The operating environment remained challenging during the second quarter of 2019 as escalating trade tensions between the U.S. and China, continued Brexit uncertainty and other geopolitical risks have served to dampen global economic growth and foster a more accommodative monetary setting among global central banks. However, the Federal Reserve’s (the “Fed”) Chair Jerome Powell labeled the July 2019 cut in the overnight interest rate as a “mid-cycle adjustment to policy,” which suggests that the decade-long expansion in the economic and credit cycle is not in imminent risk of ending. Despite the cloudy conditions, issuers carefully selected for our money market-approved list have demonstrated sound resiliency commensurate with minimal credit risk.

Certainly, persistent low interest rates have been a headwind to bank profitability, particularly in Japan and Europe, but ongoing cost efficiency and other restructuring programs focused on reducing non-core businesses while increasing attention towards fee-based businesses have been an offset. The credit environment has remained benign with no obvious impacts from the aforementioned uncertainties, but there are tentative signs that the excellent level of asset quality may have peaked. In fact, Moody’s changed its outlook on global investment banks from positive to stable as slower global economic growth, lower interest rates and elevated corporate leverage limit upside ratings potential.

In the corporate sector, performance was solid across most segments but there were pockets of mixed results. Key themes in the corporate space have been an increased focus on mergers and acquisitions (M&A), more shareholder-friendly activities, and higher leverage. As such, we have been more cautious on the sector and continue to focus on the best-in-class issuers that have demonstrated sound financial flexibility and commitment to a strong balance sheet.

U.S. BANKS

U.S. banks reported sound Q2 2019 results with softer revenues offset by continued expense control and efficiency gains. While net interest margins were pressured across the board as rates declined and deposit costs continued to rise, banks saw favorable loan growth on both the consumer and commercial side. Capital-market revenues were lower, albeit from a notably solid year-ago period, reflecting weakness in trading as well as in investment banking.

Banks noted tepid customer activity, particularly within rates and currency trading partly in response to investor uncertainty on trade and monetary policy. However, the banks’ diversity continued to enhance earnings with higher mortgage banking fees and an increase in investment management fees due to positive assets under management flows and market appreciation. Credit quality remained benign, supported by a favorable U.S. economic backdrop. Capital ratios at
all banks remained well in excess of requirements. Of note, all of the U.S. banks included in the 2019 Dodd-Frank Act Stress Testing/Comprehensive Capital Analysis and Review (DFAST/CCAR) process received a non-objection on their capital plans for the next year, which had a narrower scope this year as banks with assets between $100 billion and $250 billion were excluded. The key takeaway is that capital distributions will likely be higher on a comparative basis due to strengthened profitability on the part of the banks and a less stringent testing hypothesis on the part of the regulators.

CANADIAN BANKS
Canada’s six domestic systemically important banks (D-SIBs) reported improved results for Q2 2019. Revenue growth was broad-based and outpaced expense growth, resulting in positive operating leverage for most banks. Slower mortgage loan and consumer growth, driven by a cooling housing market and more stringent underwriting measures, led to softer Canadian retail banking results. However, this was more than offset by solid commercial banking and international banking results. In fact, the banks’ diversified franchises have increasingly supported earnings growth, with contributions from international operations showcasing a growing trend. While insurance results were softer for some banks, wealth management proved to be more resilient. Capital markets revenues were mixed with most Canadian banks noting reduced client volume, lower trading activity and higher expenses while some cited higher underwriting, advisory and corporate banking revenue. Credit quality remained solid despite marginal deterioration with impaired loan formations up and increased late-stage delinquencies. Provisions were also higher to reflect lower forward-looking macroeconomic assumptions along with increased lending growth and a shift in the seasoning and mix of loan portfolios. All of the banks currently are in compliance with the regulator’s increased capital requirements, set to take effect on October 31, 2019.

EUROPEAN BANKS
European bank earnings showed resilience in Q2 2019, bouncing back from a generally weak first quarter of the year but lacked broad-based year-over-year gains with most failing to beat Q2 2018 results. Positively, lending volumes have been trending upward although the low interest-rate environment remained a major headwind to sizable earnings growth. Commission- and fee-generating businesses performed well as this has been a major focus across the sector but investment banking performance has consistently lagged U.S. peers in both sales & trading and origination & advisory. While some of the decline can be attributed to retooled business models and the exit of capital-intensive, less profitable activities, European banks have nevertheless been losing market share to their U.S. peers. As a result, European banks have become more focused on asset and wealth management activities. Cost-cutting and digitization efforts also remained a key theme to improve efficiency in the face of revenue challenges. On a positive note, litigation costs and regulatory fines have greatly diminished but still represent an overhang, with some unresolved investigations into money laundering. The above trends are applicable to UK banks, which have also demonstrated resilient performance with no obvious impact related to Brexit outside of additional provisioning related to uncertain economic prospects.

