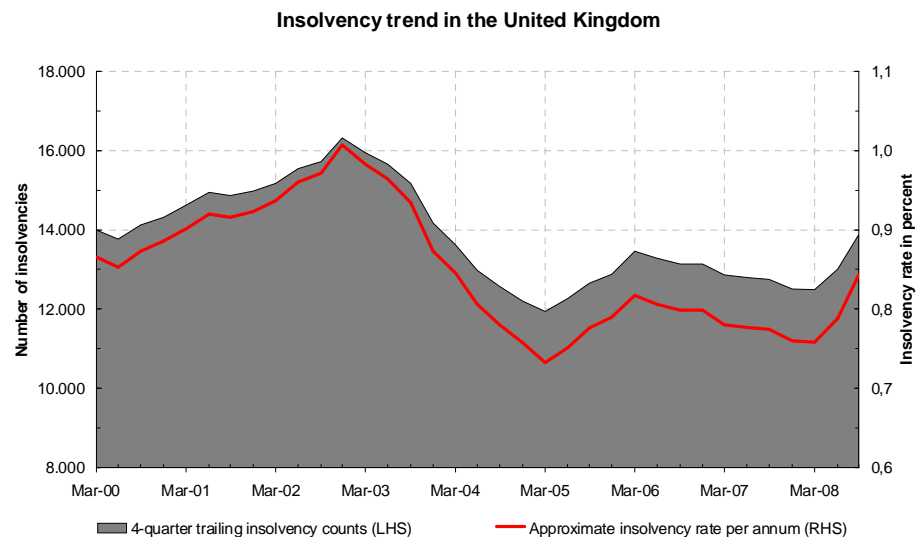
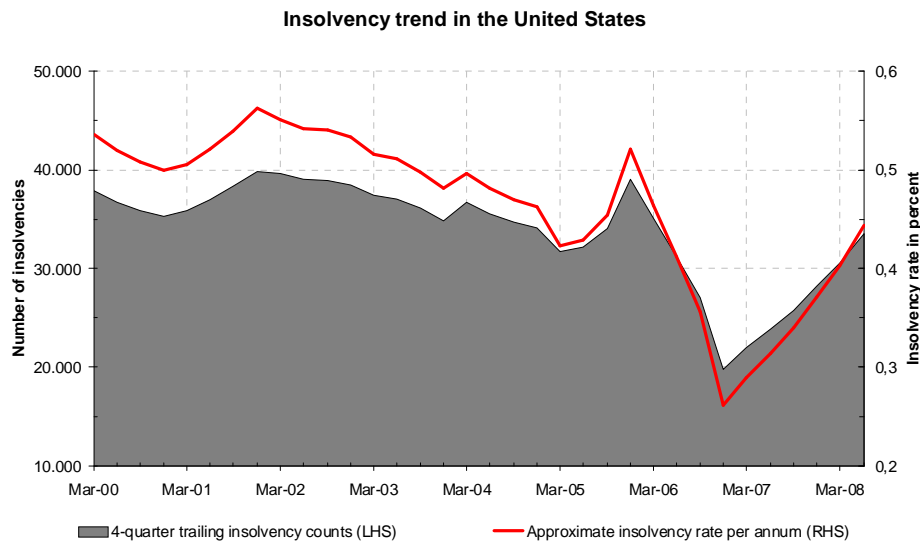
# A widespread deterioration in the insolvency environment.



Sources: Global Insight; Atradius Economic Research.

- n In response to the macroeconomic environment, insolvency counts across several of our major markets have started to rise. This observed rise in insolvencies is expected to accelerate in 2009.
- n A snapshot of the insolvency environment across markets shows a widespread deterioration, but still with some heterogeneity. The negative trend going into 2009 is consistent with increasingly negative macroeconomic and financial market expectations.
- n Both Germany and The Netherlands have displayed more benign insolvency trends until recently. The same goes for Norway and Sweden. More recent evidence, however, suggest that these markets will record increasing insolvency growth in the second half of 2008.
- n The UK, Finland, France, Japan, Denmark, the US and Spain already display a rise in insolvencies. Given negative GDP growth expectations, insolvency growth in these countries is expected to gain speed.

