4Q18 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 fourth quarter of 2018 proved to be a challenging operating environment for banks and corporates as geopolitical concerns over the uncertain outcome of ongoing U.S.-China trade negotiations and Brexit served to dampen economic sentiment with signs of slowing growth in China and Europe. While the U.S. economy demonstrated resiliency during the quarter, the aforementioned factors weighed on capital markets with turbulent conditions taking a toll on trading operations for banks globally, particularly as it relates to fixed income, currency and commodity (FICC) trading. Non-trading operations fared better on stable retail and wealth management income with North American banks outperforming international peers due to the benefit of higher interest rates. Credit quality conditions remained benign with some banks still showing improved asset quality performance; however, there were a number of banks that increased provisions to account for weaker economic assumptions based on the forward projection mandate required by accounting standard IFRS 9.

While corporate issuers resorted to higher pricing to combat rising costs, financial issuers launched renewed cost reduction programs in the face of revenue growth challenges. Despite the earnings headwinds, the high-grade financial and corporate issuers common to money market funds continued to display solid liquidity and capital metrics that were supportive of overall credit stability.

Our views on the various sectors are as follows:

U.S. BANKS

While increased market volatility adversely impacted the U.S. banks capital market activities during 4Q18, the U.S. banks still generated positive underlying earnings. Profitability benefited from a lower tax rate, higher net interest income on the back of margin expansion and commercial loan growth, reduced provisions and continued cost containment. With the U.S. Federal Reserve taking a more patient approach to further policy moves and deposit betas on the rise, the prospect for continued margin expansion is limited. The challenging market conditions took a toll on FICC and underwriting businesses of the U.S. banks with strength in equity trading and advisory serving as partial offsets. Still, on a full year basis, the capital markets business was improved from a year ago and some of the banks indicated an improved trading environment to start 2019. Other fee-based businesses performed well, but a few banks noted a decrease in assets under management and a decline in mortgage banking income. To combat earnings challenges, U.S. banks remained focused on efficiency initiatives by way of branch consolidation and reduced head count with cost savings partially directed towards increased technology spending. Asset quality continued to be solid, reflective of benign credit conditions, but growth in leveraged lending and commercial real estate bears monitoring. That said, the favorable outcome from the Federal Reserve's recent capital adequacy stress test (DFAST and CCAR) allowed a number of banks with sufficient capital buffers to announce increased share repurchase programs.

CANADIAN BANKS

The Canadian banks reported respectable results for the first quarter ending January, 31, 2019, although earnings were pressured by weaker capital markets income related to increased market volatility and higher credit costs. Aggregate net income was higher, propelled by strong growth in domestic commercial lending, stability in the Canadian retail business and solid contributions from international operations, particularly in the U.S. subsidiaries. Canadian banks benefited from rising rates in both Canada and the U.S., which boosted net interest margins. Mortgage lending growth slowed as macro-prudential measures have been effective in cooling the housing market with particular moderation in Toronto and Vancouver. Within capital markets, a difficult environment pressured FICC revenues while equity and debt underwriting fees declined with some offset from higher equity trading and advisory fees. Canadian banks have suggested that the trading environment has improved to start 2019. On the asset quality front, benign credit conditions prevailed; however, several Canadian banks recorded higher credit costs related to one large utility company that declared bankruptcy. In addition, Canadian banks booked higher provisions to buffer loan loss reserves based on downward revisions to forward looking economic and house price assumptions. Otherwise, consumer credit metrics remained in good standing supported by a manageable level of impairments and a low loan-to-value (LTV) on the uninsured mortgage book. While the Canadian banks maintained solid capital adequacy, OFSI (Office of the Superintendent of Financial Institutions), Canada's banking regulator, increased the domestic stability buffer for the banks by 25bps to 1.75% of total risk-weighted assets, effective April 30, 2019, which moves the total regulatory requirement for the banks to 13.25%. As a result, the Canadian banks are well placed to manage potential risks posed by weaker housing market, rising household and corporate debt levels and a softer economy.

EUROPEAN BANKS

The European banks reported generally weak earnings for the 4Q18 in what was otherwise a decent year for the broader European bank universe. More so than their international peers, the volatile market conditions contributed to significant declines in FICC and equity trading. In addition, ongoing headwinds from the low rate environment, subdued lending volumes and increased competition from non-bank lenders continued to be a challenge for the European banks. Although Wealth Management and Retail banking operations remained broadly resilient, the aforementioned difficult operating conditions prompted several banks to announce renewed cost savings initiatives on top of existing efficiency plans. As a result, full year expenses were generally stable to lower despite rising costs in the fourth quarter as many banks accelerated their digitization efforts. UK bank performance proved to be resilient despite the headwinds posed by uncertainty with respect to Brexit negotiations whereby the UK is expected to leave the European Union on March 29, 2019 with or without a deal.

