



Credit Outlook

2026

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Executive Summary

The **global credit outlook for 2026** is in our view characterised by apparent stability masking growing structural pressures. After two years of aggressive monetary tightening and a gradual easing phase in 2024/25, the global economy enters 2026 in something of a fragile equilibrium, shaped by geopolitical risks, constrained policy space, and rising political influence over economic outcomes.

Global growth is expected to remain broadly stable, but uneven across regions. The resilience in 2025—supported by consumption, fiscal expansion, and the first effects of monetary easing—should not be interpreted as a full return to trend. Instead, the outlook is we believe for a managed slowdown, with downside risks increasingly linked to political uncertainty, trade tensions, and structural competitiveness gaps rather than cyclical weakness alone.

In the United States, growth is expected to moderate while remaining supported by AI-related investment and technology capex. However, inflation is likely to stay above target, limiting the scope for rapid monetary easing. Elevated tariffs, labour supply constraints, and growing vulnerabilities in private credit markets represent key sources of downside risk. In Europe, growth remains modest and highly dependent on fiscal support, with Germany's shift toward higher defence and infrastructure spending acting as a partial offset to weak external demand. Political fragmentation and fiscal vulnerabilities—particularly in France—stand out as the main tail risks to the European outlook.

For **corporates**, 2025 marked a turning point in credit quality following the lagged effects of higher interest rates. While leverage and interest coverage ratios have deteriorated from pre-2023 levels, they have remained broadly resilient, particularly among investment-grade issuers. For 2026, a low-to-moderate improvement in credit metrics is expected, driven by easing monetary conditions and gradual deleveraging. However, performance will remain uneven across rating categories and sectors, with high-yield issuers and capital-intensive industries more exposed to margin pressure, refinancing risk, and regulatory uncertainty.

The **banking sector** enters 2026 from a position of consolidated strength. Profitability has normalised after the exceptional 2022/23 cycle but remains clearly above pre-monetary policy tightening levels. Capitalisation, liquidity and asset quality are robust, providing strong buffers against a more challenging environment. The focus shifts from rates-driven earnings to structurally anchored fundamentals, including efficiency, revenue diversification, and disciplined risk management. Although emerging risks—such as credit normalisation, commercial real estate exposure, and technological disruption—require constant vigilance, the overall banking outlook remains in our view stable.

Sovereign credit profiles across Europe also look likely to remain broadly stable, supported by continued market access and orderly debt management. However, differentiation is increasing beneath the surface. Sovereign risk in 2026 will be shaped less by liquidity concerns and more by debt affordability, as rising interest expenditure gradually absorbs fiscal space. Highly indebted countries face tighter constraints and higher sensitivity to adverse shocks, while sovereigns with lower interest burdens retain greater policy flexibility. In this context, institutional quality and ESG factors emerge as key stabilisers of credit profiles. Strong governance, effective public administration, and social cohesion help anchor confidence and mitigate the transmission of fiscal and macroeconomic pressures into sovereign risk. Countries with comparable debt metrics can therefore display markedly different degrees of resilience, reinforcing the importance of institutional anchoring in the current environment.

Geopolitical and Macroeconomic Environment

2025: Strategic Fragmentation, Geopolitical Stress, and Resilient Growth

One of the defining features of 2025 was the beginning of a **retreat from globalization**. This does not mean that the global order has collapsed, but rather that it is undergoing potentially profound change: the major powers are increasingly seeking to protect themselves by strengthening their domestic economies and technological capabilities.

This logic—which is more politically than economically driven—is expected to also shape economic performance in 2026. The relationship between the United States and China encapsulates this shift. What was once primarily a trade dispute has evolved into a broader struggle for control over key pillars of the modern economy: semiconductors, rare earths, batteries, and artificial intelligence (AI). While China has exerted pressure by restricting trade in critical metals, the United States has limited exports of advanced chips. Consequently, 2025 ended with a truce in place between the two nations which, although it could come to mark a turning point in the level of bilateral tensions, cannot be interpreted as the basis for a medium- or long-term solution.

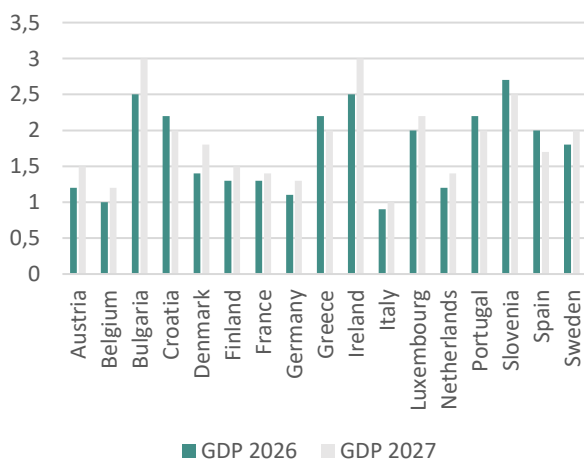
This is compounded by political uncertainty in the **US**. **Institutional fatigue**—materialized in the longest government shutdown in history—and the debate surrounding the independence of the Federal Reserve have generated nervousness. Nevertheless, capital markets appear largely unaffected, and continue to reach record highs, supported by still-abundant liquidity.

In **Europe**, the war in Ukraine, heightened tensions on NATO's eastern front, and instability in the Middle East have definitively put an end to the notion of a "peace era." The shift toward greater defence autonomy will place upward pressure on military spending, with forecasts pointing to levels not seen since the Cold War. To mitigate the impact on already weakened public finances, the EU has considered a common fund to finance this new defence spending cycle.

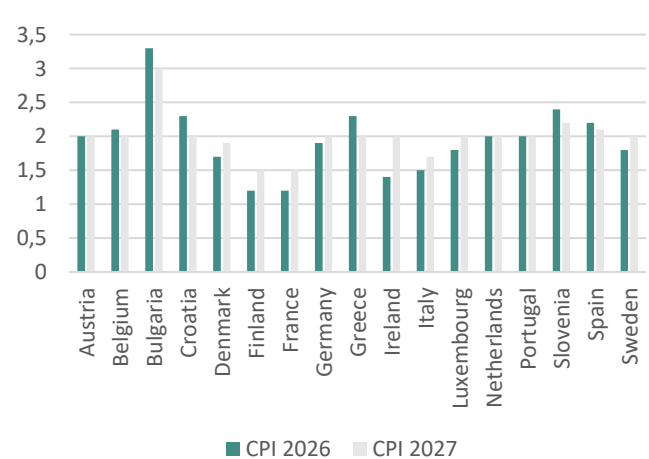
South America has continued to gain strategic relevance due to its abundance of essential minerals—copper, lithium, silver—which are critical to the energy transition and advanced technologies. While this creates opportunities, it also exposes the region to increased geopolitical pressure. In this context, the recent capture of Venezuela's president and the takeover of power by the US government, for what is labelled as a transitional period, as well as President Donald Trump's comments on Colombia, Cuba and others, do not bode well for regional stability.

From an economic standpoint, despite this challenging geopolitical environment, global economic performance in 2025 has surprised positively for two main reasons: (1) the resilience of consumption and, above all, (2) monetary policy easing. As a result, global growth is assumed to have been around 3.2% year-on-year.

Graph 1: GDP forecasts. Source: EFR and European Commission.



Graph 2: CPI forecasts. Source: EFR & European Commission.