# Actual insolvencies are on the rise in the US and the UK...

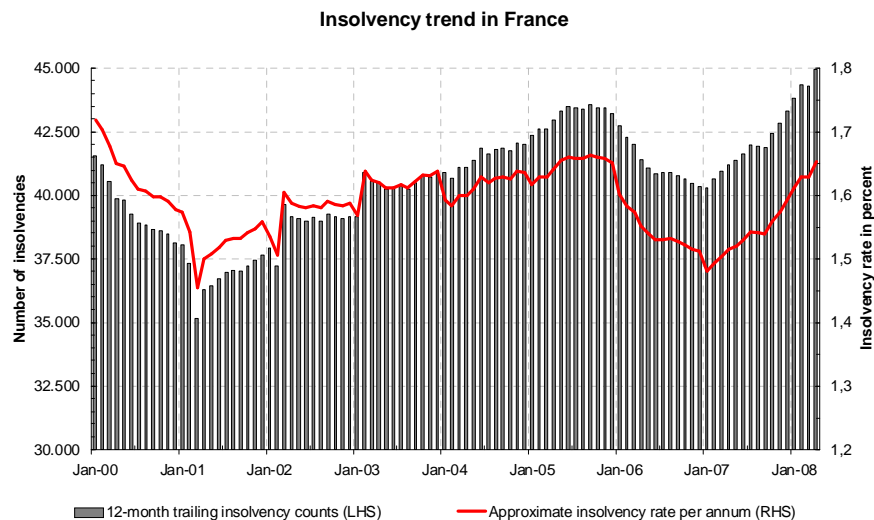
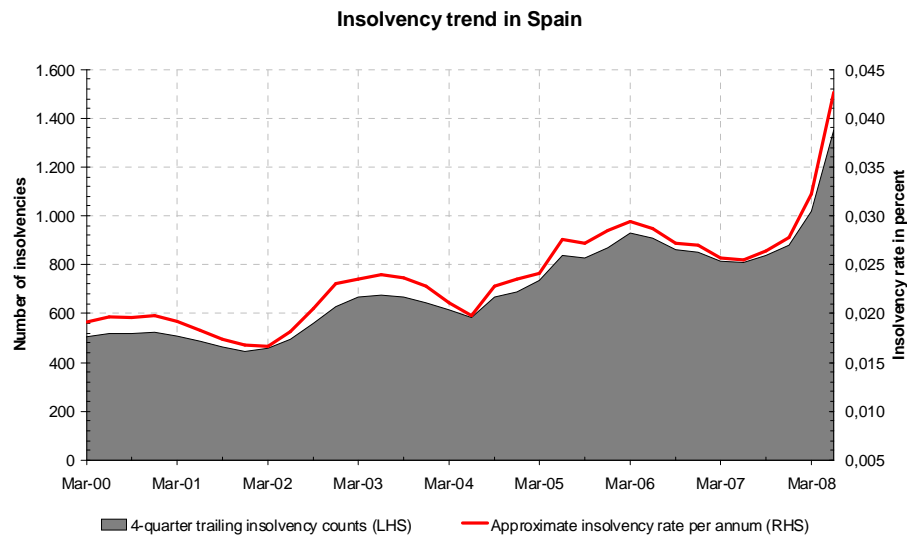


- n Deteriorating economic conditions are demonstrated by a definite rising insolvency trend. Since Q3 2006 firm insolvencies have been rising sharply in the US.
- n Given the steepness of insolvency growth in the first half of 2008 we are likely to see the number of US insolvencies breach the 40,000 mark by the end of the year, bringing the insolvency rate back above 0.5%.
- n The picture is consistent with the view of deteriorating credit quality offered by other measures (e.g. agency corporate ratings and tightening credit conditions).
- n The UK has also experienced a steep upturn in insolvencies since the beginning of 2008, reaching 14,000 in annualised terms in Q3 2008.
- n Given the current negative outlook for these countries in 2009, we expect this steep increase in quarterly insolvencies to continue.

Sources: Global Insight; Atradius Economic Research.

Note: Implied default rates calculated from known universe of companies operating in the respective markets. A change in bankruptcy legislation in the US 2005/2006 ensured a fairly steep decline initially in the number of recorded bankruptcy filings.

