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

Synchronized global economic growth, continued low interest rates, improved commodity prices, benign credit quality and accommodative monetary policy presented a relatively strong operating environment, which supported favorable credit conditions during the fourth quarter of 2017 for the large global corporations and financial institutions occupying the money market issuer space. Credit conditions are likely as good as it gets with the Federal Reserve and select other central banks poised to raise interest rates over the course of 2018 while also pulling back quantitative easing programs in favor of less supportive monetary policy. In addition, geopolitical tensions around North Korea, the Middle East, Brexit negotiations and global trade wars could present headwinds for issuers.

Conversely, the recently passed Tax Cuts and Jobs Act in the U.S. could present a modest boost to economic activity in the U.S. with a lower corporate tax rate being an overall credit positive despite the initial hefty one-time charges associated with repatriation and deferred tax asset write-downs. It remains to be seen what impact the repatriation will have on corporate cash held overseas, but corporations have indicated that excess cash will likely be put towards a combination of share repurchases, dividends, M&A, capital expenditures and debt paydown.

While the increased level of market volatility to start 2018 could portend a shift in the credit cycle, we believe the large “best-in-class” corporate and banking issuers that dominate our approved list in the money market space have defensible business models, formidable balance sheets and solid credit profiles representative of minimal credit risk.

U.S. BANKS

Fourth-quarter 2017 results for U.S. banks were impacted by the Tax Cuts and Jobs Act that was passed in December 2017. The impact was mixed as some banks reported gains related to the revaluation of deferred tax liabilities while others reported write-downs on deferred tax assets (DTAs) and a levy on repatriation of foreign earnings. Moreover, banks also reported related increased charitable contributions, one-time employee bonuses and higher legal accruals in some cases. Rating agencies noted that there will be no immediate ratings impact from tax reform. Importantly, we believe the net takeaway is that the entire sector stands to benefit from higher earnings in the long run, reflecting a lower federal tax rate.

U.S. banks saw improved core earnings from a year ago, largely reflecting higher net interest income due to the impact of rising interest rates and loan growth, albeit modest. Net interest margins continued to expand, although more visibly so for the regional banks. Despite declining mortgage banking revenues, non-interest income saw positive momentum thanks to increased trust fees and higher asset management fees on account of higher equity markets. Capital market results for the large banks were down as higher investment banking fees were more than offset by a continued decline in fixed income results due to low volatility and lower client activity. In aggregate, revenue growth was favorable while continued
expense management afforded many banks positive operating leverage. Liquidity remained excellent while capital ratios were solid. The tax reform had a limited impact on capital ratios as a significant portion of deferred tax assets were excluded from regulatory capital.

**CANADIAN BANKS**

Canadian banks maintained best-in-class profitability compared to global banking peers as a stable domestic banking market, increased diversification through U.S. subsidiaries, volume growth in a higher interest-rate environment, increased fee-based income and continued cost discipline all factored into continued earnings resilience. Capital market revenue was less of a drag on earnings as compared to U.S. peers, although reduced fixed income revenue was also evident. Canadian banks continued to face headwinds related to real estate price appreciation and high household indebtedness; however, performance remained favorable and regulators continued to be prudent and proactive in monitoring the system. Of note, Canadian banks expect a moderate earnings and limited capital impact from International Financial Reporting Standard (IFRS) 9, which changes the credit loss reserving methodology to forward looking versus incurred, effective January 1, 2018. Capital levels remained strong with average common equity Tier-1 (CET1) ratios well above regulatory minimum requirements. Total Loss Absorbing Capital (TLAC) requirements and bail-in rules are yet to be finalized but are expected during the first half of 2018. Moody’s noted that once the resolution regime takes effect, its government support assumptions will be reduced from ratings; however, its application of loss given failure (LGF) could ultimately be favorable to Canadian bank ratings.

**EUROPEAN BANKS**

Continued economic improvement and benign credit conditions supported sound underlying European bank earnings with trends broadly similar to those of the previous quarter, although an array of extraordinary items negatively affected the reported figures during the fourth quarter. Low market volatility continued to pose a headwind to investment banking revenue, particularly within Fixed Income Currency & Commodity, where the large players experienced notable declines. Equity sales and trading revenues fared better but were moderately lower. Looking forward, the increased level of market volatility to start 2018 could benefit investment banking income.