EthiFinance Ratings assumes the **U.S. economy** to have delivered 2025 year-on-year growth of 2%, driven by AI-related investment—data centre construction and associated infrastructure expenditure has tripled compared to 2023—and still-robust but highly uneven consumption. The labour market has remained resilient, albeit with a gradual loss of momentum, with the unemployment rate expected to have ended the year around 4.5% and wage growth near 3.5% YoY. Job creation continued to slow, particularly in the second half of the year, largely due to labour supply constraints and cutbacks in US government employment. Inflation is not believed to have converged with the Fed’s 2% target in 2025 and probably ended the year in a 2.7–3.0% range, largely penalized by the direct effects of tariffs.

In **Europe**, growth has been moderate but better than most initially expected, with GDP growth estimated around 1.4%, similar to the Eurozone average. The diversion of Chinese products from the U.S. market has resulted in import price deflation, which, combined with controlled energy prices, could lead inflation to close the year at 2.0%. The UK is expected to report growth of around 1.4% in 2025, but with higher inflation (3.4%) due to energy, fiscal, and food-related factors.

China is expected to register growth of 4.8% for 2025, weak relative to historical norms but supported by exports and industrial activity. Full year CPI is expected to end the year at 0% (0.8% at December), reflecting deflationary pressures. In the rest of Asia-Pacific, growth in 2025 was supported by front-loading of exports ahead of new tariffs and more stable domestic demand.

2026: A Managed Slowdown in a Politically Constrained Global Economy

For 2026, we assume the global economy will remain exposed to geopolitical tensions, trade fragmentation, and increased state intervention. Nevertheless, global growth is likely to be relatively stable, albeit with pronounced regional differences and a growing influence of political—both domestic and international—factors on macroeconomic outcomes.

In the **US**, GDP growth is expected by the OECD to be around 1.7%, with AI investment and technology capex acting as the main cycle drivers. The economy is expected to maintain its “K-shaped” profile, with consumption primarily driven by higher-income households. Inflation is likely to remain sticky, around 3%, due to elevated tariffs and immigration restrictions limiting labour supply expansion. The Federal Reserve is expected to cut rates moderately (a further 50–100 bps), although its room for manoeuvre may be constrained by political uncertainty in what is a midterm election year.

However, the US economic outlook faces material downside risks stemming from two interconnected areas: the rapid expansion of AI-related investment and growing fragilities in private credit markets. While AI remains a key growth driver, its scaling is increasingly constrained by physical and economic limits, notably pressure on electricity grids and water resources, which has already triggered local opposition and project cancellations. At the same time, the heavy concentration of capital expenditure in data centres raises the risk of overinvestment, particularly if revenue generation fails to keep pace, potentially leading to a sharp valuation correction. This risk is amplified by the fast obsolescence of advanced hardware, forcing companies to monetize investments within very short timeframes, and by the high market concentration in a handful of mega-cap firms, increasing systemic volatility if earnings disappoint. In parallel, the private debt market shows signs of late-cycle fatigue, with rising default rates among highly leveraged borrowers, limited transparency, and structural illiquidity. Refinancing pressures—especially in the US commercial real estate sector, where a large volume of debt matures by end-2026—could act as a catalyst for broader market repricing, heightening the risk of spillovers to the real economy and financial conditions.

For the **Eurozone**, we expect economic growth to remain moderate in 2026, at around 1.3%. We foresee a gradual improvement over the year, primarily supported by fiscal stimulus, with Germany’s increased defence and infrastructure spending acting as the main growth catalyst. Inflation is projected to range between 1.9% and 2.1%, broadly consistent with the ECB’s price stability target. Nevertheless, weak external demand and intensifying competitive pressure from Chinese exporters will continue to weigh on the region’s growth potential.

From our perspective, the main downside risks to the European outlook stem from political fragmentation, fiscal vulnerabilities, and structural competitiveness gaps. Political instability represents a material constraint, particularly in France, where persistent difficulties in forming a government capable of delivering credible budgets and advancing structural reforms have increased the risk of policy paralysis and renewed electoral uncertainty. In parallel, there is growing

political fragility in Germany ahead of regional elections, while broader fragmentation at the European level continues to hinder coordinated decision-making in strategic areas such as defence and economic autonomy.

These political constraints interact with a weakening fiscal backdrop, most notably in France, where a deficit persistently above 5% of GDP and a debt-to-GDP ratio exceeding 110% heighten sovereign risk. In our view, a loss of investor confidence in French government bonds could generate spillover effects to other large euro area issuers, representing a non-negligible tail risk for the region's financial stability. Externally, we would underline that Europe's export-oriented growth model faces increasing headwinds. The delayed impact of U.S. tariffs is expected to weigh on activity in 2026, while competitive pressure from China is intensifying as excess supply is redirected toward European markets, challenging domestic industry and pricing power. On the opportunity side, targeted fiscal support in core economies and increased spending linked to defence and infrastructure can partially offset these headwinds. However, we stress that Europe continues to lag behind its global peers in advanced technologies, particularly AI, and that elevated energy costs—driven by the transition away from Russian gas and reliance on more expensive alternatives—remain a structural drag on industrial competitiveness.

China is expected to continue its structural slowdown, with growth in the 4.0–4.6% range amid persistent deflationary pressures. The central bank is expected to implement selective interest rate cuts to support activity, although with limited policy space. Economic rebalancing policies will continue to address excess capacity, while the property sector crisis remains a key risk to domestic stability.

India is expected to remain the fastest-growing major economy, with growth around 6.7% by the OECD for FY25/26 easing to 6.4% in FY26/27. Inflation is likely to remain contained, allowing further official rate cut to 5% from the current 5.25% level. Growth will be supported by favourable demographics, infrastructure investment, the assumed continued availability of cheap Russian oil, and the country's ability to attract investment flows even in a global environment shaped by high U.S. tariffs.

Beyond the Easing Cycle: Central Banks Search for Neutrality

We expect global **monetary policy** in 2026 to enter a phase of transition toward so-called neutral interest rates. Following the easing cycle of 2024 and 2025, central banks need to balance between inflation control and economic activity. This transition, however, will not be uniform.

In the **United States**, we expect the Federal Reserve to pursue a cautious and gradual easing approach. Our baseline scenario is for a moderate number of rate cuts over the year, bringing the federal funds rate into a range of approximately 2.75–3.25% by end-2026. The pace of easing will depend on the degree of labour market softening and the Fed's willingness – under a new chair - to accept inflation remaining above target, due not least to tariff-related effects. There is also a material source of uncertainty linked to the end of the current Fed chair's term in mid-2026 and the choice of replacement, which could raise questions around policy continuity and institutional independence.

In the **euro area**, the European Central Bank is approaching the nadir of its easing cycle (having cut its rates eight times since June 2024). We expect the deposit rate to stabilise around 2.0%, although weaker economic conditions in core economies—particularly Germany—could prompt limited additional cuts during the year. Overall, we view the ECB's stance as broadly accommodative but increasingly constrained by diminishing marginal returns from further easing.

In the **United Kingdom**, policy rates are projected to decline gradually toward the 3.25–3.5% range, with the timing and extent of further cuts conditional on persistent services inflation and the inflationary impact of fiscal measures.

Outside the core advanced economies, we would underline the increasingly divergent paths of Japan and China. In **Japan**, we expect the Bank of Japan to continue its gradual policy normalization, with one measured rate hike aimed at exiting decades of ultra-loose monetary conditions and moving policy rates to 1.0% by end-2026. By contrast, **China's** central bank is likely to maintain a selective and targeted easing bias, using limited rate cuts and reserve requirement adjustments to counter deflationary pressures and excess capacity.

