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

The operating environment became more challenging for issuers operating in the money market space during the second quarter of 2016 due to increased pressures on global economic growth, continued low interest rates, currency headwinds, low commodity prices and heightened geopolitical uncertainty, particularly following the UK referendum result in favor of leaving the European Union (Brexit). To combat these forces, a number of issuers have focused on cost-reduction efforts and other strategic initiatives to enhance business models as a way to support profitability. For corporates, this has meant an increase in acquisitions as well as more shareholder friendly activities, although the focus has been to maintain a solid balance sheet and credit profile.

In the banking universe, a number of issuers in the U.S. and Europe rebounded from a weak first quarter as increased volatility with respect to Brexit helped drive fixed income earnings in the rates and currency space higher. Net interest margin compression was also a universal theme, particularly in Europe and Japan in the face of negative interest rates. Credit conditions remained generally benign with small pockets of stress in the oil and gas, shipping and agricultural sectors appearing well contained from an asset quality perspective. Following rigorous stress tests in the U.S. and Europe, bank issuers were given a good bill of health as balance sheet fortification efforts by way of deleveraging, raising capital and building liquidity has put banks in a solid position to withstand adverse macroeconomic and market conditions. As such, the issuers we focus on in the cash investment universe displayed sound resiliency with solid credit profiles evidencing minimal credit risk.

U.S. BANKS

For 2Q16, U.S. banks generally reported higher net income compared to the prior quarter, but flat to down from a year ago. For the large banks, 2Q16 earnings reflected a rebound in capital markets revenue, still benign credit costs and cost containment. In particular, capital markets revenue increased with the Fixed Income Clearing Corporation (FICC) up solidly, driven by growth in rates and currencies, albeit partly offset by lower underwriting fees as global initial public offering (IPO) markets remained weak. That being said, headwinds remained, such as energy exposures, continued low interest rates and related pressure on margins as well as macroeconomic uncertainty pertaining to Brexit and the U.S. election. Cost containment and re-engineering efforts have remained priorities in the face of revenue pressure while some regional banks have looked to acquisitions. As U.S. banks were more proactive than international peers in provisioning for energy related exposure during the previous quarter, credit costs were visibly lower during the quarter with an expectation that additional energy-related losses will be manageable.

Rating agencies have recently noted that stable credit outlooks reflect healthy asset quality metrics, improved capitalization, sound liquidity and strong regulatory oversight. All major U.S. banks within our coverage reported Advanced Approach (fully phased-in) Common Equity Tier 1 (CET1) Ratios and Supplementary Leverage Ratios that were well above minimum requirements. Despite the severity of the stress tests under Comprehensive Capital Analysis and Review (CCAR) 2016, the banks under coverage received no objections to their capital plans, with Morgan Stanley being the exception, having received a ‘conditional’ non-objection due to deficiencies in the bank’s capital planning process, which need to be remediated by year-end. Early in the quarter, U.S. regulators released their assessment of the systemically important bank’s resolution plans/living wills. Of note, Citi was the only global systemically important bank (G-SIB) to receive a
pass on its resolution plans by both the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve (Fed), notwithstanding some shortcomings that need to be addressed. This represents a significant achievement for the bank, which was previously saddled with various risk-management concerns. Morgan Stanley and Goldman Sachs were deemed to have shortcomings, having received a split decision by the two regulators, while the other banks were deemed to have deficiencies by both regulators and need to resubmit plans by October 1, 2016 or face stringent consequences. Given the time frame, banks are more likely than not to resubmit effective plans. Regional bank capital levels remained solid with all banks reporting fully phased-in Standardized or Transitional ratios that were well above required minimums.

**CANADIAN BANKS**

Canadian banks continued to operate in an environment of slow growth and continued low interest rates. Despite the challenging environment, the banks reported decent returns with improved capital markets and marginal loan growth benefiting results. Some banks benefited from a decline in expenses while others saw increases such as restructuring charges at Bank of Montreal (BMO) attributed to severance costs from headcount reductions. Similar to U.S. banks, cost containment remains a strategic priority at Canadian banks given continued revenue growth challenges. Banks have been seeking earnings diversification through expansion into U.S. markets and the wealth management arena, which is a potential positive. However, rating agencies have noted that such strategic shifts may increase risk profiles, which in turn may pressure ratings, as evidenced by Royal Bank of Canada’s recent negative outlooks across the board reflecting its growing capital markets business, particularly in the U.S.

Energy exposures remained a headwind with aggregate provisions up modestly on account of direct loans to oil and gas companies and retail loans in the oil-producing region of Alberta. That being said, exposures remained manageable in the context of the Canadian banks’ solid balance sheets, the secured nature of reserve-based lending and modest improvement in credit outside of the energy-related sector. Of note, loan-to-value ratios in related uninsured mortgage portfolios remain relatively healthy. Another headwind is the high level of consumer indebtedness; however, this is mostly offset by the fact that a majority of mortgages held are explicitly guaranteed by the government.

Canadian bank balance sheets continued to benefit from strong capital ratios, a large stable deposit base and solid liquidity, all of which compared favorably among global peers. Canadian regulators have yet to adopt an ‘effective’ bail-in regime as this has been delayed by the relatively new government. As such, Canadian bank ratings continue to benefit from implied government support; however, improved loss absorbing capacity should offset most if not all of the uplift if and when rating agencies reduce or eliminate implied support from their ratings.

