3Q18 Money Market Credit Trends by Sector

INVESTMENT FOCUS

December 2018

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

The operating environment for the third quarter of 2018 was generally supportive of sound performance for the high grade financial and corporate issuers operating in the money market space despite mixed sentiment. Global economic growth remained expansionary, but less synchronized compared with conditions at the beginning of the year. This was somewhat reflective of the divergence in monetary policy where the Federal Reserve (the "Fed") remained on course to raise interest rates further towards a "neutral" rate objective while rates remained stuck at zero in Europe and Japan. Factors at play weighing on sentiment are increased tensions on the trade front between China and the U.S., uncertainties over the path to Brexit looming in 2019 and other geopolitical risks. These issues have increased market volatility recently and presented currency headwinds for issuers, but so far credit quality conditions have remained benign. While it's too early to tell when the cycle will turn, we remain focused on careful credit selection, utilizing a top-down, bottom-up approach to identify the best-in-class financial and corporate issuers with business models that we believe are defensible through the cycle.

Our views on the financial and corporate sector are as follows:

U.S. BANKS

Results for U.S. banks continued to benefit from a lower effective tax rate, minimal credit costs and positive operating leverage, largely due to controlled expenses with technology spending modestly offset by efficiency improvements, such as branch rationalization. Revenues grew at a slower pace as loan growth decelerated and the positive benefit of rising rates moderated somewhat. That being said, most banks still stand to benefit from the rate environment as balance sheets remained asset-sensitive while deposit betas were helpful, albeit increasing. The large global banks received a boost from equities, both underwriting and trading, which offset lower fixed income, currencies and commodities (FICC) trading for most banks. Investment banking fees were flat from a year ago although still strong, with traditional investment banks showing better performance than universal banks. Asset quality remained solid with nonperformers and charge-offs continuing to decline while reserve coverage was broadly stable. On the funding side, deposit growth continued to outpace lending growth; however, deposit betas have increased as non-interest-bearing accounts decreased in favor of more attractive deposit alternatives. Capital and liquidity metrics remained well above regulatory minimums, although it is anticipated that deregulation in the U.S. could result in large regional banks having reduced compliance requirements as it relates to the more stringent stress testing, liquidity and capital mandates that would apply to the larger, systemically important banks.

CANADIAN BANKS

The big six Canadian banks reported improved results from a year ago as favorable economic conditions and higher interest rates contributed to lending growth (especially in the commercial sector), wider margins and stable credit quality. Canadian banks also benefited from the strength of the U.S. economy and higher U.S. rates with the banks' U.S. subsidiaries outperforming domestic operations given that the business mix has focused on growing wealth management assets. Improved capital market results and continued expense management initiatives also factored into the better outcomes. Results were somewhat held back by a falloff in mortgage lending as higher rates and the impact of macro-prudential measures have worked towards cooling the Canadian housing market. Still, asset quality in the mortgage portfolio remained benign. Funding continued to be solid with mild reliance on interest-bearing deposits and wholesale funding. With the implementation of an operational bail-in regime in September 2018, short-term creditors were protected as all issuance with an initial maturity of 400 days or less will be excluded from bail-in.

EUROPEAN BANKS

Underlying performance within the European bank universe was sound in Q3 2018. A majority of adjusted earnings were either flat or exceeded those of Q3 2017. The reported figures were more mixed relative to comparable periods due to various one-off exceptional items related to regulatory infractions — a persistent headwind for the sector. On the revenue side, interest income was resilient as volume gains and lower funding costs have largely offset the difficult rate environment. Fee- and commission-generating businesses performed well, lifted by higher asset valuations, robust inflows, and strong card commissions driven by higher consumer spending during the summer months. Revenues from capital market activities were down on weaker FICC results and lower sales and trading within corporate and investment banking (CIB). There was a widening gap in investment banking revenues between the European and U.S. banks as the Europeans have scaled back their operations to focus efforts on expanding wealth management operations. Mitigating the revenue headwinds were the ongoing operating expense reductions along with lower credit impairments. Asset quality continued to improve, reflective of benign credit conditions. Uncertainty over the unresolved path to Brexit continued to weigh on sentiment, but UK and European banks have prepared contingency plans for less favorable outcomes with certain businesses moved to newly created subsidiaries within the European Union (EU). In fact, European and UK banks passed recent stress tests where a hard Brexit and other severe economic and market scenarios were factored in — a testament to the strength of their capital and liquidity positions in our view. As European banks have implemented the EU Bank Resolution and Recovery Directive (BRRD), senior unsecured creditors have become more protected by a larger stack of subordinated capital. While there have been select negative rating actions in the sector, the rating agencies have had a bias towards positive rating actions for the broader universe of European and UK banks on the basis of sound performance coupled with a more robust capital and liquidity position.

ASIA/PACIFIC BANKS

Australian banks continued to report healthy profitability metrics given their efficient low-risk business model that has contained operating expenses and worked to keep credit costs low. That said, core results were pressured by margin compression due to rising funding costs and lending competition, although recent moves made by the banks to reprice home loans should serve as an offset. In response to macro-prudential measures focused on the housing market, interest-only and investor loans declined while owner-occupied loans grew. Notwithstanding the regulatory focus on mortgage-related risk, asset-quality metrics continued to be sound, reflective of the benign credit environment. In other regulatory matters, a Royal Commission has uncovered misconduct within the financial sector that resulted in restructuring costs, compensation to customers and costs associated with the remediation process for Australian banks. This may continue to be an earnings headwind for the banks until the issues are resolved. That said, the costs are manageable given that Australian banks are largely in compliance with the Australian Prudential Regulatory Authority's (APRA) "unquestionably strong" capital mandate, with the capital targets likely being increased once APRA opines on total loss-absorbing capital requirements.

Japanese banks continued to report moderately good results supported by gains on the release of loan loss reserves as well as gains on the sale of equity holdings. This reflected an operating environment with benign credit conditions and a stable domestic economy. However, core banking operations for the Japanese banks remained weak as the zero-interest-rate environment and lack of domestic lending growth pressured margins further despite modest lending growth overseas. Japanese banks maintained sizable unrealized securities gains — mostly equity-related as bond-related valuations have turned slightly negative — which should remain the case even after the recent market pullback post earnings. The unrealized gains served to prop up capital metrics to strong levels, but Japanese banks appear well placed to meet regulatory requirements excluding gains and when risk-weighted assets are revised upwards to comply with full implementation of Basel III rules in 2019.

CORPORATES

In the third quarter of 2018, corporates reported another overall solid quarter as companies continued to benefit from a good global economic environment. Foreign currency continued to be a headwind but results on an organic basis were decent. Snacking was a strong category in the quarter for food companies and consumer products benefited from innovation, which drove volumes. Oil and gas continued to benefit from increased production and higher pricing. Diversified manufacturers benefited from growth in multiple business lines but operating profits for some were hurt by currency fluctuations. The technology sector continued to experience solid top-line growth across the board. Specifically for the technology sector, leverage has generally come down across the sector with some companies retiring short-term debt, all while preserving sizable liquidity buffers.

Credit quality in the corporate sector remained stable. Cash-flow generation was solid and liquidity levels remained adequate. Share repurchases remained a use of cash with some corporate issuers authorizing new programs in the quarter, but we believe this will be managed within the limits of current credit ratings. Overall, we continue to believe that most high grade corporate issuers operating in the money market space remain committed to maintaining their strong credit ratings.

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MARK-44577-2018-12-14
CIS-CCMTY-0918