Corporates

The following assessment derives from EthiFinance Ratings' own coverage of credit ratings (with a sample of 153 corporate issuers selected). Overall, 2025 is assumed to have marked a turning point in the evolution of corporates' credit quality. After two years of significant changes in monetary policies, trade tensions, deteriorating macroeconomic conditions, and looming political uncertainty, credit metrics have been quite resilient overall (c.8% of downgrades, c.6% of upgrades) but uneven across rating categories and industries.

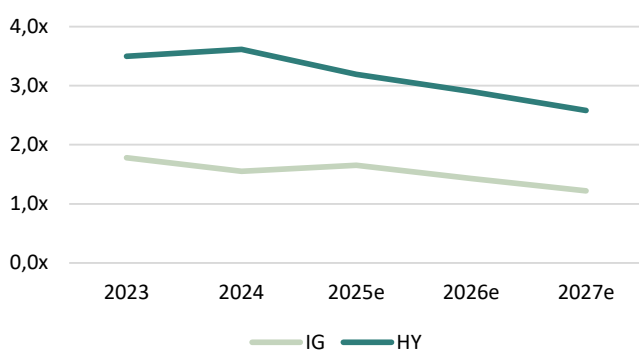
Some sectors have particularly suffered from the accumulation of several years of significant investments and regulatory constraints such as the automotives industry, engineering & construction, materials, real estate in France, or independent power producers (IPPs) to name a few. Conversely, former more troubled sectors have slowly recovered from the Covid years, such as the aeronautics industry, commercial and professional services, transport, and the hotel industry.

Uneven leverage ratio between IG and HY in 2025, set to improve from 2026 onwards

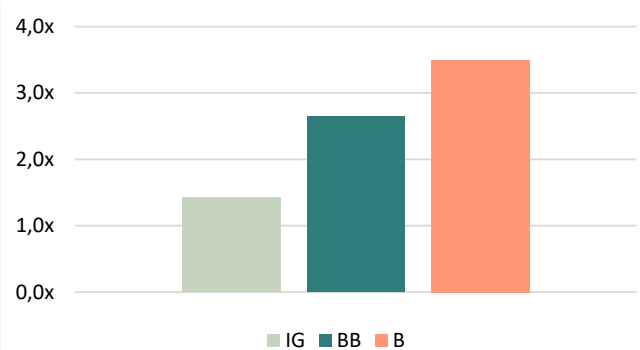
Of the 153 companies used for the analysis, 23 were assessed using the infrastructure volatility table of our methodology and therefore form a distinct group compared to the remaining 130 typical corporate issuers. For the infrastructure issuers (made up of 17 IG and 6 non-IG issuers), adjusted net leverage ratios for both the IG and HY issuers are expected to be broadly unchanged at end-2025 compared to end-2024 (6.5x on average) due to their very stable businesses, with a gradual slow deleveraging expected from 2026 onwards.

Regarding the bulk of corporates, the IG issuers are expected to report a broadly unchanged net adjusted leverage ratio, at a very reasonable level of 1.6x for 2025, with gradual improvement expected from 2026 onwards. For the HY issuers (made up of 70% of BB categories and 30% of B categories), the adjusted net leverage ratio is estimated to have improved to around 3.2x for 2025, and continue to do so in 2026.

Graph 3: Adjusted net leverage ratio. Source: EFR (excl.infra).



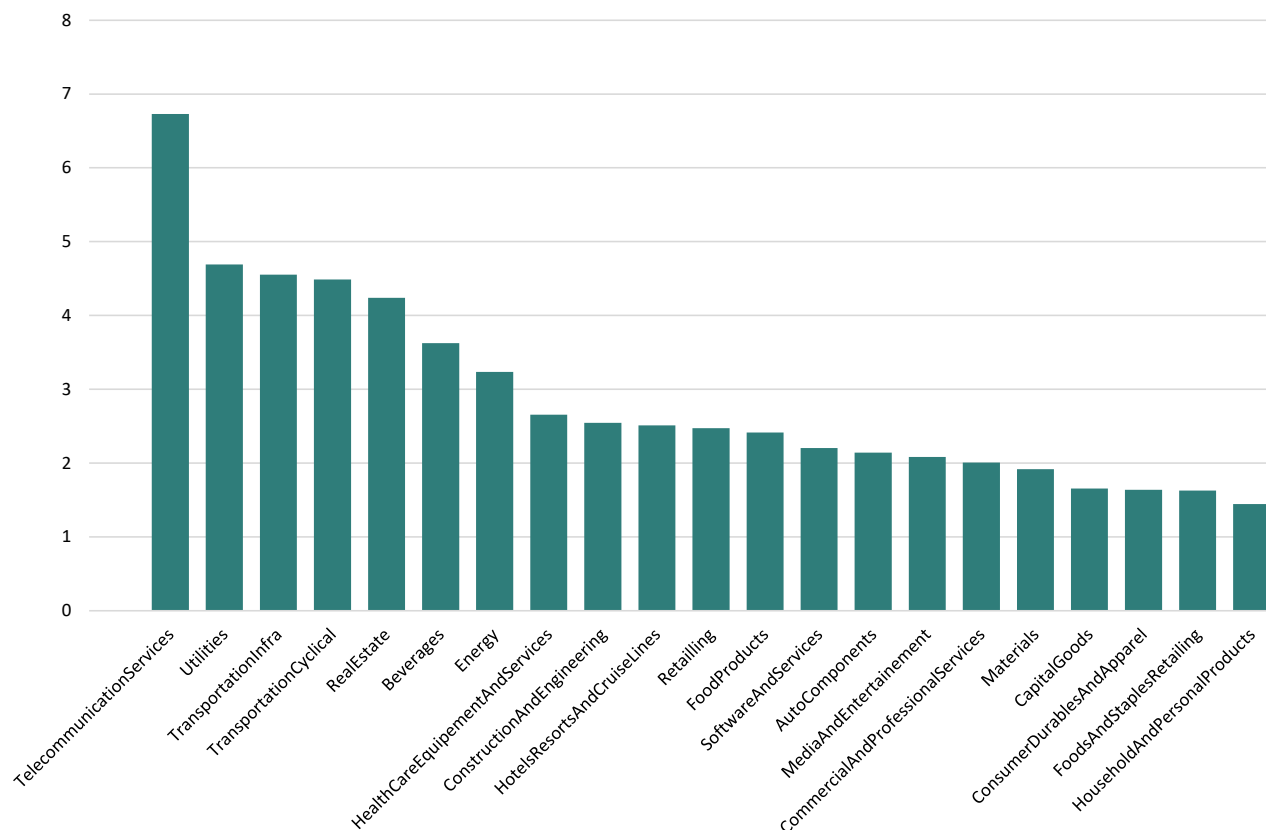
Graph 4: Adjusted net leverage 2026e by rating categories



For 2026 and 2027, we anticipate overall deleveraging. This could position the IG portfolio with around 1.2x leverage on average. Regarding the high-yield categories, leverage dynamics are more volatile, as they are conditioned by margin sensitivity to demand and input costs. However, we still expect some improvement overall, which could drive the average net adjusted leverage ratio to below 3.0x by end-2027, albeit with clear differences across rating levels.

Regarding leverage by industry, the graph below shows the 2026 expected adjusted net leverage ratio across the 153 issuers (including infrastructure issuers mostly in utilities, telecommunications, and transportation infrastructure).

