Commentary
Cash

January 2022

2022 Credit Research Outlook: Fear Central Banks More Than Public Health

Peter K. Hajjar
Head of Cash and Structured Credit Research
Fixed Income, Cash and Currency

As we began 2021, there was hope that the expected roll-out of widespread global vaccination campaigns during the year would make COVID-19 a diminishing factor for global economies. While it is fair to say that impacts were diminished relative to 2020, the pandemic has not yet transitioned to an endemic as we roll into 2022, and we must still consider its ramifications. As of the time of writing, cases of COVID-19 in many developed market countries are on a significant upswing as virus variants have increased transmission efficiency. The good news is that global healthcare systems are much better prepared to counter virus variants, be it in terms of the availability of testing, vaccines, therapeutic treatments, or our understanding of the science behind the virus's spread. Further, pharmaceutical companies will likely get quicker approval for the development and launch of new types of vaccines, booster dosages, and antivirals that will be effective in limiting serious illness caused by virus variants, most notably the Omicron variant that emerged in 4Q21.

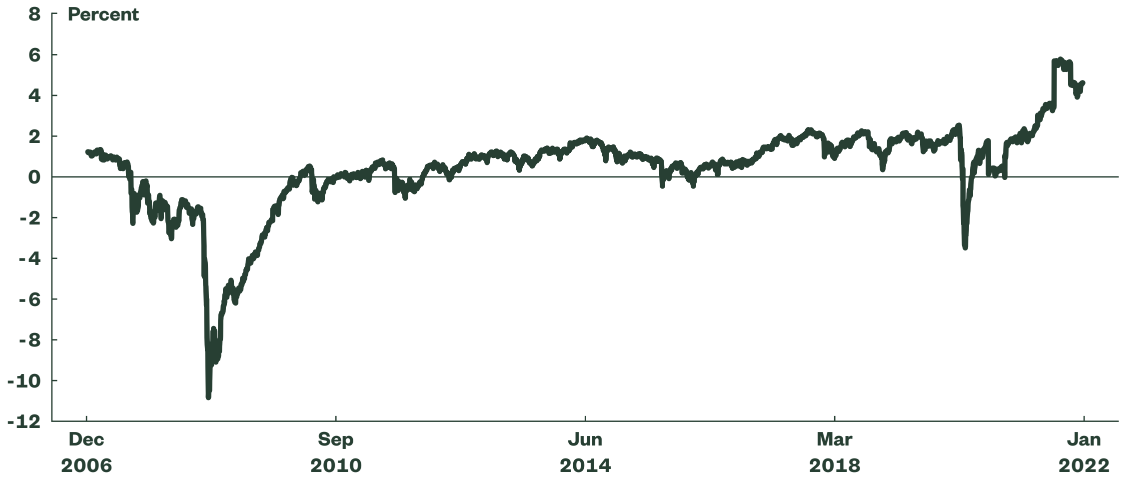
While there is certainly risk that the Omicron (or other variants) can materially disrupt global economic growth during 2022, our credit research team has adopted a "base case" that is consistent with that of our own Chief Economist, Simona Mocuta. Due in part to the virus knowledge and production scale for vaccines and treatments that we've gained over the last two years, Simona has not changed her global growth forecasts for full-year 2022 at the time of this writing. While there will be negative impacts from the variant to economic growth at the beginning of 2022, activity could be "made up" through the remainder of the year, especially given the likelihood that additional pharmaceutical treatments will become available as the year goes on. US Federal Reserve Chairman Jerome Powell noted in July of 2021 (speaking about the Delta variant) that, "What we've seen is with successive waves of COVID over the past year and some months now, there has tended to be less in the way of economic implications from each wave. We'll see whether that is the case with the Delta variety. But it's certainly not an unreasonable expectation."[1]

While supply-driven constraints and COVID surges in various parts of the world have caused variability in economic growth rates in recent months, the latest economic data in the US has been quite strong. Recent US Institute for Supply Management (ISM) manufacturing and non-manufacturing (services) purchasing managers' index (PMI) reports showed production, orders, and employment readings that were historically strong. Indeed, November US non-manufacturing ISM readings hit all-time highs for the headline, business activity, and new orders. It is also important to recognise that differing approaches to managing the pandemic have emerged at the country level. In the UK and the US, governments have shifted a bit more toward an approach of "learning to live with the virus." The bar for imposing severe restrictions on activity is generally higher than in Europe and in China. These strategic differences will continue to be significant factors in the potential divergence of country-level economic performance going forward.