**EUROPEAN BANKS**

European bank earnings rebounded in 2016 following the weak results reported in the prior period given the very difficult operating conditions at the start of the year. Market related businesses benefited from higher client activity while most banks enjoyed a sizeable capital gain from the sale of shares of Visa Europe, which was acquired by Visa Inc. Modest lending growth largely offset pressure from the low-rate environment; however, net interest margins were compressed as the ability to re-price mortgage and deposit products waned — a trend that will likely continue post Brexit given expectations for even more accommodative policy. With the Brexit vote coming at the end of June, 2Q16 earnings saw little immediate effect for European banks but this will be a topic to monitor moving forward as negotiations around the impending split advance. UK banks mentioned that Brexit has not had much of an impact on business yet and that there is no real tangible sign of credit or economic stress; however, the FX effect of a sharply lower sterling was cited as a reason for slightly lower capital ratios.

Although not overly concerning at this point, higher impairments related to oil and shipping exposures were seen at many institutions, but overall asset quality continued to improve. We do expect further deterioration in these portfolios moving forward, although losses should be manageable and asset quality concerns around other geopolitical hotspots such as Turkey and Russia have been negligible. The European Banking Authority (EBA) recently published the results of its 2016 European Union (EU)-wide stress test, which covered 51 European banks and was designed to analyze how a bank’s capital position develops over a three-year time frame in a baseline and adverse scenario. Although there was no pass or fail as was the case in the 2014 test, the European Central Bank (ECB) gave a benchmark for a CET1 ratio of 5.5% plus any applicable G-SIB buffers. As the banks...
have enhanced their capital position over the past few years, they entered the test in a much stronger position. The results of the test were positive, with a median fully loaded CET1 ratio of 9.4% in the adverse scenario and a median leverage ratio of 4.0%. As expected, the weaker banks were Italian, Irish, and Austrian while the Nordic banks were the strongest performers. The national supervisors will now review the results, speak with the banks and apply additional capital requirements on a bank specific basis if deemed necessary. This differs from the 2014 test in which any capital shortfalls were required to be rectified within nine months.

**ASIA-PACIFIC BANKS**

The operating environment in the Asia-Pacific region has become more challenging as economic growth has slowed and monetary policy has shifted to a more accommodative stance as reflected by the implementation of negative interest rates in Japan in early 2016 and a recent cut in the Australian policy rate to 1.5%. Against this backdrop, earnings have been more resilient among the Australian banks while the Japanese banks, have experienced weaker earnings.

The Japanese banks, first quarter earnings as of 6/30/16 were noticeably lower, resulting in weak mid-single-digit return on equity (ROE). Profitability was pressured by a decline in spread income due to flat domestic lending growth, slower overseas lending growth, overall compression in net interest margins and currency effects from yen appreciation. In addition, lower equity markets in Japan resulted in reduced equity-related gains that were only partially offset by increased bond gains. Favorably, the credit environment remained benign such that impairment costs were minimal; however, energy-related exposures are more elevated than global peers and could be a source of asset quality pressures going forward. Capital adequacy ratios remained strong, albeit slightly lower, as significant levels of unrealized gains declined in line with the downturn in the Japanese equity market. The difficult operating environment is largely reflective of the challenging economic conditions in Japan, which prompted Fitch to revise the rating on Japan to negative and subsequently the ratings on the Japanese banks to negative as well.

Australian banks continued to display resiliency in financial results as of 3/31/16, although ROEs declined from the mid-teens range to the low-teens range in part due to increases in the equity base following capital raises in the latter half of 2015. Revenue growth was muted as modest lending growth and the favorable impact on margins from mortgage re-pricing was nearly offset by lower fee income, particularly from markets related earnings within the institutional banking business. The credit environment remained benign overall with negligible mortgage-related charge-offs, but total credit costs increased noticeably off a low base to a still manageable level given some weakness in agricultural and resource related exposures. Aussie banks continued to be well capitalized, especially when ratios are converted from the Australian Prudential Regulation Authority’s (APRA) more conservative approach to an internationally harmonized Basel III basis; however, ratios are expected to decline moderately when the risk weight on mortgages increases to 25% in July 2016. Notwithstanding credit stability, Standard and Poor’s recently revised the outlook on Aussie banks to negative following the change in outlook on Australia to negative that was prompted by uncertainties over Australia’s fiscal consolidation plans post the recent national election.

**NON-FINANCIAL CORPORATES**

In the second quarter of 2016, earnings were weak for many companies across the corporates universe due to persistent headwinds such as low commodity prices, currency and geopolitical issues. The impact of Brexit and the instability in Venezuela remain to be seen, although many companies expect a minimal impact to operations. The oil and gas names continued to report weak results due to low oil prices, which also impacted some of the diversified manufacturing companies. The pharmaceutical sector was mixed as solid results driven by new products were offset by the negative impact of patent expirations. Consumer products reported solid organic results helped by its product diversity and innovations. We continue to believe most corporates are focused on maintaining solid balance sheets and credit profiles in order to maintain strong credit ratings. However, we have seen some corporates being more financially aggressive, borrowing for share repurchases and acquisitions — all of which could place pressure on ratings for some corporate issuers. We expect continued ratings pressure on the oil and gas sector. The outlook for the remainder of 2016 remains cautious given the expectation for continued pressure on commodity prices and uncertainties in the global economy.
An investment in any money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in a money market fund.

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