1H18 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.

Continued global economic expansion and accommodative financial market conditions remained supportive of a good operating environment for issuers within the money market space during 1H18, but overall sentiment was mixed as signs of global growth being less synchronized emerged against the backdrop of escalating trade tensions, ongoing geopolitical risks and pressures on emerging markets given currency fluctuations. These factors have not yet derailed monetary policy as stimulus is gradually being withdrawn to varying degrees with the Federal Reserve (the "Fed") continuing its path towards normalized rates while the European Central Bank (ECB) looks to end its quantitative easing by the end of 2018 before it expects to move off its negative interest-rate policy by the summer of 2019. While it remains difficult to predict how long the extension of the current credit cycle will last, we remain focused on careful credit selection utilizing a top-down, bottom-up approach to identity the best-in-class financial and corporate issuers with business models that are defensible through the cycle. As such, we have avoided issuers in emerging markets or peripheral European economies and continue to favor issuers domiciled in the strong, diversified, highly rated advanced economies.

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

FINANCIAL SECTOR

According to the ICI Monthly Taxable Money Market Fund Portfolio Summary as of August 2018, financial issuers comprised 75.6% of the $528.9 billion in total industry prime assets under management (AUM) when aggregating across repurchase agreements (15.9%), certificates of deposit (28.0%), time deposits (8.8%) and financial commercial paper (22.9%) with an additional 8.4% comprised of asset-backed commercial paper that is primarily sponsored by global banks. The next largest asset class within prime money markets was U.S. Treasury debt along with U.S. government agency debt, which combined accounted for 9.0% of industry AUM.

In our view, North American banks continued to lead the pack in overall financial performance, followed by Asia-Pacific banks, then European banks. U.S. banks in particular benefited from tax reform and from a rising interest-rate environment by way of wider net interest margins while banks in Europe and Japan continued to face net interest margin pressure from the zero rate environment. Capital markets and investment banking performance were solid in the U.S. and mixed elsewhere. Expense discipline continued to be another theme as a number of banks benefited from further cost efficiencies. Still, litigation-, conduct- and restructuring-related charges continued to impact results for a few banks in multiple jurisdictions, but progress has been made in resolving legacy issues as reflected by the waning level of related charges. Banks globally continued to benefit from a benign credit environment by way of low credit costs or gains on the release of loan loss reserves in some cases despite the implementation of International Financial Reporting Standard (IFRS) 9, which forces banks to recognize credit losses in a more forwardlooking manner. For banks within our coverage, emerging market exposure to hotspots such as Turkey was limited and deemed manageable.

Housing-related risk due to potential asset bubbles in certain markets has been a big focus of regulators across multiple jurisdictions with a number of macro-prudential measures implemented to safeguard the system. However, an emerging trend in 1H18 was the scaling back of certain post-financial crisis banking regulations in the U.S. That said, all banks within our universe have built up significant liquidity and capital buffers since the financial crisis with levels comfortably above regulatory requirements. Our thoughts on the various banking jurisdictions are as follows.

U.S. BANKS

U.S. banks showcased strength in 1H18 with positive operating leverage, negligible credit costs and tax reform underpinning solid results throughout the period. For the large global banks, investment banking revenues were solid and trading revenues were up notably from a year ago, reflective of macro trends and increased client activity. The banks continued to benefit from modest but steady loan growth and higher spread income due to net interest margin expansion, which benefited from higher short-term interest rates as assets repriced faster than liabilities. However, this positive effect has been tapering off and the banks are starting to see a more competitive environment for deposits as non-interest-bearing deposits have trended lower. Still, U.S. banks remained in a comfortable funding position as overall deposits well exceeded loan balances. Asset quality remained excellent as non-performers continued to trend lower. Emerging market exposure to hotspots such as Turkey was limited and deemed manageable.