Graph 5: Average adjusted net leverage ratio by sectors in 2026e (including infrastructure). Source: EFR

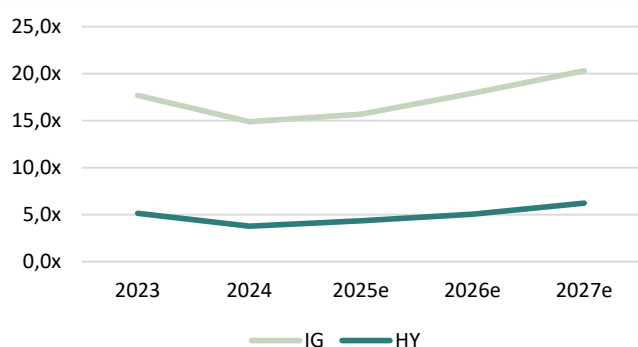


Interest coverages through the cycle have been affected by the lagging effect of the rise in interest rates over 2022-24

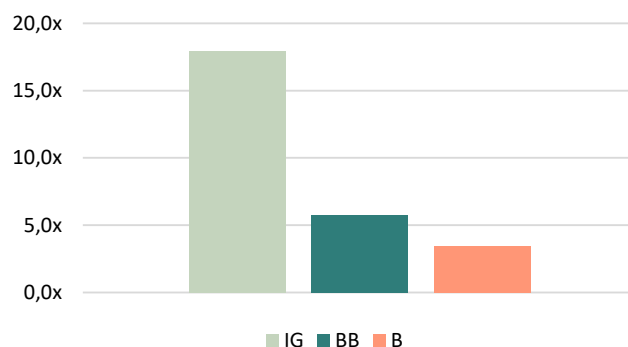
The evolution of interest coverage reflects issuers' differing capacity to absorb financing costs across risk categories and sectors. In this respect, excluding infrastructure issuers, IG companies have maintained comfortable headroom throughout 2025. However, the current expected average of 15-16x that we expect issuers will report for 2025 is lower compared to pre-2023 levels.

In the HY segment, again excluding infrastructure issuers, interest coverage ratios are structurally lower, and will probably have ended 2025 around 4–5x. The higher debt load of HY's issuers drives the lower interest coverage, which leads to lower resilience to financial or business shocks.

Graph 6: EBITDA/Interest. Source: EFR (excl.infra)



Graph 7: EBITDA / Interest by ratings 2026e. Source: EFR



This contraction observed over 2024/25 is attributable to the lagged impact of the rise in interest rates and the refinancing of long-term debt at higher interest rates with respect to years prior to 2023. As a reminder, the German

government 10-year bond yield was below 1% between 2014 and August 2022 - even in negative territory between early 2019 and late 2021 - before climbing back to 2% and above, a level which has been sustained since August 2022.

Looking ahead, the recovery in interest coverage expected throughout 2026–27 therefore points to two opposite effects:

- On one side, a gradual effect of the normalisation of short-term interest rates, driven by the central banks rates cuts, which in YoY terms is expected to improve interest coverage ratios as the average cost of variable interest rate debt improves alongside expectations of strengthened operating cash generation.
- On the other side, the normalisation of long-term debt interest expense as the refinancing of pre-2023 debt will be made at higher average rates, which will to some extent offset the improvement in interest coverage ratios through the cycle.

Graph 8: Interest rate by ratings 2026e. Source: EFR

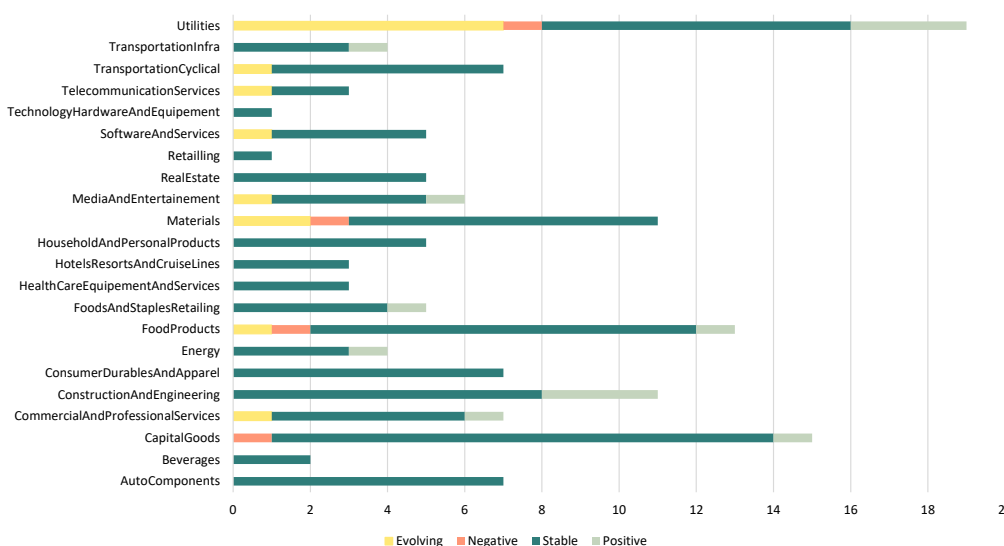


Overall, excluding infrastructure issuers, we expect the average cost of debt to stabilise over 2026-27 for both IG and HY issuers. For IG issuers, we anticipate an average cost of debt of around 4%, for HY around 7%. Meanwhile, we expect the gap between average IG and HY spreads to remain relatively stable and continue to be a key factor in differentiating credit profiles. Consequently, interest-coverage wise, excluding infrastructure issuers, IG issuers' ratios are likely to maintain comfortable coverage above 15x, whereas those for BB and B categories are expected to improve to approximately 6x and 4x, respectively, by end-2027.

Low-to-moderate improvement expected in credit ratios for 2026, but uneven performance expected depending on credit ratings

For 2026, we can reasonably expect a low-to-moderate uplift in credit metrics among issuers as monetary policies in general ease further and issuers adapt to changing macroeconomic conditions.

Graph 9: Outlooks by sectors. Source: EFR.



However, this outlook may be changed by a complex geopolitical environment that keeps uncertainty elevated in energy markets, as well as international trade and supply chains, with uneven impacts across sectors: import-intensive businesses will remain exposed to cost volatility, export-oriented industries will face additional risks stemming from persistent trade tensions, and activities dependent on strategic commodities will continue to be subject to episodes of price stress. Consequently, credit quality evolution will be uneven. While IG issuers are expected to exhibit more stability than HY issuers, those exposed to specific regulations will be more exposed to a sudden change in rules, all the more so as their credit quality is low.

As a result of such uncertainty, the utilities sector, particularly the IPPs, presents the highest portion of Evolving outlooks among our covered companies, alongside the Engineering and Construction players that act as contractors for renewable projects. Additionally, the Capital Goods sector has the highest portion of Negative outlooks. Although the Automotives sector was hit quite hard over 2025, with several downgrades of key auto components manufacturers, it will be interesting to see how the industry now responds to the recent U-turn on the thermal engine ban in 2035 in Europe as well as the increasing competition from Chinese EVs and whether this could exert further pressure on credit metrics.