## ...as well as in the Eurozone...

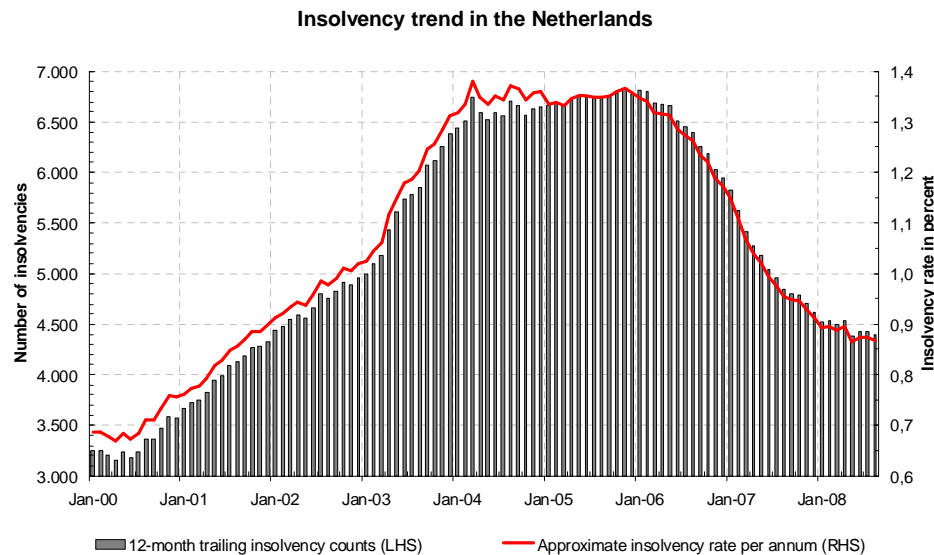
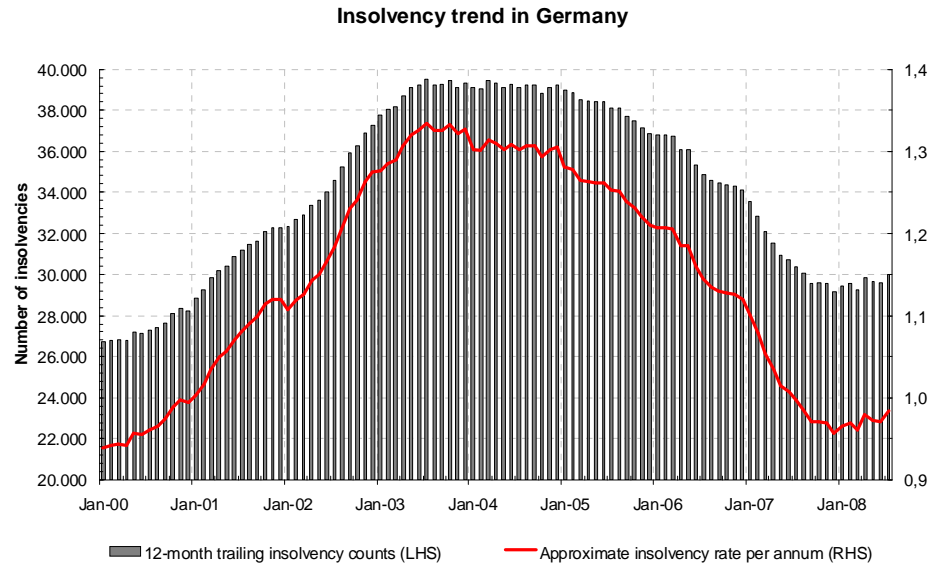


- n Based on data to the end of the second quarter, insolvency rates in Eurozone are also beginning to pick up.
- n The number of insolvencies has increased dramatically in Spain since Q4 2007. This is consistent with the poor performance of the Spanish economy and evidence of deteriorating payment capacity.
- n Spain represents a special case in terms of insolvency legislation. As a result, the implied default rate is just a few basis points. However, the credit quality of Spanish firms has deteriorated steeply.
- n Similarly, the number of insolvencies has picked up sharply in France. The increase has been most evident amongst construction companies, retailers and business services.
- n France is traditionally regarded as a high insolvency market, with a default rate of roughly 1.6%. The number of insolvencies reached 45,000 in Q2 2008.

*Sources: Global Insight; Atradius Economic Research.*

*Note: Implied default rates calculated from known universe of companies operating in the respective markets. Local definitions of insolvency are likely to vary across markets, why direct cross-comparisons between countries should be avoided.*

