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4Q16 Money Market Credit Trends by Sector

INVESTMENT FOCUS

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Commentary by the Credit Research Team at BNY Mellon Cash Investment Strategies (CIS), a division of The Dreyfus Corporation

The credit environment improved during the fourth quarter of 2016 as commodity prices stabilized, asset quality continued to be benign and favorable financial market conditions persisted. Still, the low interest rate environment, particularly in Europe and Japan, served to pressure net interest margins and temper overall revenue growth. For some corporate issuers, revenues were pressured by currency headwinds and by commodity prices that have not recovered enough. Most banks experienced reduced credit costs as performance in oil gas portfolios improved during the quarter with the Singaporean banks and select Norwegian banks being the lone exceptions with higher provisions over the course of the year. Corporate and financial issuers alike continued to counter revenue challenges with ongoing or expanded expense cutting initiatives. Overall, a number of corporate and North American banking issuers posted one of the better quarters in recent memory. Meanwhile, performance amongst the UK and European banks remained mixed as litigation and restructuring costs related to legacy business continues to weigh on results. In Japan, adequate profitability continued to be supported by above average securities-related gains and very low credit costs, which masked weak operating results. Balance sheet fortification efforts remained an ongoing trend with banks disclosing improved capital, leverage, liquidity and funding metrics. For corporates in particular, merger and acquisitions (M&A) has been an ongoing trend with some displaying a propensity for meaningful acquisitions.

Going forward, geopolitical issues will take center stage in 2017 as we await details related to new policies and potential regulatory initiatives from the Trump Administration, ongoing developments on the UK's intent to exit the European Union and upcoming elections in Europe, particularly in Germany and France. Notwithstanding these uncertainties and operating challenges, we believe the large global financial and corporate issuers common to the money market space remain well positioned with healthy credit profiles evidencing minimal credit risk.

U.S. BANKS

Fourth-quarter 2016 capped a strong finish to the year for U.S. banks as they continued to execute on strategic priorities to deliver positive operating leverage. With continued tepid revenue growth, banks remained focused on expense management discipline with some announcing new or expanded cost save initiatives. The large banks saw a boost in capital markets revenues from a favorable trading environment. In particular, Fixed Income Clearing Corporation (FICC) revenues, while seasonally lower than 3Q16, were much higher than 4Q15. This reflected client re-engagement and strong performance across products, but notably so within rates and currencies. Equity-related revenue increased at a more measured pace on improved performance in derivatives. Aggregate FICC and equity revenue represented the strongest quarter for the industry since 2009. Investment banking results were mixed with debt underwriting higher but equity underwriting down amid a continued slow IPO market and advisory softer. Overall loan growth was decent with margins flat to slightly down and fee income benefiting from strength in mortgage banking and trust and investment

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management. The large banks are generally all well-capitalized with an average Common Equity Tier 1 (CET1) ratio of 13.2% and all banks noted compliance with the Liquidity Coverage Ratio (LCR). For the most part, the banks entered 2017 with favorable competitive positions, shrinking legacy portfolios and fairly healthy loan books.

CANADIAN BANKS

Canadian banks benefited from stabilizing oil prices as impaired oil and gas loan formations eased. Drawn exposure to oil and gas remained manageable for the Canadian banks at just 1%-3% of total loans. The housing market continued to be a focal point as growth in house prices remained elevated in Canada with the rating agencies and the IMF suggesting potential overvaluation. House price growth was strongest in Toronto and Vancouver while prices have adjusted to more sustainable levels in the oil-dependent provinces. High levels of consumer indebtedness also remained a headline. That being said, performance in the Canadian mortgage books remained favorable and overall asset quality continued to be benign. Bank profitability was pressured by the low rate environment with some banks revising down medium-term return on equity (ROE) targets; however, earnings for the 4Q16 were generally higher with broad-based revenue growth outpacing expense growth. Of note, almost all businesses saw improved results on account of good volume growth, stronger trading performance, solid AUM growth and higher fee-based assets. Furthermore, banks continued to make investments via expansion into U.S. markets and the Wealth Management business as a means of diversification. Funding remained favorable and the banks easily met Basel III liquidity requirements with an LCR between 124% - 131%. Capital levels were solid with an average CET1 ratio of 10.6%. The banks' outlooks remained negative at Moody's reflecting the likelihood of a reduction in systemic support as the Canadian government has proposed a bail-in regime for the large banks.