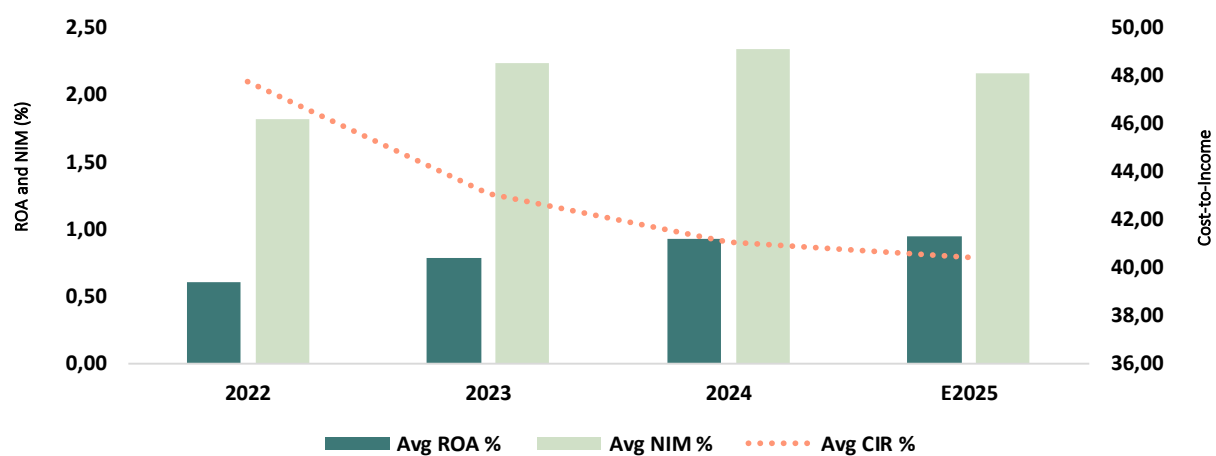
Banks

The European banking sector enters 2026 from a position of consolidated strength, having largely completed the adjustment to the post-tightening monetary policy environment over the course of 2025. The exceptionally high profitability cycle driven by restrictive monetary policy between 2022 and 2023 has gradually given way to a more normalized operating framework. At end-2025, the sector had absorbed most of the downward pressure stemming from declining official rates and slower economic momentum, allowing banks to enter 2026 with earnings, capital generation and liquidity profiles that, while less cyclical, remain fully supportive of credit quality. This transition underscores a shift from rates-driven performance to structurally anchored fundamentals across profitability, efficiency, solvency, asset quality, and liquidity.

Profitability dynamics reflect this rebalancing

Following the 2023 peak, 2024 and 2025 have been characterised by earnings moderation, as net interest margins have compressed in response to lower reference rates and heightened competition for deposits. This trend is consistent with developments observed globally, particularly in the United States, where declining policy rates and a softer macroeconomic backdrop are expected to continue exerting pressure on net interest income. However, this pressure is partly mitigated by the progressive reduction in deposit costs, which provides a degree of margin defence and limits downside risks to profitability. At end-2025, this adjustment is thought to be largely complete, with profitability stabilizing at levels that remain clearly above pre-2022 norms.

Graph 10: Profitability¹ and efficiency trends. Source: EFR



At the same time, revenues diversification has continued to gain structural relevance. Banks have increasingly relied on non-interest income—such as fees from asset and wealth management, investment banking, payments, and transactional services—to compensate for softer loan-driven revenues. This trend reinforces the transition toward more balanced and recurrent income profiles, reducing sensitivity to interest rate cycles. In this respect, European banks benefit from a comparatively favourable backdrop, with corporate earnings expected to rebound strongly, supporting business volumes and fee generation across banking segments. Internationally, profitability trends remain heterogeneous: while most regions face cyclical normalization, Japan stands out as an exception, where the Bank of Japan’s tightening cycle is expected to support an improvement in banking sector profitability. In the United States, banks are projected to sustain solid returns, with return on common equity expected to remain in the 10.5–11.5% range, despite margin headwinds.

Within Europe, Spanish banks under EthiFinance’s coverage continue to demonstrate a resilient profitability profile. Results for 2025 are expected to confirm their ability to sustain solid earnings through diversified income streams, disciplined pricing of liabilities, and effective funding cost management. While interest-driven revenues are expected to

¹ ROA refers to return on assets; NIM to net interest margin; and CIR to the cost-to-income ratio.

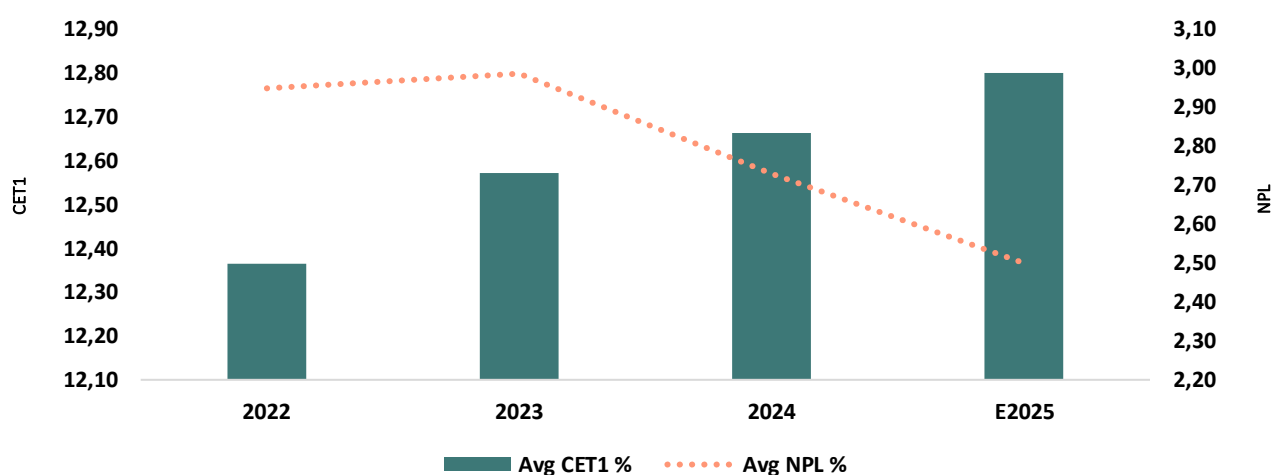
contribute less incrementally entering 2026, profitability is forecast to remain broadly stable rather than entering a corrective phase. This resilience reflects not only revenues diversification but also the structural efficiency that characterizes Spanish institutions, providing a meaningful buffer against cyclical pressure on margins.

Efficiency remains a central pillar supporting earnings sustainability as banks move into 2026. As of end-2025, the scope for further structural cost reductions remains constrained by ongoing investments in digitalization, automation, cybersecurity, and regulatory compliance. Consequently, efficiency gains are increasingly driven by revenues resilience rather than aggressive cost-cutting. Spanish banks continue to exhibit a clear structural advantage relative to European peers, reflecting longstanding cost discipline, optimized branch networks, and advanced digital operating models. Looking ahead, efficiency ratios are expected to remain broadly stable at favourable levels, reinforcing the sector's capacity to sustain profitability in a normalized interest rate environment.

From a solvency perspective, European banks enter 2026 with capital positions firmly anchored at robust levels.

The expected end-2025 numbers will probably confirm that capital ratios remained supported by retained earnings and accumulated reserves, even as risk-weighted assets have increased moderately. Capitalization remains significantly stronger than historical benchmarks, enhancing shock-absorption capacity. Although shareholder distributions remain elevated, internal capital generation continues to offset payouts, preserving comfortable buffers above regulatory requirements. In Spain, disciplined capital management and sustained profitability have allowed banks to further narrow the gap with core European peers, supporting stable solvency assessments going into 2026.