While negative COVID-related developments could certainly disrupt the current macroeconomic and credit cycle, we believe that central banks present the greater "disruptor" risk. Supply chain disruptions and high energy prices have caused inflation to overshoot most economists' estimates in 2021, and if new restrictions are announced to combat surges in COVID infections, the easing of supply bottlenecks could be further delayed and goods price inflation could be slower to decline. As such, we see a risk that central banks may elect to tighten policy, even if economic growth weakens materially. This risk is most pronounced in the US, given the recent hawkish shift in the Federal Reserve's interest rate policy outlook. We appreciate the enhanced focus on inflation, given that it has proven not to be transitory in many ways, but an aggressive tightening cycle during 2022 could stifle economic growth materially, as well as cause significant financial market volatility and financial condition tightening. Simona believes the "best course of action (for the Fed) is to hike slowly and allow the economy to naturally cool off, which it will do by the second half of 2022 and into 2023." Certainly, such a course of action would be beneficial to the current credit cycle.

Historically, financial conditions have been supportive of economic growth when interest rates are rising along with inflation expectations. However, higher rates with declining inflation expectations are correlated with tighter financial conditions.[2] As financial conditions are quite important to the path of the credit cycle, we will be watching these relationships closely. Again, we'll focus on the US as we view it as the most at-risk for financial condition tightening. The good news is that financial conditions begin 2022 at historically strong (i.e., "easy") levels, as demonstrated by the Bloomberg Financial Conditions Index Plus (includes quantification of financial stress in the US money, bond, and equity markets, but also includes indicators of asset-price bubbles related to tech stock prices and the housing market).

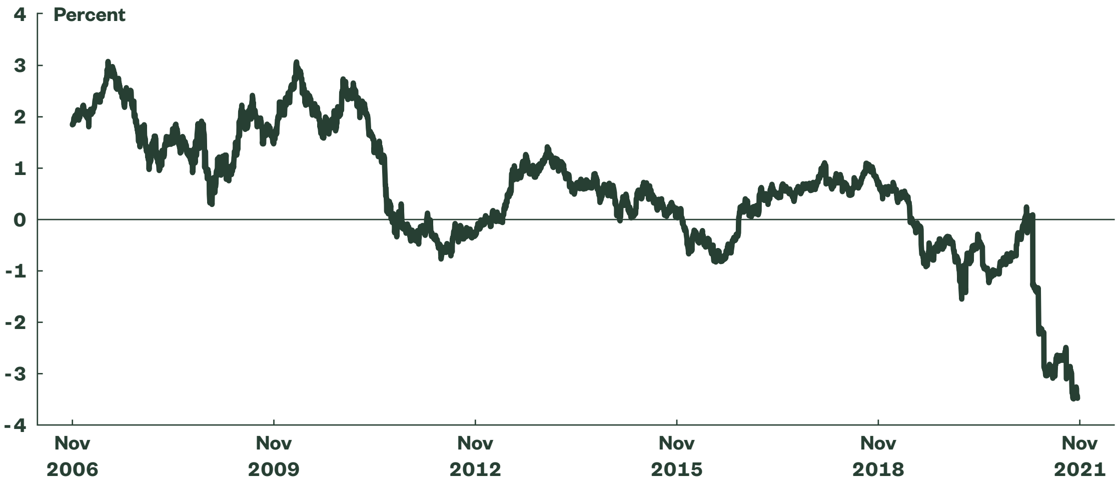
Figure 1
Bloomberg Financial Conditions Index Plus (December 2006 to Present)



Source: Bloomberg Data as of 03/01/2022.