CORPORATES

In the fourth quarter 2016, corporate earnings were still impacted by continued pressure on commodity prices but were overall better than we have seen in the past few quarters. Comparisons on a year-over-year basis were easier and many of the companies' efforts at reducing capital spending and cutting costs improved or maintained operating profit. Currency and geopolitical issues still remained headwinds for many corporates. Pharmaceutical companies continued to be hurt by generic competition, offset by the performance of new products. E-commerce sales in the holiday period were strong, helping companies like UPS. Consumer Products' organic sales continued to benefit from new innovations and product and geographic diversity. M&A remained a big theme in corporates as companies continue to focus on tuck-in acquisitions. However, we have also seen some companies using overseas cash or levering up balance sheets for meaningful acquisitions which has put pressure on credit ratings. Nevertheless, overall balance sheets and credit profiles remained healthy in investment grade corporates. We believe many companies still have financial flexibility to weather an uncertain economy. The outlook for 2017 remains cautious with expectations for continued volatility in commodity prices and uncertainties in the global geopolitical environment.

EUROPEAN BANKS

European and UK bank earnings for 4Q16 exhibited many of the trends seen in the prior quarter. Market facing businesses performed well as client momentum continued to pick up pace following the slowdown in the first half of the year leading into the June Brexit vote. Interest income remained pressured from low rates and loan renegotiations but has been resilient thanks to lending growth, low funding costs and the re-pricing of deposit products. Spread income will likely remain pressured going forward as the European Central Bank reaffirmed its interest rate policy in December 2016 and guided for rates to remain low for an extended period of time. Offsetting some of the pressure was improved

asset quality which led to reduced credit costs, particularly within Italian and Irish subsidiaries of the French and Benelux banks. Operating expenses continued to be aggressively managed as IT and digitalization costs were offset by branch closures and staff reductions. Liquidity profiles were generally robust while capital levels increased as the banks received a regulatory reprieve in the form of a lower 2017 requirement following a revision to the Pillar 2 portion of the calculation. Ongoing legal battles remained a headwind for the industry. Although we expect to see a number of settlements across the industry in 2017, there are signs that such costs are peaking as management teams look to put past transgressions to a close.

From a geographic perspective, not surprisingly, the Nordic banks continued to lead our European bank universe in most metrics thanks to consistent earnings, well managed expenses, excellent credit quality and robust capital levels. Oil related exposure, particularly at DnB in Norway, have required elevated provisions but manageable as the rebound in oil prices has led to some stabilization in the second half of the year. Benelux banks have rebounded nicely as the Dutch economy has steadily improved, although the commercial real estate segment has lagged the housing recovery. French banks continued to suffer from the difficult domestic rate environment but business and geographic diversification have helped to offset the pressure.

ASIA PACIFIC BANKS

Australian banks continued to display resiliency as a good level of profitability was maintained. While net interest margins generally faced further compression, modest revenue growth was achieved as residential mortgage lending growth remained healthy. The credit environment remained benign with the banks reporting manageable exposure to the mining sector and New Zealand agricultural sector. Capital metrics weakened slightly during the quarter, but remained solid with the average CET1 ratio at 9.5% under Australian Prudential Regulation Authority's more conservative framework. Aussie banks easily met the Basel III liquidity requirements with an average LCR of 134% and a first time reporting of a net stable funding ratio that averaged 106% with both ratios comfortably above the 100% requirement.

The Japanese banks continued to face earnings pressure from the negative interest rate environment and subdued loan demand, particularly within Japan. As a result, spread income declined as net interest margins compressed further to anemic levels. This challenging operating environment has been cushioned by three factors – all of which have contributed to satisfactory profitability. First, the favorable securities market environment fostered notable gains from bond and stock holdings despite ongoing efforts by the banks to reduce Japanese Government Bonds and equity stakes. Secondly, recent weakening in the Yen provided a boost to international profits. Lastly, the benign credit environment has resulted in minimal credit costs and in some cases gains from the release of loan loss reserves. That said, Japanese banks could potentially face headwinds from their higher than average exposure to the oil and gas sector as well as documented exposure to Toshiba, a troubled Japanese power company. Capital metrics remained sound with an average CET1 ratio of 11.3%, albeit padded by sizeable unrealized securities gains. A notable trend during the quarter was the improvement in the loan to deposit ratio amongst the three megabanks from 70% on average a year ago to 67%.

Singaporean bank profitability was pressured by further net interest margin compression and increased credit costs associated with elevated oil and gas exposure. These factors resulted in ROEs declining from above 10% recently to just below 9% while the non-performing loan ratio ticked higher to 1.4% in the most recent quarter. In fact, Moody's downgraded the stand-alone credit profiles of the Singaporean banks in December 2016 as a result of profitability and asset quality headwinds, but affirmed the lofty Aa1 senior unsecured credit ratings of the three major Singaporean banks given strong loss absorbing capital buffers and a very high likelihood that the Singaporean Government would support the banks if needed. Capital metrics were amongst the strongest globally.

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