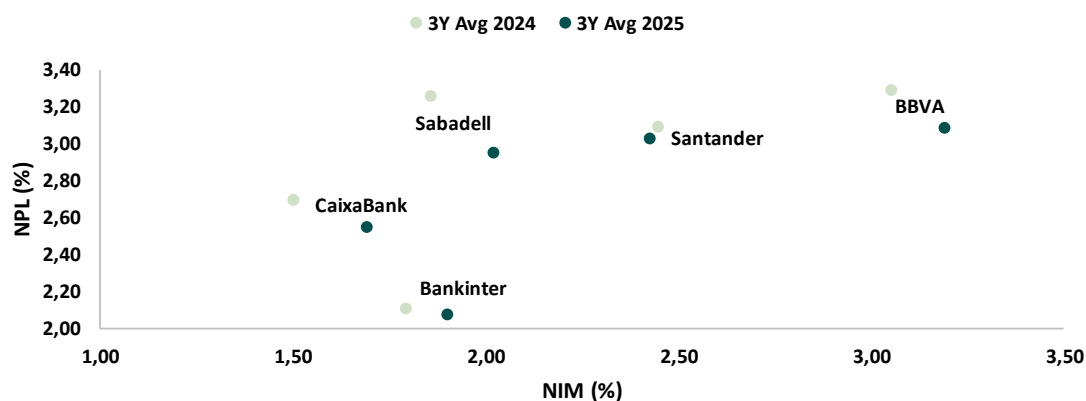
Graph 11: Solvency and asset quality trends. Source: EFR



Asset quality trends remain broadly supportive of credit stability albeit with emerging risk differentiation.

Across the EU and EEA, non-performing loan ratios remain low by historical standards, supported by high coverage levels, although developments vary across jurisdictions. In Spain, improvements in asset quality continue to reflect favourable labor market dynamics and prudent underwriting standards. Within Ethifinance's rated portfolio, asset quality indicators remain consistent with contained risk profiles, and coverage ratios reinforce banks' capacity to absorb potential losses.

Graph 12: NIM and NPL (2024 vs 2025e). Source: EFR

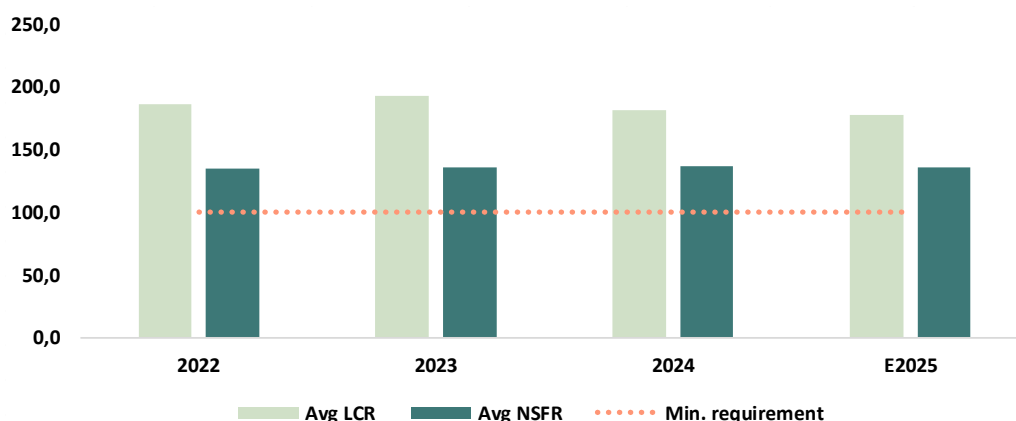


Looking to 2026, global credit conditions introduce additional considerations. Credit losses are expected to rise moderately at the global level, driven primarily by consumer credit and heightened uncertainty in Asia-Pacific linked to tariff-related risks. While European banks appear less exposed to these pressures, the environment calls for continued prudence. In commercial real estate, the market appears to have reached a cyclical trough, yet banks are expected to remain selective in new lending, limiting downside risks from this segment. Business model differences remain relevant: internationally diversified groups such as Santander and BBVA benefit from higher margins associated with emerging markets, albeit with moderately higher credit risk, while domestically focused banks retain lower risk, more stable profiles.

Liquidity continues to represent a core credit strength.

The expected end-2025 numbers are likely to confirm that liquidity buffers, while gradually normalizing following the withdrawal of excess central bank liquidity, remain well above regulatory requirements. Banks have actively managed this transition by reallocating liquidity towards government bonds and covered bonds, optimizing yields while preserving high-quality liquid asset profiles. Funding structures remain stable, with the replacement of maturing TLTRO funding by market-based instruments and retail deposits proceeding smoothly. Net stable funding ratios remain comfortably above regulatory thresholds, supported by resilient deposit bases.

Graph 13: Liquidity trends. Source: EFR



Nevertheless, structural challenges are emerging, particularly in the United States, where regulatory developments such as the GENIUS Act could accelerate the adoption of stablecoins. This introduces a potential long-term risk to traditional bank deposits, with estimates suggesting that a meaningful share of deposits could migrate towards digital alternatives. Although this risk remains largely concentrated outside Europe, it underscores the importance of maintaining strong liquidity management and competitive deposit franchises.

Beyond traditional financial metrics, innovation and regulation are increasingly shaping banks' medium-term credit profiles. The financial sector is expected to be among the main beneficiaries of AI monetization in 2026, as banks transition from isolated pilot projects to tangible applications in sales, trading, risk management, and personalized client offerings. The success of this transition, however, will depend on the modernization of data infrastructure, which remains fragmented in many institutions. At the same time, regulatory trends diverge across regions. In the United States, a shift toward supervisory simplification could catalyse M&A activity, while in Europe excess capital and improved valuations are also expected to support consolidation dynamics within the banking sector.

Finally, operational and non-financial risks are gaining prominence. Financial crime risks are increasing in sophistication, driven in part by the use of AI by criminal networks. This trend is expected to require further investment in integrated, technology-driven defence systems in 2026, reinforcing cost pressures but also supporting the resilience of operational risk frameworks. Overall, as 2026 begins, European and Spanish banks have financial profiles that are no longer supported by exceptional cyclical tailwinds but are firmly underpinned by strong structural fundamentals. Profitability has stabilized at sustainable levels, efficiency remains high, capital buffers are robust, asset quality is resilient, and liquidity positions are ample. At the same time, emerging risks linked to credit normalization, technological disruption, and regulatory change are becoming more relevant. From EthiFinance's perspective, the interaction of these factors continues to support a stable credit outlook for 2026, reflecting the sector's capacity to navigate a more complex and normalized operating environment without material deterioration in credit fundamentals.

Sovereigns

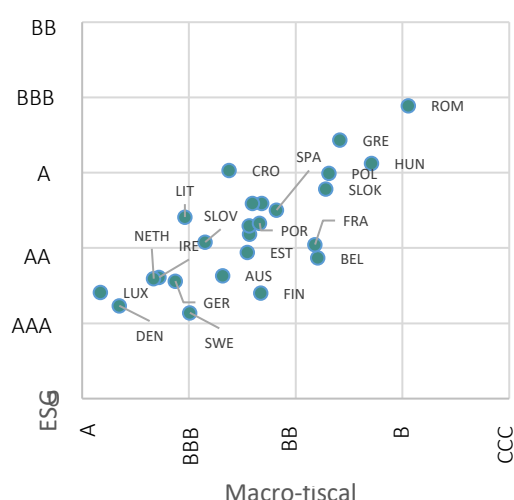
Entering 2026, **sovereign credit profiles across Europe remain broadly stable**, supported by **continued market access, orderly debt management, and a still-accommodative—albeit normalising—monetary policy environment**. However, beneath this aggregate stability, credit differentiation is becoming more pronounced, driven by uneven fiscal trajectories, divergent growth potential, and varying degrees of institutional and political resilience.