## ...even if there are differences across member countries.

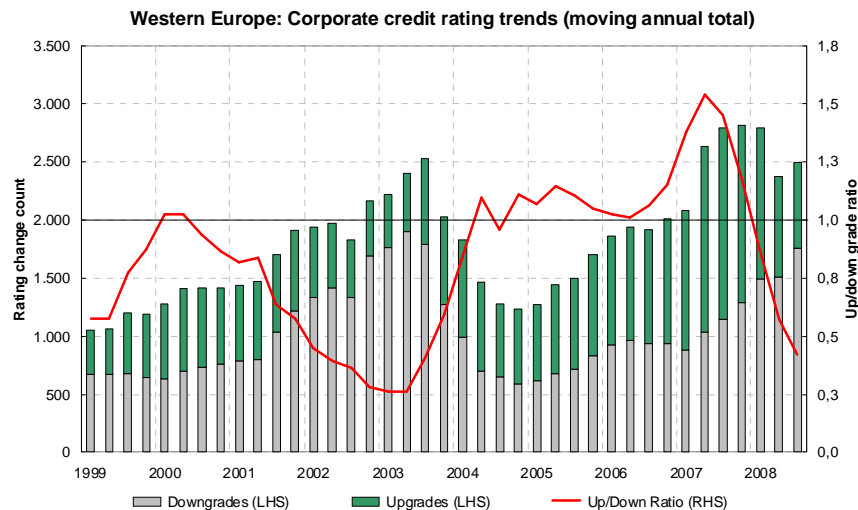
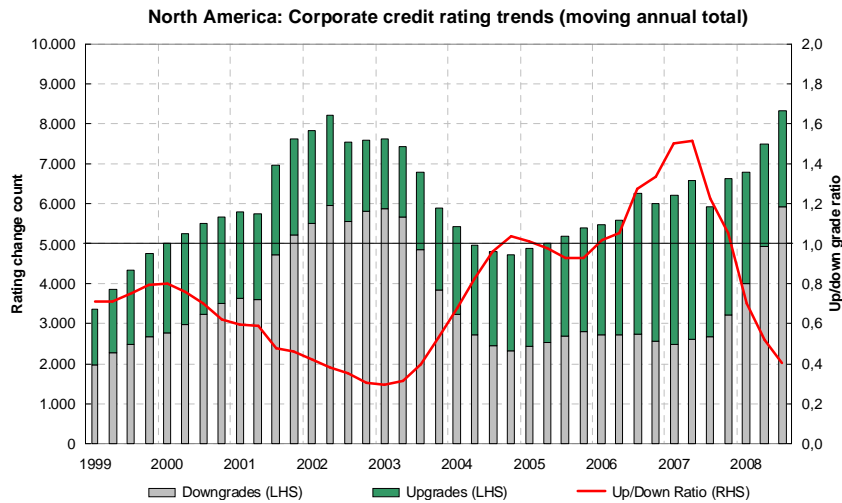


- n Other markets are displaying signs of a turn in the cycle.
- n In Germany there is a tendency towards increasing insolvencies after years steady decline in quarterly filings.
- n The German insolvency rate climbed above 1.3% in 2003 in response to weak economic performance. In early 2008 the rate bottomed out at just under 1% and is now trailing upwards again.
- n A similar change in the trend can be observed in The Netherlands.
- n Despite observed heterogeneity in insolvency trends, there is now evidence of a shift towards increasing insolvency rates across all major markets.

Sources: Global Insight; Atradius Economic Research.

Note: Implied default rates calculated from known universe of companies operating in the respective markets. Local definitions of insolvency are likely to vary across markets, why direct cross-comparisons between countries should be avoided.

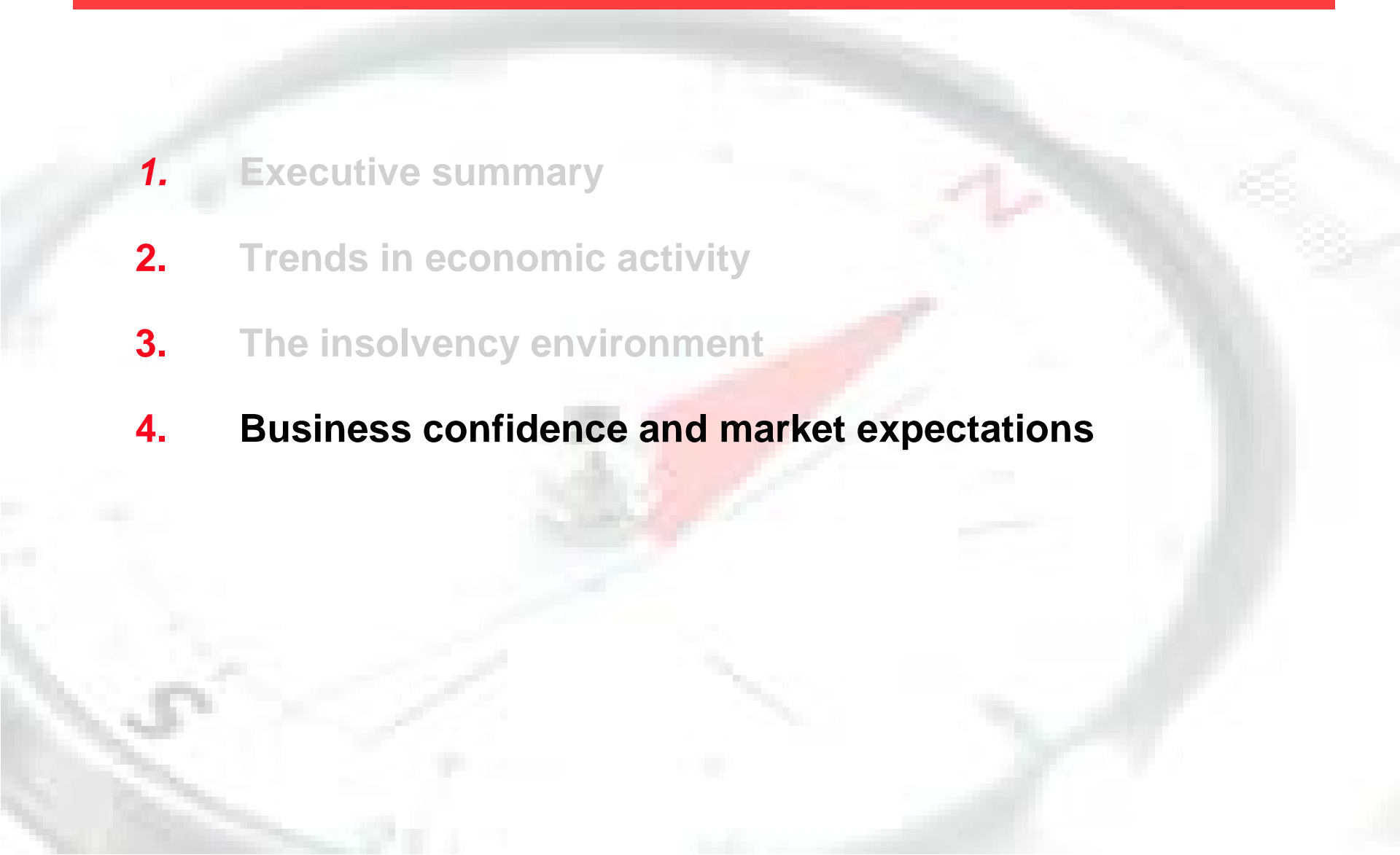
# A further deterioration in credit quality is expected.