Another key consideration for financial conditions and lending conditions (either at banks, or in the capital markets via the bond market) are "real interest rates" — i.e., interest rates that have been adjusted to remove the effects of inflation to reflect the real cost of funds to the borrower and the real yield to the lender, or to an investor. Real interest rates will have a material impact on the willingness to borrow and lend within the economy, as well as on the valuation of financial assets (equity and fixed income). Accordingly, if market participants believe that real interest rates are likely to remain low into the future, the risks of a bursting asset-price bubble, of financial market volatility, and of financial condition tightening are diminished. The chart below demonstrates the historically supportive condition of current real interest rates, using the US 10 Year Treasury Bond yield and its relationship to core US CPI, as a proxy.

Figure 2
Real Interest Rates: US 10 Year Yields Relative to Core CPI



Source: Bloomberg Data as of 03/01/2022.

We believe that risk asset markets, including credit markets, can take a modest increase in real interest rates in stride, particularly if it comes against the backdrop of a strong macroeconomy. However, if credit markets start to believe that central banks have fallen behind the inflation curve, expectations about the future path of real rates could shift suddenly, causing significant credit market volatility and financial conditioning tightening. Despite this risk, we also believe that the massive increase in global sovereign debt will continue to bias central banks toward various forms of financial repression in their monetary policies. If sovereign defaults are not an option to de-lever the financial system (and we don't believe they are), a long period of financial repression is likely in order, which should help keep real interest rates lower than they would otherwise be.

The Cash Investment Universe

As our readers know, the Global Cash investment universe is concentrated in debt issued by large global banks and financial institutions, so we always consider the risks associated with the current credit cycle in that context.

Most global banks in our investment universe began 2021 in a relatively strong fundamental credit position, and they generally ended the year in an even stronger one. Throughout the pandemic the global banking sector has been a source of strength in mitigating macroeconomic impacts. The significant evolution of banking regulations since the Global Financial Crisis (GFC), especially as they pertain to systemically important banks, have ensured that bank capital buffers are materially higher, and funding and liquidity conditions are more stable, than they were prior to the GFC.

Tailwinds for Fundamental Bank Credit Profiles in Our Coverage Universe

When we consider factors and risks related to COVID-19 variants, central bank monetary policy tightening, interest rates, and inflation, we have a relatively constructive view on the potential impacts on bank credit profiles in our investment universe in 2022. Other tailwinds include:

- **Balance Sheet Asset Quality Is Pristine:** For many of the global banks on our credit approval list, asset quality for loan books begins 2022 in historically strong condition. While charge-offs cannot go much lower, we don't think they will increase materially in the near term, as typical bank corporate borrowers still have a significant amount of cash and liquidity on their balance sheets, while consumers in most economies that are relevant in our bank coverage universe are in the best shape that they've been in for decades, from a credit perspective. There is material cushion for macroeconomic and loan portfolio performance deterioration before bank credit profiles are weakened, in our view.

- **Rate Hikes Support Bank Profitability:** Within a short period of time in mid-December, the Bank of England surprised markets by announcing its first rate hike in more than three years, and the US Fed announced an accelerated pace of asset purchase tapering. It remains to be seen whether or not these central bank actions will kick off a more pronounced scale of global interest rate hikes from developed market central banks. However, at the time of this writing, futures markets were now pricing-in almost 75 bps of rate hikes from the Fed in 2022, when essentially none were priced in earlier in 2021. Higher rates and more positively sloped interest rate curves are highly correlated with stronger bank profitability. Importantly, higher rates also give banks the opportunity to shift excess cash (which is at historically high levels within banking systems) to higher-yielding assets — loans or securities — which would be a significant benefit to net interest margins for the banks. As we've noted in previous publications, the ability of banks to organically accrete capital through profit is an important factor in our fundamental credit assessments.

- **Bank Management Teams Are Forecasting Improving Loan Growth:** Commercial loan pipelines continue to grow, providing the prospect for additional profitability tailwinds. If labour shortages and supply chain constraints start to abate during 2022, as management teams expect, corporate credit line utilisation rates should increase, further enhancing aggregate loan balances.