Unlike in previous stress episodes, sovereign risk in 2026 is not characterised by liquidity shortages but by the gradual erosion—or preservation—of fiscal space. As the repricing of public debt continues to filter through sovereign balance sheets, and fiscal rules regain prominence, the interaction between debt affordability, political execution capacity, and medium-term growth becomes the key determinant of creditworthiness.

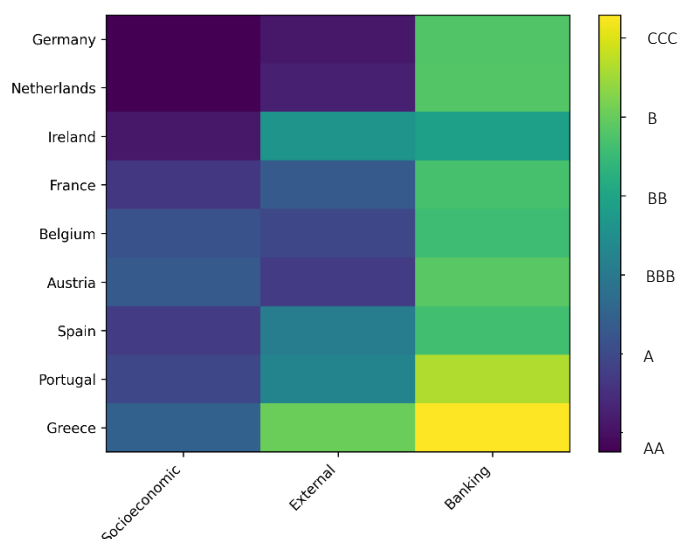
Macro-fiscal strength versus institutional anchoring: cross-country comparison

The current sovereign credit landscape is best understood through the interaction between macro-fiscal fundamentals and institutional and ESG strength, as these two dimensions increasingly determine how countries absorb shocks and navigate the post-tightening environment. While headline stability still characterises the European sovereign space, the underlying distribution of credit profiles reveals a growing degree of structural differentiation.

Graph 14: EFR's Sovereign Credit Map. Source: EFR



Graph 15: EFR's Sovereign Heatmap. Source: EFR



At one end of the spectrum, countries such as **Germany, the Netherlands, and the Nordic sovereigns** combine comparatively strong macroeconomic fundamentals with solid public finances and very high ESG scores. Even where short-term growth performance has weakened—most notably in Germany—their credit profiles remain supported by moderate debt levels, low interest burdens, and strong institutional credibility. This combination provides a high degree of confidence in policy execution and preserves fiscal room to accommodate cyclical fluctuations or higher structural spending needs without undermining market confidence.

A second group of sovereigns, including **France, Spain and Italy**, occupies a more intermediate position. These countries share broadly sound institutional frameworks and social cohesion, reflected in relatively strong ESG scores, but face more challenging macro-fiscal positions. Elevated debt levels, persistent fiscal deficits, and, in some cases, weaker growth potential weigh on their public finance assessments. Within this group, however, important differences emerge. Spain benefits from comparatively strong near-term growth dynamics and a more favourable debt maturity profile, while Italy remains structurally constrained by the size of its debt stock and a higher sensitivity of interest costs to market conditions. France, meanwhile, combines high deficits with increasing political fragmentation, which has begun to weigh on fiscal credibility despite otherwise strong economic fundamentals.

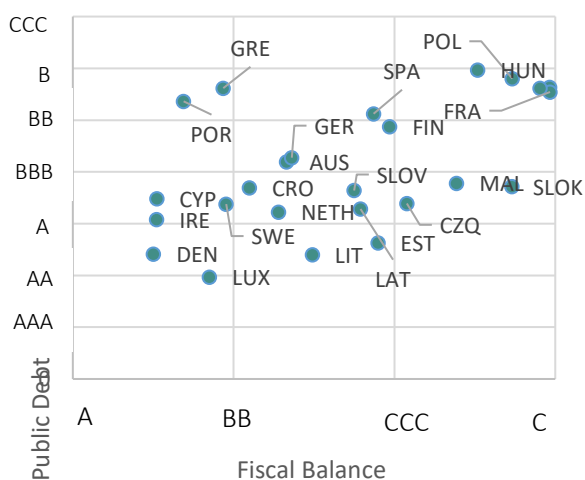
Further along the spectrum, **Portugal and Greece** illustrate how sustained fiscal adjustment and structural reforms can reshape sovereign credit profiles over time. Although both countries continue to carry high debt ratios (around 98% of GDP for Portugal and 151% for Greece), improvements in fiscal discipline, external balances, and institutional

effectiveness have strengthened their resilience, narrowing the gap with higher-rated peers and reducing their exposure to adverse confidence effects.

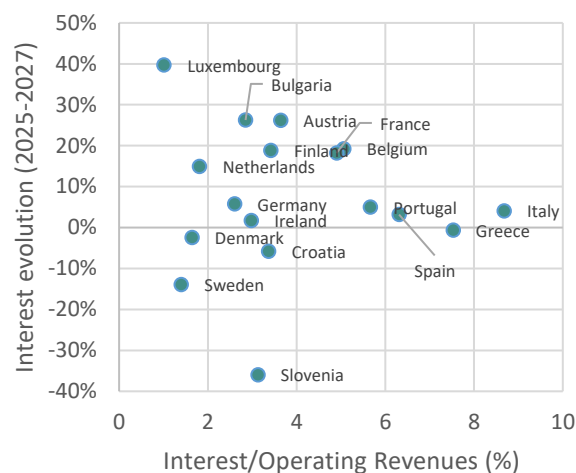
Debt affordability: interest burden as the binding fiscal constraint

In the current macroeconomic environment, the key question is no longer whether sovereigns can refinance their obligations, but rather how much fiscal space is absorbed by debt servicing costs and the extent to which this constrains policy choices going forward. This distinction is particularly relevant in the European context. The gradual repricing of sovereign debt following the tightening cycle of 2022/23 continues to feed through to public accounts with a lag, reflecting the maturity structure of outstanding debt. As a result, even as official rates stabilise or decline, interest expenditures are set to increase further for several countries, reducing the room for discretionary fiscal action in 2026.

Graph 16: EFR's Fiscal and Debt Pillar assessment. Source: EFR



Graph 17: Debt Affordability. Source: EFR



Cross-country comparisons highlight meaningful differences. **Germany and the Netherlands remain clear outliers**, combining relatively low debt ratios with contained interest burdens. In these cases, the rise in interest costs has been modest and remains easily absorbable within existing revenues frameworks. This provides these sovereigns with greater fiscal optionality, allowing them to accommodate higher structural spending—most notably on defence and energy security—without undermining debt dynamics.

By contrast, **Italy** stands out as the most constrained large sovereign. With one of the highest debt ratios in the euro area (138% of GDP as of end-September 2025) and a rapidly rising interest bill, debt servicing absorbs a materially larger share of public revenues than in peer countries. This makes Italy particularly sensitive to changes in market sentiment and limits the scope for countercyclical fiscal policy. Even under benign growth assumptions, stabilising debt requires sustained primary surpluses, increasing the political and social costs of adjustment.

France and Spain occupy an intermediate position but diverge in important ways. Both countries face high debt levels, yet their affordability profiles differ. France combines persistent fiscal deficits with a debt structure that is gradually repricing at higher rates, leading to a steady increase in interest costs as a share of revenues. This trend, coupled with political fragmentation, has begun to weigh on fiscal credibility. Spain, by contrast, benefits from stronger nominal growth dynamics and a longer average debt maturity, which has slowed the transmission of higher rates to the budget. As a result, while Spain's debt stock remains elevated, its near-term affordability metrics are comparatively more favourable.