The benign credit environment remained a positive factor for the European banks; however, there was a modest increase in provisioning for some banks against offshore energy lending exposure with the previous trend of banks benefiting from the release of loan loss reserves having largely ended. For the UK banks, impairment costs remained low inclusive of additional provisions booked to account for downward economic projections related to Brexit headwinds. In November 2018, the UK banks passed the Bank of England (BOE) stress test in which none of the major UK banks were required to raise additional capital. Litigation costs related to legacy financial crisis transgressions has largely decelerated from the broad European banking sector. However, a handful of European banks – particularly in the Nordic region – have been involved in money laundering allegations. The outcome of these investigations remain opaque with regards to potential fines and sanctions, but viewed as manageable relative to the strength of the European banks solid capital position.

ASIA-PACIFIC BANKS

The Japanese banks reported subdued results for its third quarter ending December 31, 2018. Margin pressure amid the zero interest rate environment and sluggish domestic loan demand remained a persistent theme suppressing operating income for the Japanese banks. The benign credit environment was another continuing trend with credit costs remaining low if not additive to earnings in the way of reserve releases while impaired loans declined. However, volatile capital market conditions during the quarter adversely impacted trading income with the Japanese banks reporting a reduction in both equity and bond-related gains. While unrealized securities gains remained sizeable for the megabanks, there was a noticeable drop during the quarter with some of the banks reporting unrealized loss positions on foreign bond holdings. Still, the Japanese banks remain well capitalized excluding unrealized securities gains. The funding profile of the Japanese banks remained attractive with significant deposit bases, but they have increasingly looked to the U.S. dollar funding market to fund overseas lending growth.

Singaporean banks posted reasonably good profitability for the fourth quarter of 2018, but similar to global peers, its earnings were pressured by weaker trading results and a slight dip in fee income. Otherwise, a higher interest rate environment in Singapore coupled with good international loan growth helped to boost spread income. Regulators have maintained macro-prudential measures, which have worked to cool the housing market and keep a lid on domestic lending growth. Overall, asset quality conditions remained benign with non-performers stable with credit costs still low despite an uptick in provisions due to seasoning. Although lending grew at a faster pace than deposits, Singaporean banks maintained an attractive funding profile with limited reliance on wholesale funding. Capital and liquidity metrics were solidly above regulatory mandates.

Profitability for the Australian banks remained stable for their first quarter ended December 31, 2018. Revenues were flat to moderately higher as growth was held back by margin compression, slower lending growth and a decline in markets-related income. While remediation costs were lower, a final Royal Commission report released by the Australian Government cited deficiencies in the Australian bank's conduct and compliance protocols, which could result in additional costs as the banks put additional systems and control measures in place beyond measures implemented before the final report was released. A pullback in housing-related credit growth was a notable development as macro-prudential measures and tighter underwriting standards contributed to reduced interest-only loans. House price growth has also softened, notably so in Sydney and Melbourne. These trends reflect measures taking by both the regulators and the banks to stem a perceived over-heated housing market; however, asset quality indicators remained healthy with credit losses and impaired loans remaining at cyclical lows. Regulators in both New Zealand and Australia have raised capital requirements with the Aussie banks well placed to meet the APRA's (Australia Prudential Regulatory Authority) "unquestionably strong" Common Equity Tier 1 (CET1) target of 10.5% by January 2020.

CORPORATES

In the fourth quarter 2018, corporates continued to report good results despite headwinds such as higher raw material costs and competition. To offset some of the higher costs, companies in sectors such as consumer products and food and beverage raised prices on their products. Snacking remains a growth driver. Emerging Markets continued to outperform the Developed Markets in the consumer space. Oil and Gas continued to benefit from higher pricing which helped cash flow generation. Pharmaceuticals benefited from new medicines. The investment grade technology sector continued to generate solid top-line growth in 4Q18, albeit at a more conservative pace. Overall credit quality was stable. Corporates continued to generate solid cash flow and maintain adequate liquidity. We have seen more merger and acquisition activity (i.e. oncology is a growth area for Pharmaceuticals) and a focus on share repurchases. We believe most corporates in our coverage will maintain current credit ratings and remain committed to their investment grade ratings. Oil and Gas companies have reduced debt and continue to focus on maintaining strong balance sheets. Specifically for the technology sector, credit profiles remain sound with low to moderate leverage and strong liquidity positions. We remain cautious for the overall corporate space and will continue to monitor shareholder friendly policies and change our recommendations accordingly. Looking ahead for 2019, corporates expect organic growth but remain cautious given the continued uncertainties including the global economy, consumer behavior, currency and higher input costs.

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Deposit beta measures how responsive management's deposit repricing is to the change in market rates. **Common Equity Tier 1 (CET1)** is a component of Tier 1 capital that consists mostly of common stock held by a bank or other financial institution.

Views expressed are those of the advisor stated and do not reflect views of other managers or the firm overall. Views are current as of the date of this publication and subject to change.

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