- **Healthy Fee Income Outlook:** The current outlook for investment banking fees remains strong- aided by the M&A multiplier effect. While trading revenues could decline, they would be declining from historically high levels, and management teams expect results to remain above pre-pandemic levels. While higher rates would likely result in a meaningful decline in mortgage refinance activity, growth in purchase activity is expected in jurisdictions such as the UK, Canada, and Australia. Asset and wealth management fees will be largely dependent on global capital market performance.

Risks to Fundamental Bank Credit Profiles in Our Coverage Universe

Earlier in this publication, we identified central banks as the primary risk factor to our 2022 outlook, via the risk of aggressive tightening cycle before COVID-related disruptions cease. This could stifle economic growth materially, as well as cause significant financial market volatility and financial condition tightening. As bank financial performance is highly correlated with economic growth, we have to view this type of scenario as a primary risk to our outlook. However, there are other risk factors to consider:

- **Higher Rates Are Not Guaranteed:** We continue to believe that the US Fed is in the best position to be the global driver of higher rates, but tapering earlier does not necessarily mean the Fed will raise rates as soon, or as often, as the market thinks. Further, even if the Fed does hike, we could still see meaningful yield curve flattening, particularly if COVID-related economic disruptions materialise. A combination of these factors would weigh on securities portfolio reinvestment rates and continue to cause some banks to remain hesitant in deploying excess liquidity. These types of scenarios could derail the optimistic outlook for bank profitability in 2022.

- **Loan Growth Is Not a Forgone Conclusion:** If inflation proves more persistent and hotter than expected, the Fed (and perhaps some other global central banks) might be prompted to raise rates at an even more accelerated rate than currently expected. In this case, we believe that the degree of monetary policy tightening would weigh heavily on the economy, and thus the willingness to lend and borrow within the banking system. Furthermore, demand for commercial real estate could remain muted owing to low levels of customer activity in the office and retail segments, which have undergone structural changes. On the consumer side, increased liquidity and COVID variant concerns keep could limit consumer borrowing.

- **Global Central Bank Divergence:** The positive impact that higher rates can have on bank profitability (and thus, bank capital levels) is particularly important to the consideration of our outlook for the credit profiles of European and Japanese banks. These are more structurally challenged banking sectors in our coverage and investment universe, having suffered from the profit-headwinds associated with low interest rates for the extended time period leading up to the onset of the pandemic. However, there are reasons to be skeptical that interest rates in those jurisdictions will embark on a higher path any time soon, even if the Fed and other central banks begin an extended rate hike cycle.

- **Diminishing Tailwinds from Investment Banking, Capital Markets, and Other Sources of Fee Income:** Monetary policy is becoming less accommodative, with rate hikes and/or the reduction of quantitative easing forecast for nearly all major central banks, which means the "central bank put" for risk assets is unlikely to be available to support markets as it has for the last few years. These factors threaten the outlook for the investment banking, trading, asset management, and capital markets-related activities that were so strong during 2021.

- **Asset Quality Can Only Get Weaker:** As noted above, loan asset quality for most banks in our coverage universe is nearly pristine entering 2022. However, any pick-up in loan growth will need to be met with higher loan loss reserves, and should economies deviate materially from expectations, it could have a disproportionate effect on loan credit quality and loan loss reserves.

In considering these risk factors, we think that it is important to note that we expect the materiality of such risks, should they emerge, to be borne more by equity investors rather than debt investors — at least in the near term. For investors in senior debt, the strong condition of fundamental credit profiles for most of our bank credit approval universe in 2022 provides a basis for some fundamental deterioration, without materially altering credit profiles. Our credit research team's adjustments to our credit approval list occurs most frequently through changes in the maturity restrictions we place on approved investment counterparties for Global Cash funds. If the economic outlook were to significantly deteriorate due to prolonged COVID restrictions and/or significant financial condition tightening, European banks would most likely be most at risk for maturity restriction reductions. While European banks recovered faster than previously expected since the onset of the pandemic, their quality ranking relative to other major banking regions has not changed. The European banking sector is still held back by structural challenges (lack of banking union, high legal risk, over-concentration), which increase the sector's vulnerability relative to others during periods of economic weakness. Further, the European economic outlook has dimmed more materially than other regions and its recovery is likely to be a slower and more protracted.