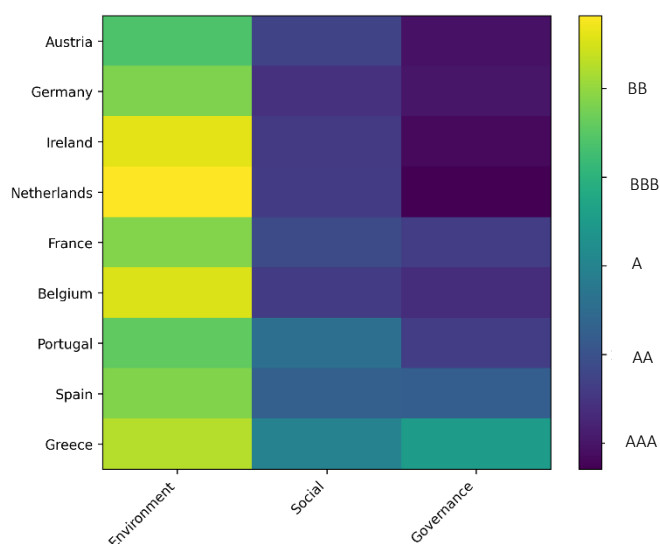
Portugal and Greece illustrate a different dynamic. Despite still-high debt ratios, both countries have materially improved debt affordability through a combination of fiscal consolidation, liability management, and stronger growth. Lower average funding costs and longer maturities have helped stabilise interest burdens, reducing vulnerability to interest rate shocks and supporting improved market confidence. Their experience underscores the importance of policy credibility and active debt management in mitigating affordability risks.

From our view, rising interest burdens have broader implications beyond sovereign balance sheets. Higher debt servicing costs crowd out productive expenditure and reduce the capacity of fiscal policy to support growth during downturns. In countries where interest payments consume a growing share of revenues, fiscal policy becomes increasingly pro-cyclical, reinforcing the risk of low-growth equilibria. Looking into 2026, the debt affordability channel is therefore set to remain the primary constraint on sovereign credit profiles, particularly for the highly indebted countries. While an abrupt deterioration in market access is not anticipated, the gradual tightening of fiscal space increases the sensitivity of these sovereigns to adverse shocks—whether stemming from weaker growth, renewed inflationary pressures, or political instability. In this environment, maintaining debt affordability, rather than merely stabilising debt ratios, emerges as the central challenge for fiscal sustainability.

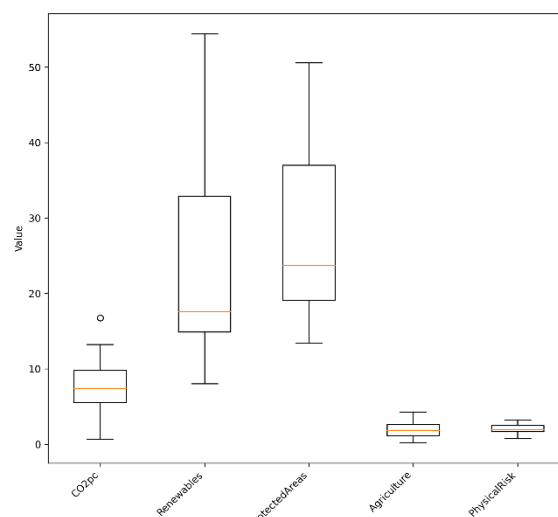
ESG: institutional strength as a stabiliser of sovereign credit profiles

ESG factors have become an increasingly important buffer for sovereign credit resilience. While they do not replace sound macroeconomic or fiscal fundamentals, they play a critical role in shaping how countries absorb shocks, implement policy adjustments, and preserve market confidence over time. In this sense, we highlight that environmental factors, while less immediately binding for sovereign credit quality, interact with fiscal and institutional capacity over the medium term. Stronger environmental scores suggest a greater ability to manage the costs of the climate transition, reducing the risk that environmental challenges translate into sustained fiscal pressure.

Graph 18: EFR's ESG Heatmap. Source: EFR



Graph 19: EFR's Environmental related indicators.



Countries in the core euro area and Northern Europe, such as **Germany, the Netherlands, Austria and Ireland**, display consistently strong ESG profiles, with solid scores across all three dimensions. These strengths translate into predictable policymaking, effective public administration, and a higher degree of social cohesion, all of which help limit the transmission of economic or fiscal stress into sovereign risk. Governance stands out as the most influential component within the ESG framework. Countries with strong institutions, high government effectiveness, and respect for the rule of law tend to manage periods of fiscal tightening more smoothly. Even when public finances come under pressure, credible institutions help anchor expectations and reduce the risk of abrupt shifts in market sentiment. This institutional anchor remains a key differentiator within the investment-grade universe.

Among large euro area economies, ESG profiles are mixed. **France and Italy** illustrate how weaker governance and social indicators can amplify fiscal challenges. In both cases, political fragmentation and reform/austerity fatigue reduce execution capacity and narrow the margin for policy errors. While these weaknesses have not triggered immediate credit stress, they increase sensitivity to adverse shocks at a time when debt affordability is becoming more constrained. By contrast, **Spain and Portugal** present more balanced ESG profiles. Governance and social indicators are broadly aligned with euro area averages, supporting policy continuity and helping to stabilise investor confidence during periods of adjustment. This balance has been an important factor in moderating sovereign risk, even as fiscal constraints persist.

The social dimension also plays a meaningful role in shaping credit resilience. Countries with lower vulnerability in employment, more inclusive labour markets, and relatively contained income inequality tend to face fewer political constraints when implementing fiscal consolidation or structural reforms. Where social pressures are higher, adjustment processes are more complex and credit sensitivity increases.

Stability persists, but resilience will matter more than ever

In conclusion, the sovereign outlook for 2026 remains broadly **stable** at an aggregate level. Funding conditions are orderly, refinancing risks are contained, and no systemic stress is anticipated. However, this overall stability conceals **increasing divergence across countries**, driven by differences in fiscal space, debt affordability, and institutional strength.

Sovereign risk in 2026 is shaped less by access to markets and more by the **capacity to absorb higher interest costs** within public finances. Rising interest payments are gradually narrowing fiscal margins, particularly in highly indebted countries, increasing sensitivity to growth disappointments or policy slippage. As a result, debt affordability has become a more binding constraint on credit profiles than headline debt levels alone.

At the same time, **institutional quality and ESG factors** play a crucial stabilising role. Strong governance, effective public administration, and social cohesion help anchor confidence and moderate the transmission of fiscal and macroeconomic pressures into sovereign risk. This explains why countries with comparable debt metrics can display very different degrees of credit resilience, and why differentiation within the investment-grade universe is becoming more pronounced.

Large euro area economies illustrate this dynamic clearly. Core sovereigns with strong institutions and ample buffers retain greater policy flexibility, while highly indebted countries with weaker execution capacity operate with a narrower margin for error. In several cases, balanced ESG profiles have helped preserve stability despite ongoing fiscal challenges. Looking ahead, the main risks to the sovereign outlook are **structural rather than cyclical**. Prolonged low growth, rising interest burdens, and political fragmentation could gradually erode fiscal sustainability and confidence if not addressed through credible and consistent policies. Conversely, sovereigns combining manageable debt dynamics with strong institutions are better positioned to navigate the current environment without material credit deterioration.



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