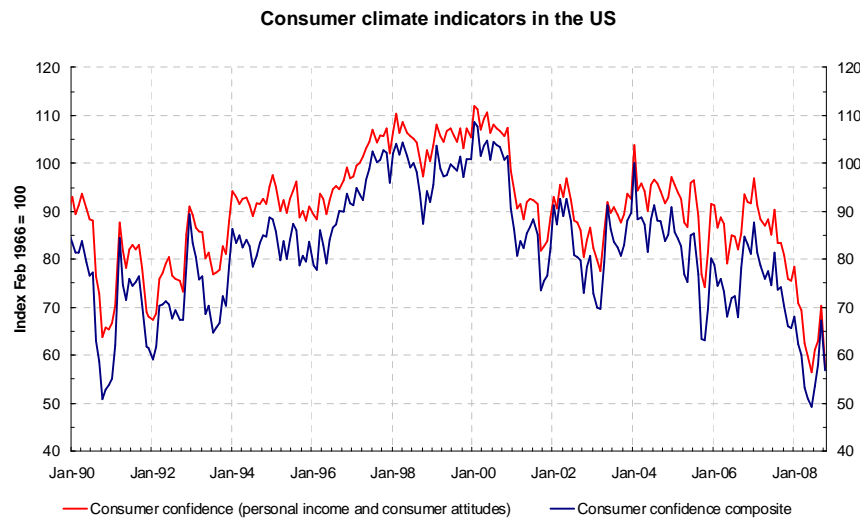
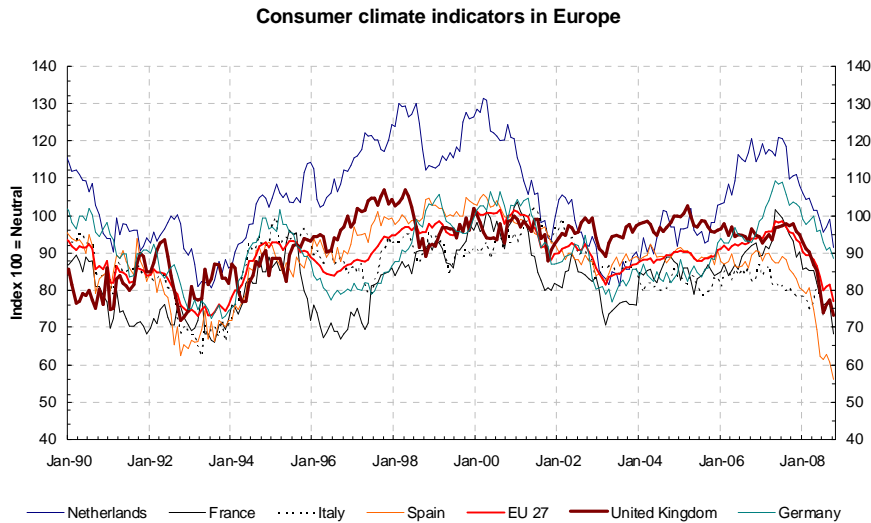
- n The activities of rating agencies illustrate the general deterioration in credit quality that has taken place over the last quarters.
- n The upgrade/downgrade ratio has now fallen well below 1, but the turning point in the cycle emerged already in Q1 2007.
- n Rating downgrades are now outstripping upgrades both in Western Europe and the US by a ratio of 2 to 1.
- n The default environment amongst the rated universe of firms has been very benign since 2004, consistent with previously strong economic growth. The default rate in 2007 within one of the rated agency pools was under 0.4%.
- n Experience from previous downturns gives perspective in terms where we could go. The credit cycle has turned sharply in 2008 and we are heading for a recessionary environment last seen in the early 1990s. At that time the global default rate reached 3-4%.

