The operating environment during the third quarter of 2019 remained challenging for issuers within the money markets, driven by escalating U.S./China trade tensions, continued Brexit uncertainty and other geopolitical risks. These headwinds have served to slow global economic growth, but growth remained expansionary amongst the major advanced economies. To combat these macroeconomic forces, global central banks have adopted more accommodative monetary policy settings. While low, zero or in some cases negative interest rates presented profitability challenges for issuers, the combination of compressed rates, continued economic expansion and improved labor market data all supported benign global credit conditions.

Notwithstanding the aforementioned headwinds, the high investment grade financial and corporate issuers that populate our approved list demonstrated resiliency during Q3 2019. Although 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 identity the best-in-class financial and corporate issuers with sound financial flexibility, strong balance sheets and business models that are defensible through the cycle.

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

**NORTH AMERICA BANKS**

U.S. banks reported good results in Q3 2019 despite the impact of a flat yield curve as solid loan and deposit growth served to cushion margin compression. Strong consumer confidence against the backdrop of low unemployment also helped to propel fee income higher, thanks to a pickup in mortgage refinancing and higher consumer card spending. Notwithstanding the uncertain macro outlook clouded by geopolitical risks and slower global economic growth, capital markets revenue trended higher, particularly within debt underwriting and fixed income, currencies and commodities (FICC) with advisory and equity underwriting growing at a slower pace. Benign credit quality conditions prevailed, although credit card charge-offs drifted higher from a low base due to portfolio seasoning. New Current Expected Credit Loss (CECL) accounting standards to take effect January 2020 could result in higher loan loss reserve provisioning, but this is expected to be manageable from an earnings and capital standpoint. This, along with the lower interest rate environment, trade uncertainty, slower global growth and expectation of higher technology spending to adapt to digitization and growing cyber risks all serve to present challenges for U.S. banks going forward. That said, the U.S. banks are adept to manage these challenges given the strength of their earnings diversity and balance sheet.

Results for the six large Canadian banks in Q3 2019 (ended July 31, 2019) were good despite a backdrop of weakening macroeconomic conditions and trade...
uncertainty. Results were highlighted by healthy loan growth both in the U.S. and Canada and improved trading results driven by interest rate trading and global markets financing. This was somewhat tempered by increased expenses, subdued margins of non-domestic businesses given recent Federal Reserve cuts and notably higher provisions as banks adjusted economic assumptions with an expectation for credit costs to normalize from historical lows. Despite higher provisions, the credit environment remained benign with manageable losses and nonperformers. Although house prices rebounded recently from a significant slowdown – aided by healthy domestic economic conditions, lower mortgage rates and an increase in immigration – regulatory measures and tighter underwriting have mitigated a buildup of imbalances in the Canadian housing market. The Canadian banks are well placed to meet more stringent regulatory capital metrics imposed by the Office of the Superintendent of Financial Institutions (OSFI) with the domestic stability buffer to be raised in 2020 and total loss-adsorbing capacity (TLAC) guidelines set to take effect on November 1, 2021.

EUROPEAN BANKS

European bank earnings once again proved resilient in Q3 2019; however, profitability growth has become more difficult. Interest income was broadly lower to stable with only a few banks posting improvement as volume gains and reduced funding costs could not fully offset the margin pressure from the low rate environment. The introduction of a tiered rate structure for deposits at the European Central Bank (“ECB”) could help banks preserve margins; however, any further rate cuts could erode the benefits. Fee based revenues from wealth and asset management businesses have served to stabilize earnings although weak client activity weighed on capital markets revenue. In addition to revenue headwinds, credit costs ticked up from cyclical lows while reserve releases slowed. While this trend was also true for the UK banks, there has not been any obvious impact from Brexit uncertainties other than a moderate increase in provisioning as a precaution. Nevertheless, overall asset quality remained sound thanks to a generally benign credit environment. Positively, underlying operating expenses trended lower amidst staff reductions, branch closings, and the offloading of poorly performing businesses. That said, the ability to reduce total costs has been limited by ongoing digitalization efforts, exceptional restructuring costs and higher expenses around know your customer and anti-money laundering requirements. This said, the ability to reduce total costs has been limited by ongoing digitalization efforts, exceptional restructuring costs and higher expenses around know your customer and anti-money laundering requirements, particularly in the Nordic region where a handful of banks remain under investigation and potentially subject to regulatory fines. Despite profitability pressure, capital levels remain well ahead of requirements and banks have taken steps to preserve capital, such as reducing or suspending both dividend payments and share buyback programs. The French banks remain the laggards of the broader European peer group in regards to the CET1 and Leverage ratios but have gradually been improving and remain fully compliant with regulatory targets. The UK banks recently passed a Bank of England Stress Test that did not require any of the UK banks to bolster their capital even in a hard Brexit scenario. Although a hard Brexit on the current January 31, 2020 deadline appears less likely following the outcome of the recent UK election, the exact timing and details of a potential Brexit remain uncertain.