The low interest-rate environment in Europe remained a challenge, but increased lending volumes have served as an offset. While European banks have also been able to lower their cost of deposits, this opportunity has diminished in the early part of 2018. In general, bank business models have shifted with a greater focus on increased non-interest income and reduced reliance on short-term wholesale funding in an effort to lessen interest-rate sensitivity. These efforts were apparent in the most recent quarter with stable to improved net interest margins and strong performance recorded in wealth and asset management businesses.

On the business model front, UK banks have begun to shift their core retail and business banking assets into separate ring-fenced banking entities ahead of the January 1, 2019 deadline for UK banks to ring-fence core retail and business banking assets from wholesale banking activities. While credit ratings look to be adversely impacted for the wholesale banking businesses housed in the non-ring-fenced banks, we expect stable to slightly higher ratings for core UK banking businesses that will comprise the UK ring-fenced banks.

European banks are beginning to bear fruit on strategic expense-reduction efforts with digitization of banking operations an ongoing theme that has accelerated IT-related costs. Several European banks booked large DTA charges related to new U.S. tax laws, but ultimately the new U.S. tax rules are deemed a credit positive over the long term. During the quarter, European banks were impacted by other extraordinary items with charges related to the collapse of Carillion in the UK, additional litigation reserves, and ongoing restructuring charges. Credit quality continued to improve with several banks benefiting from a release of reserves related to previously troubled portfolios as
stabilization has abated concerns around shipping and oil exposures.

**ASIA-PACIFIC BANKS**

Underlying results for Australian banks remain good against a favorable economic backdrop. Revenues were up modestly and margins were relatively stable notwithstanding the impact of the bank levy and competitive pressures in home lending. Asset quality remained healthy with nonperformers low and delinquencies stable to down. Australian banks expect a manageable impact from the forward-looking IFRS 9 accounting standard as it relates to reserving and impairment recognition. Elevated house prices and household leverage remained headwinds but tempered by low interest rates and continued macro-prudential measures. Australian banks have reported slowed growth in investor loans and interest-only loans as they aim to curtail such lending in accordance with regulatory requirements that might become more restrictive given higher risk weights for related loans proposed by the Australian Prudential Regulatory Authority (APRA). We believe Australian banks remain well positioned to meet APRA’s “unquestionably strong” CET1 ratio requirement of 10.5% while the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) remained well in excess of regulatory minimums.

Japanese banks continued to report moderately acceptable levels of profitability supported by increased equity-related gains, diminished bond-related gains and benign credit conditions that have allowed some banks to book gains on the release of loan loss reserves. While economic conditions in Japan have improved, domestic banking remained challenged by a further compression in spreads due to the negative interest-rate environment that has only been partially offset by reasonably good growth in offshore lending at a slightly more favorable margin. Japanese banks continued to benefit from a deep pool of deposits and a healthy liquidity profile comprised of a significant pile of cash and a highly liquid security portfolio. Capital levels remained robust, but excess capital is limited if sizable unrealized securities gains are excluded.

Singaporean banks reported improved underlying profitability during the quarter, aided by higher interest rates, good loan growth and good performance in wealth management. However, Singaporean banks boosted specific reserve levels and increased the recognition of non-performing loans, primarily related to oil and gas exposure, in preparation for the more forward-looking Singapore Financial Reporting Standards (SFRS) 9 accounting standards that came into effect in January 2018. Still, overall credit quality remained relatively benign with stable conditions expected for 2018. Capital adequacy continued to improve to healthy levels as Singaporean banks have been reducing risk-weighted assets.

**CORPORATES**

Overall fourth-quarter 2017 earnings were positive, reflecting the continued improvement in global economic conditions. Improved commodity prices, leaner organizations, and higher-margin assets helped revenues and operating income in the fourth quarter. Geopolitical risk in certain markets and increased competition continued to be headwinds for corporate issuers. M&A activity has increased across the board, but these mostly strategic acquisitions should help with operations in the long run. Overall credit profiles remained positive with strong liquidity and relatively stable credit ratings in the quarter. However, shareholder-friendly activities, such as a step-up in share repurchases and a focus on dividends, have increased. This theme is expected to continue following the recently enacted Tax Cuts and Jobs Act as corporations have suggested that excess cash repatriated to the U.S. could be put towards a combination of share repurchases, dividends, M&A, capital expenditures and debt paydown.

Still, we believe corporates are committed to their strong investment-grade ratings and rating agencies have suggested a limited ratings impact given the long-term credit positive view supported by a lower tax rate, positive cash flow implications and prospects for investments to moderately stimulate the U.S. economy.