Sources: Standard and Poor's; Moody's; Fitch Ratings; Bloomberg; Atradius Economic Research.

Note: Tracking the activities of rating agencies gives a good indication of the general direction in which credit quality is moving. The upgrade and downgrade actions of Moody's, S&P and Fitch are counted, and a ratio of the two calculated.

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# Negative expectations dominate the view of the future.

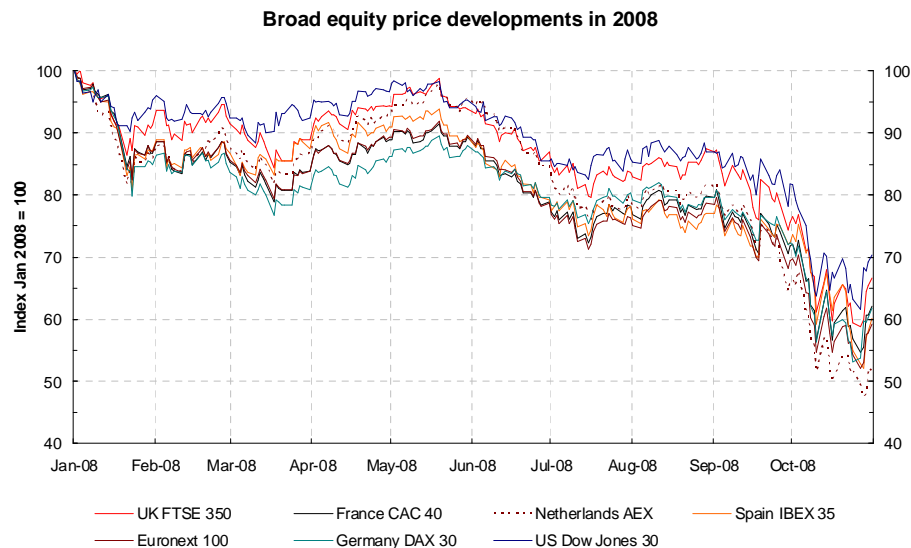
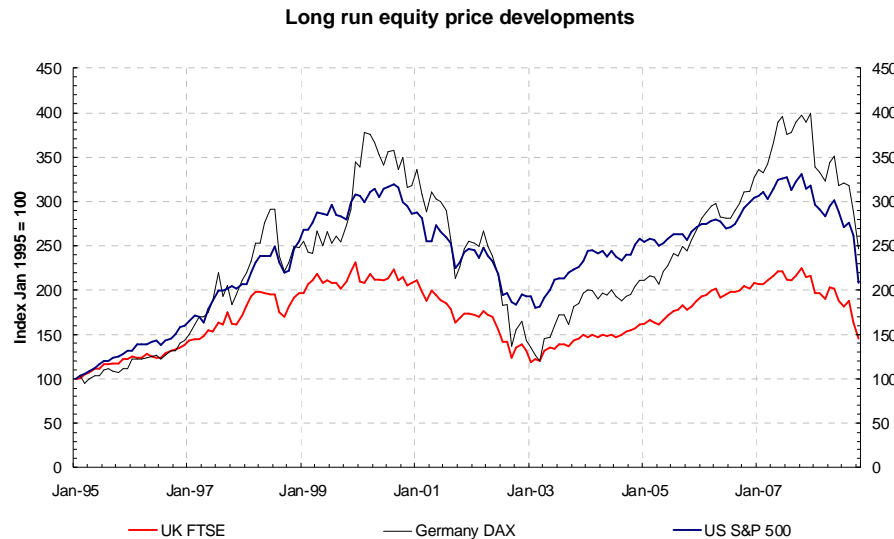


- n Expectations for a slowdown are anchored by the increasingly pessimistic outlook of consumers with regard to their own financial situation and spending intentions.
- n The development of consumer expectations across European markets suggests a steep decline in confidence since the start of the year.
- n In Spain, which has seen one of the largest slowdowns in economic activity, confidence has dropped to an all-time low. Generally, the level of confidence is comparable to previous episodes of very weak economic conditions.
- n The closely watched Michigan index which tracks consumer confidence in the US has also suffered sharp declines in recent months, hitting a 28-year low in June. Despite some recovery over past months, the level of confidence still hovers at very low levels.