JAPANESE BANKS

The Japanese banks reported mediocre results for their first half ended 9/30/19 as core banking operations continued to be hampered by ultra-low interest rates as net interest margins have significantly compressed while slow domestic growth in Japan has stifled domestic lending growth. Still, the mega Japanese banks managed to beat reduced expectations with each bank more than half way towards their full year earnings target on higher than expected bond-related gains, continued albeit reduced equity-related gains and below normal credit provisioning. We remain cognizant that the Japanese banks have been incentivized to hunt for yield outside of Japan via growth in offshore investments and international lending, but so far this has been well
managed. The ability of Japanese banks to book gains on the release of loan loss reserves looks to have diminished as a few banks posted small credit costs in what could be a trend towards normalizing credit costs. Similarly, non-performers ticked up from historical lows; but asset quality remained benign. The strength of global financial markets, including the Japanese equities market, has supported strong capital metrics for the Japanese banks due to the inclusion of sizeable unrealized gains, which if excluded would result in metrics that still exceed regulatory thresholds but at a more pedestrian level. Liquidity metrics remained solid while the Japanese banks continued to benefit from significant levels of deposit funding.

AUSTRALIAN BANKS

The Australian banks reported flat to slightly lower income in FY 2019 (ended 9/30/19) due in part to lower interest rates and competitive pressure. New Zealand banking was the best performing business as both domestic retail banking and business banking were softer reflecting still tempered credit growth, increased credit provisions and lower institutional banking volumes. Across the board, banks saw reduced fee income reflective of the removal of customer fees for certain products while expenses were higher due to elevated remediation costs associated with the Royal Commission’s report of misconduct issues. All of the banks are currently in the process of implementing plans based on recommendations by the Commission and by the Australian Prudential Regulation Authority (“APRA”), following accountability self-assessments. Despite a slight weakening in the Australian housing portfolio as late stage delinquencies continued to tick up, asset quality remained healthy reflective of benign conditions in Australia. Funding and liquidity remained favorable with the banks having a higher reliance on wholesale funding than peers but maintaining good diversification in terms of product and currency. The Australian banks have displayed sound capital metrics that were above APRAs “unquestionably strong” CET1 benchmark of 10.5% set to take effect on January 1, 2020 and expected to be minimally impacted by increased capital requirements imposed by the New Zealand Bank regulator for the main operating subsidiaries of the Australian banks.

CORPORATES

Third quarter 2019 earnings remained solid across most of the corporate names we cover, especially on an organic, constant currency basis. Many of the same issues and headwinds such as tariffs, Brexit, high raw material costs and volatile currency that impacted the second quarter continued into the third quarter. The consumer products, food and beverage sectors were impacted by higher raw material costs and brand investments which impacted margins and operating profit but were offset by higher pricing. Earnings in the Oil & Gas sectors were hurt by continued low commodity prices.

We continue to believe that credit ratings risk has increased due to higher leverage across our universe from a combination of lower operating profit and higher debt to fund acquisitions or share repurchases. In fact, a handful of companies were assigned negative outlooks by the rating agencies following third quarter results. Despite the higher credit risk, we continue to believe that cash flow generation and liquidity levels are adequate.

A cautious outlook for the Corporate sector remains for the near to intermediate term with a few companies expecting less robust economic conditions for next year that could lead to softer results. That said, the long-term outlook remains generally healthy. We believe the companies in our coverage universe remain committed to strong balance sheets and investment grade ratings as they have the financial flexibility to manage the aforementioned headwinds.

Past performance is not indicative of future results.
All investments involve risks, including loss of principal. Certain investments involve greater risks that should be considered along with the objectives, fees and expenses before investing.

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