One macro trend worth watching is the emergence of deregulation, with banks below $250 billion in assets no longer subject to enhanced prudential standards while the Fed has shown more leniency toward bank capital plans under recent stress tests. That said, capital among U.S. banks remained solid with common-equity Tier 1 (CET1) capital metrics comfortably above regulatory requirements with all banks expected to meet total loss-absorbing capital (TLAC) requirements ahead of the effective January 1, 2019 deadline with debt issued predominantly out of the holding company.

CANADIAN BANKS

The big six Canadian banks saw softer mortgage origination and pressured capital market revenues with reduced results in global markets and corporate and investment banking. Nonetheless, aggregate earnings improved on the back of expanded net interest margins, continued improvement in efficiency ratios due to focused cost discipline and greater contribution from fee-based businesses, particularly in wealth management. Asset quality remained solid despite the vulnerability of high household debt levels and elevated house prices with the housing market starting to show signs of cooling following a series of macro-prudential measures implemented by Canadian regulators. Regulatory scrutiny over cybersecurity has also stepped up following reports of customer data privacy breaches for some banks.

Funding and liquidity remained solid with the use of wholesale funding relative to deposits declining further. Canadian banks have also lengthened the average maturity of their wholesale borrowings and increased their funding in foreign currencies. One of the more notable trends during 1H18 was the passage of a bail-in regime to become effective from September 23, 2018 with all senior unsecured debt issued beyond 400 days subject to bail-in (short-term creditors protected) and TLAC requirements with an effective date of November 2021. Capital and liquidity levels remained robust with CET1 capital ratios and liquidity coverage ratios (LCRs) well above regulatory requirements. Canadian banks are primarily expected to meet TLAC requirements by rolling over maturing debt into TLAC-eligible debt with minimal needs for incremental new issuance.

EUROPEAN BANKS

European banks under our coverage generally reported weaker 1H18 results compared to the exceptionally strong market-related revenue and Visa Europe share sale gains booked in 1H17. Despite a pickup in lending growth, spread income declined as the low interest-rate environment continued to pressure net interest margins. As an offset, non-interest income growth was solid as banks have grown fee-based business to combat interest-rate sensitivity. In addition, banks have been focused on expense-reduction initiatives by way of digitization and reductions in headcount as well as branches. A few banks in Europe and the UK continued to be plagued by lingering litigation, conduct and restructuring costs, but these expenses are waning in a sign that progress has been made in resolving legacy issues. Despite the implementation of IFRS 9 on January 1, 2018, asset-quality metrics improved as the credit environment remained benign and as non-core portfolios continued to roll off. Exposure to emerging market hotspots, such as Turkey, was limited to a handful of large European banks with exposure considered manageable relative to the size of the overall balance sheet.

European bank balance sheets expanded since year-end 2017 on lending growth, larger liquidity portfolios and central bank deposits. In the UK, banks are ahead of schedule with January 2019 ring-fencing legislation whereby the major banks have largely completed asset transfers so that the retail and commercial banking operations are ring-fenced from the capital markets and wholesale banking operations. As it relates to the UK, the outcome of Brexit negotiations remains uncertain with the March 2019 deadline to exit the European Union looming. Capital metrics and liquidity levels remained solid with CET1 capital and LCR ratios comfortably above regulatory requirements. New lending has largely been met with deposit growth and many banks utilize the stable and efficient European covered bond market to help limit their need for unsecured funding. Rising interest rates in the U.S. have not deterred European banks from raising funds in the short-term U.S. market as the incremental cost of funding has been immaterial. Prime money market funds showed increased exposure to French, Dutch, Swedish and UK issuers as several banks have come to market with new U.S. commercial paper programs while repurchase agreement (repo) operations have also expanded.