Sources: Global Insight; DGECEFIN; The Conference Board; Atradius Economic Research.

Note: In the ICON-Konsumbarometer a value above 100 indicates an optimism surplus among the respondents.

# Asset market corrections reflect increased downside risks...

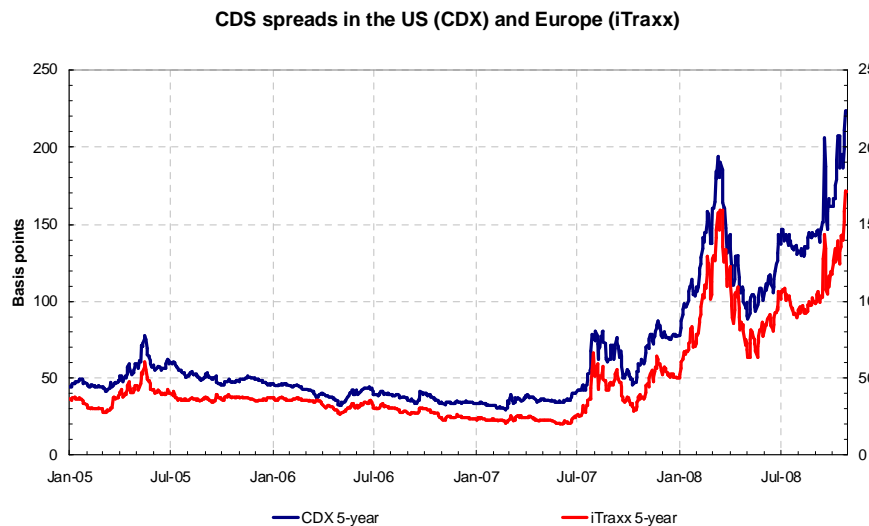
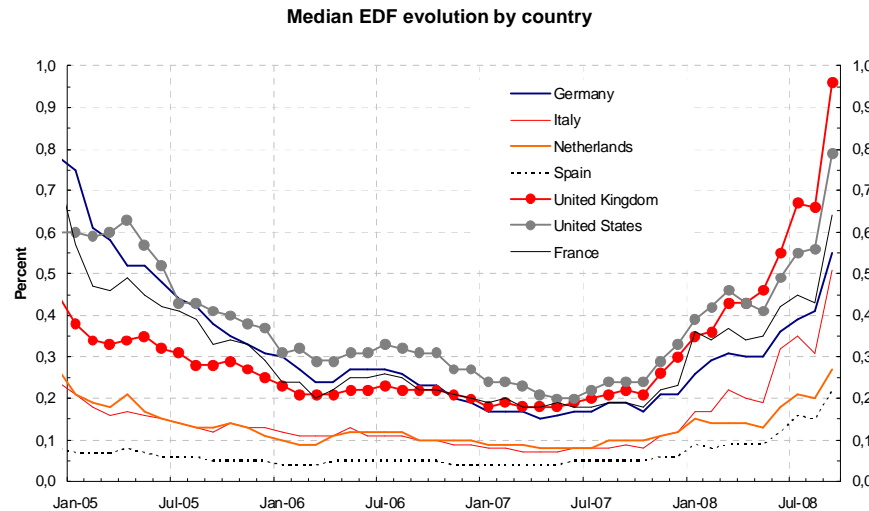


- n Diminishing expectations for the profitability of firms, as revealed by their equity market valuation, have been visible across all markets.
- n Decreasing stock prices across all markets reflect concerns about the global economic outlook. Fire-sales and financial market panic have also played a part in pushing stock prices down.
- n Since the beginning of 2008, equity markets have declined between 30 to 45 %, with the largest reductions taking place in October.
- n Valuations are now in line with the levels that prevailed in 2004. Given the steepness of the downturn there is scope for further equity declines as earnings estimates continue to be adjusted downwards.
- n The decline in stock prices puts pressure on financial collateral and lowers the valuations of firms' balance sheets. It also erodes the financial wealth of already stretched consumers.

Sources: Global Insight; Atradius Economic Research.

Note: National indices, denominated in national currencies. The number of included firms and the composition of indices differ between countries (e.g. DAX 30, FTSE 100, S&P 500).