Negative interest rates, while initially viewed as temporary, have now been a part of the European landscape for roughly five years with the European Central Bank (ECB) signaling that rates may stay at current or even lower levels until at least the first half of 2020. Banks have up until recently refused to charge retail clients for deposits; however, the major Swiss banks announced fees for their wealthiest customers with balances over a specified limit, with one bank in Denmark following suit. Meanwhile, the ECB is exploring the prospects of a tiered system as it relates to euro area bank reserves, which could reduce the cost banks pay to leave deposits with the ECB — although the overall impact to profitability remains uncertain until details emerge. The cost of credit ticked up in the quarter for a number of banks.
but this was more due to specific client issues rather than a broader downturn in asset quality. Non-performing loans are well contained and credit costs remain below the through-the-cycle average.

AUSTRALIAN BANKS
Australian banks reported softer profitability during the first half of 2019, but it was still solid on an international basis. Earnings were pressured by tepid loan growth, tighter margins as funding costs rose on increased competition, and a continued drag from compliance and remediation costs associated with industry-wide conduct shortcomings uncovered by Australia's Royal Commission. Collectively, this led to weaker results in the Australian retail banking businesses while business and corporate banking displayed stable to improved performance. The New Zealand segments benefited from solid growth in both housing and business lending. In Australia, the impact of a series of macro-prudential measures served to effectively cool the housing market. However, since the May 2019 national election, some of these measures were eased, threats to reduce housing related tax perks were alleviated and the Reserve Bank of Australia (RBA) cut its policy rate by 25 basis points to 1.0%. As such, conditions could result in faster mortgage-related credit growth in the banking sector and renewed concerns about the Australian housing market. That said, asset quality has remained benign with minimal net charge-offs; however, late-stage delinquencies in the housing portfolios have ticked up from a low base. A positive outcome of the Royal Commission conduct review was the Australia Prudential Regulatory Authority's (APRA) decision to increase the capital requirements for the four major Australian banks with the banks in good shape to meet the "unquestionably strong" Common Equity Tier 1 (CET1) ratio of 10.5% by 2020. In addition, APRA clarified its approach to loss-absorbing capital whereby senior creditors would not be subject to bail-in and the possibility of government support was not ruled out. Following this announcement, Standard & Poor's (S&P) affirmed Australian banks and revised its outlook from negative to stable on the view that Australia remains highly supportive of its banks. Still, the conduct shortcomings could pressure ratings as reflected by Fitch's negative outlook on the sector.

JAPANESE BANKS
Japanese banks posted mixed results for their first quarter ended June 30, 2019. Core profitability remained subdued as the slowing economy both domestically and globally has suppressed loan demand while the persistent ultra-low interest-rate environment has further compressed net interest margins. These factors swayed S&P to downgrade the primary Japanese broker-dealers while Moody's lowered their macro profile for Japanese banks to highlight that core profitability is structurally weak; however, senior unsecured ratings remained intact for major mega and trust banks as the rating agencies view Japan as being highly supportive of its major banks. While earnings have been supported by a benign credit environment with some banks still showing gains from the release of loan-loss reserves, there have been tentative signs that credit costs and non-performing loans may begin to normalize. The main offset to weak core earnings during the quarter was the continued benefit of securities gains in which bond gains rebounded due to a rally in international bond holdings. As such, Japanese banks were largely in line with full-year earnings targets, which were slightly lowered from last year's results. Despite the weak core earnings story, Japanese banks maintained very strong liquidity and capital positions with the latter supported by sizable, albeit slightly lower, unrealized securities gains.

CORPORATES
Second-quarter 2019 earnings were solid across most corporate sectors on an organic, constant-currency basis with some sectors reporting weaker results. Higher prices helped the consumer products and food companies. Pharmaceuticals benefited from innovative medicines, which offset the impact of patent expirations and generic competition. However, the oil & gas sector reported weaker earnings.

Past performance is not indicative of future results.
due to lower commodity prices. There were a few profit warnings from some of the diversified manufacturers due to a slowdown in industrial production in certain end markets. As a result of weaker earnings for certain companies and increased debt to fund acquisitions, we did see higher leverage in selective corporates during the quarter. We believe corporates will remain focused on M&A as there were some notable acquisitions announced during the quarter in the pharmaceuticals and oil & gas sectors.

We believe credit-ratings risk has increased due to higher leverage and share repurchase activity. However, we believe credit quality overall remained solid and corporates remain committed to high-investment-grade credit ratings. Cash flow generation remained robust and liquidity levels were adequate. We also believe corporates remain cautious given a number of headwinds that continue to impact the markets, such as tariffs, Brexit, higher raw material costs and volatile currency. Given the credit quality of our coverage, though, corporates have the financial flexibility to offset these headwinds and manage their balance sheets.

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