AUSTRALIAN BANKS

Australia's four major banks continued to report healthy profitability despite net interest margin compression due to increased short-term wholesale funding costs and increased compliance costs following a Royal Commission inquiry into misconduct in the Australian financial system. Regulators have also been clamping down on Australian banks with macro-prudential measures aimed at cooling the housing market, increasing underwriting standards and forcing banks to hold additional capital against mortgage exposure. These measures have served to soften house price appreciation while investor loan growth has slowed. While owner-occupied credit growth continued, customers are now subject to reduced maximum borrowing capacity constraints and banks have been raising interest rates on mortgages.

Of note, S&P recently commented that it no longer views the institutional framework of Australia's banking sector to be in the lowest risk category although remaining one of the highest ranked. At the same time, the agency is taking a more positive view of the economic risk framework for the banks due to unwinding housing market risks. This view is incorporated in S&P's negative outlook for Australian banks as is the potential for reduced government support if Australia were to implement a bail-in regime, which at the moment does not look likely in the near term. The Australian banking regulator, APRA, has subjected the major banks to an "unquestionably strong" CET1 benchmark of 10.5% under its more conservative assumptions and severe stress-test scenarios, which all banks are well positioned to meet.

JAPANESE BANKS

Japanese banks reported an aggregate increase in profitability as banks generally booked gains from the release of loan loss reserves and continued to benefit from securities-related gains with equity-related gains up solidly amid diminishing bond-related gains. Given the low-rate environment domestically, which continued to pressure net interest margins, Japanese banks have been growing their international loan books while expanding fee-based businesses to combat interest-rate sensitivity. The Japanese economy has continued to recover with moderate growth considered good by Japanese standard and tentative signs of inflation emerging. This trend was rewarded by S&P with a revision to the outlook on the Japan sovereign rating from stable to positive. That said, the Bank of Japan (BOJ) has not signaled that it will move off its zero-rate policy any time soon.

Japanese bank balance sheets are highly liquid, represented by large securities portfolios and significant cash balances. Although Japanese banks have shed non-strategic equity holdings and reduced Japanese government bond (JGB) holdings while shortening the duration of the JGB portfolio, the banks continue to benefit from sizable levels of unrealized gains. Still, the solid capital metrics would still be considered good excluding unrealized gains with CET1 capital comfortably above regulatory requirements. Japanese banks are also well above regulatory requirements as it relates to the LCR ratio given that the banks are flush with deposits that easily exceed loan balances. However, the short-term U.S. dollar market has become an important source of funding both on an unsecured basis and via repo as Japanese banks look to build out their international lending book.

CORPORATE SECTOR

First-half 2018 results for corporates were solid on an organic basis as companies benefited from the continued momentum from an improving global economy. Pharmaceuticals performed well, driven by new product development. Some consumer products and beverage companies reported lighter results due to increased competition and challenging markets but underlying results were still good. Most of the oil and gas companies under coverage reported solid results due to higher prices and higher production. Issuers in the technology sector performed well as top-line growth was lifted by tax cuts while liquidity and leverage metrics improved.

We believe there are a number of headwinds that could impact results for the second half of the year such as the impact of tariffs, currency fluctuations, geopolitical risks and increased competition. Companies are expected to use repatriated cash and benefits from tax cuts to reinvest in the business and fund share repurchase and merger-and-acquisition (M&A) activity. While most of the acquisitions so far have been strategically significant, they still increase credit and business risk and possibly leverage. If there is pressure on credit ratings, we believe most would be limited to a one-notch downgrade. However, management teams are offsetting these headwinds with cost cutting and focusing on higher-margin businesses as well as innovation (healthier food products, more convenient consumer products, multiple-channel delivery systems) which will help drive sales and operating income. We still believe overall liquidity levels and credit profiles will remain good with most corporates focused on maintaining current credit ratings. Our corporate universe generally has large cash balances and access to credit facilities, which they can use for funding needs. While many corporate issuers have access to commercial paper programs, utilization tends to be limited. As of August 31, 2018, non-financial commercial paper represented just 4.3% of the $528.9 billion in industry prime assets under management.

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