# ...manifested in rapidly increasing expectations of insolvencies.

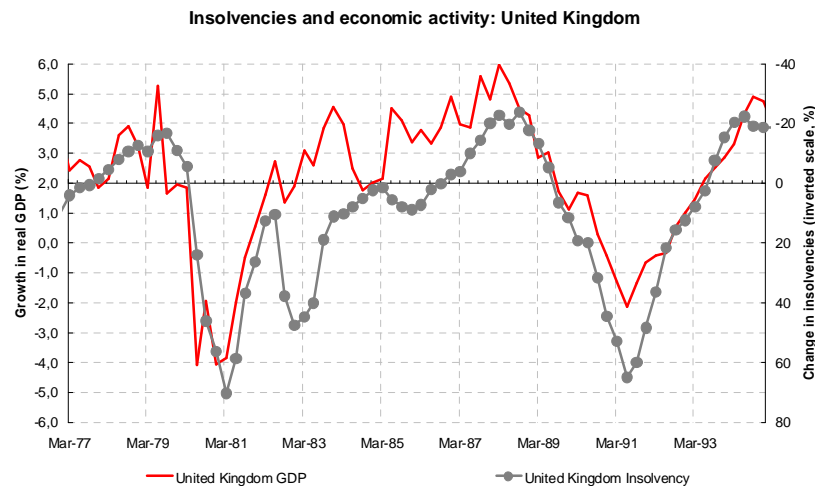
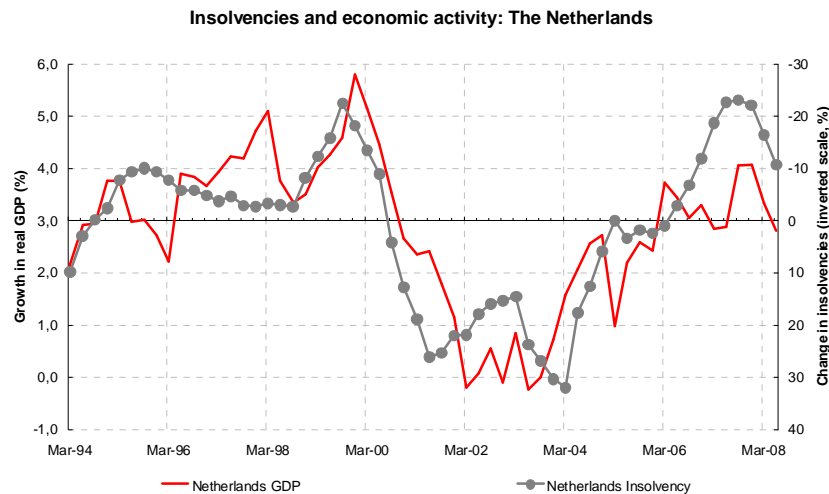


- n Expected Default Frequencies (EDFs) have increased significantly over past months, signalling a sharp turn in the insolvency trend.
- n This deterioration has been evident since mid-2007. EDFs are rapidly approaching the levels that prevailed during the previous downturn in 2001.
- n Taking into account that EDFs reflect the universe of large and listed companies, these trends illustrates the rapidly increasing likelihood that large value credit events will occur. This is also consistent with the negative rating trends described in the previous section.
- n At the same time Credit Default Swaps (CDS) spreads have widened significantly, implying a broad based increase in the perception of default risk (granted that the absence of market liquidity is exacerbating the situation).
- n The re-pricing has been broad based regardless of rating class. The indices in the chart are composed of a selection of liquid CDS instruments for investment grade companies.

Sources: Moody's KMV Credit Monitor; Bloomberg; Atradius Economic Research.

Note: EDF in monthly observations from January 2005 (last: September 2008). The EDF represents a tool for tracking listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year ahead default forecast. The median EDF for a country represents the 50th percentile in the listed firm universe.

# What can we expect? Insolvencies rise quickly during recessions.



- n We know that insolvencies rise as economic growth slows. This pattern is robust across all markets.
- n History provides us with a rough guide to the path of insolvency growth ahead. The following country-specific examples may serve as good illustrations.
- n During the last downturn in the Netherlands in 2003, insolvencies increased some 30% per annum while GDP growth went from roughly 3% to the region of 0%.
- n In times of contraction however, similar to the situation confronting the UK in 2009, insolvency growth tends to be more forceful. Revisiting past episodes of contraction in the UK (in the early 1980s and 1990s, respectively) suggests that insolvency growth can rapidly reach a year-on-year rate of approximately 60%.
- n Similarly, Sweden and Finland experienced several years of accelerating insolvency growth during the deep 1990/93 recession.
- n **These trends put the current macroeconomic outlook into perspective: The deterioration in insolvencies is likely to be both sharp and persistent.**

Sources: Global Insight; Atradius Economic Research.

Note: The insolvency growth has been calculated using 4-quarter trailing insolvency counts. Economic growth rates based on GDP in constant prices (i.e. real GDP growth).



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