In closing and in the context of the global central bank focus on inflation in 2022, the most important factors for bank credit quality is indirect — which is to say that banks' financial performance is highly correlated with economic growth and financial conditions. Modest inflation, even if persistent, could benefit economic growth and financial conditions, but the opposite would be true if inflation and inflation expectations overwhelm personal and corporate incomes. Fundamentally, and with regards to a bank's balance sheet health, higher inflation allows borrowers to pay lenders back with money that is worth less than it was when it was originally borrowed, which benefits borrowers. Still, when inflation causes higher prices, the demand for credit increases, which benefits lenders.

To summarise, in a below-average inflationary environment banks tend to see higher asset valuations and better asset quality, but lower loan growth and net interest margins. In an above-average inflationary environment, the opposite is true. So, while there are positive and negative factors in both scenarios, we continue to take comfort in the demonstrated stability of the fundamental credit profiles of most debt issuers in our global credit research coverage universe during the pandemic-induced global recession. For us that means continuing to select cash investment counterparties that are best-equipped to maintain their fundamental credit profiles through a variety of macroeconomic scenarios, including a higher inflation path and tighter financial conditions.

Endnotes

1 Federal Open Market Committee Press Conference, 28/07/2021.

2 Morgan Stanley Global Macro Research; "Getting Real on Rates"; 28/02/2021.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US $3.86 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

ssga.com

Marketing communication

State Street Global Advisors Worldwide Entities

Abu Dhabi: State Street Global Advisors Limited, ADGM Branch, Al Khatem Tower, Suite 42801, Level 28, ADGM Square, Al Maryah Island, P.O Box 76404, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. T: +971 2 245 9000. **Australia:** State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services License (AFSL Number 238276). Registered office: Level 14, 420 George Street, Sydney, NSW 2000, Australia. T: +612 9240-7600. F: +612 9240-7611. **Belgium:** State Street Global Advisors Belgium, Chaussée de La Hulpe 185, 1170 Brussels, Belgium. T: +32 2 663 2036. State Street Global Advisors Belgium is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Canada:** State Street Global Advisors, Ltd., 1981 McGill College Avenue, Suite 500, Montreal, Qc, H3A 3A8, T: +514 282 2400 and 30 Adelaide Street East Suite 800, Toronto, Ontario M5C 3G6. T: +647 775 5900. **France:** State Street Global Advisors Europe Limited, France Branch ("State Street Global Advisors France") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors France is registered in France with company number RCS Nanterre 899 183 289, and its office is located at Coeur Défense – Tour A – La Défense 4, 33e étage, 100, Esplanade du Général de Gaulle, 92 931 Paris La Défense Cedex, France. T: +33 1 44 45 40 00. F: +33 1 44 45 41 92. **Germany:** State Street Global Advisors Europe Limited, Branch in Germany, Brienner Strasse 59, D-80333 Munich, Germany ("State Street Global Advisors Germany"). T: +49 (0)89 55878 400. State Street Global Advisors Germany is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Hong Kong:** State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland:** State Street Global Advisors Europe Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 49934. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy:** State Street Global Advisors Europe Limited, Italy Branch ("State Street Global Advisors Italy") is a branch of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Italy is registered in Italy with company number 11871450968 — REA: 2628603 and VAT number 11871450968, and its office is located at Via Ferrante Aporti, 10 - 20125 Milan, Italy. T: +39 02 32066 100. F: +39 02 32066 155. **Japan:** State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands:** State Street Global Advisors Netherlands, Apollo Building 7th floor, Herikerbergweg 29, 1101 CN Amsterdam, Netherlands. T: +31 20 7181 000. State Street Global Advisors Netherlands is a branch office of State Street Global Advisors Europe Limited, registered in Ireland with company number 49934, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. **Singapore:** State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland:** State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom:** State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States:** State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641. T: +1 617 786 3000.

ID858651-4141893.1.1.GBL.RTL 0122
Exp. Date: 31/01/2023