Commentary
Global Cash Management

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Credit Research Update

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The "Black Swan" event that is the COVID-19 crisis is unprecedented with regard to macroeconomic and financial market developments. Financial market volatility has arguably been as severe as it was during the Global Financial Crisis.

While market volatility may be as severe as it was during the Global Financial Crisis (GFC), it is important to compare the fundamental credit considerations of the current crisis to the GFC. The GFC was a "balance sheet recession" caused by inflated housing price bubbles bursting, materially impairing household balance sheets and forcing a shift towards saving and deleveraging, at the expense of spending. The GFC developments exposed vulnerabilities in a highly-leveraged global banking system. At first, the COVID-19 crisis looked to be a temporary corporate earnings disruption but rather suddenly transformed into a volatile liquidity scramble, demonstrated by swift corporate liquidity line draws, a spike in commercial paper spreads and curve distortions in cash and other fixed income markets. These occurrences indicate that investors and corporate treasury departments are shoring up cash in an expediated manner.

Unlike during the GFC, banks generally have plenty of capital and liquidity. That said, prudent regulation and legislation have handcuffed the sector's ability to deploy liquidity or capital in order to effectively suppress the market liquidity strains triggered by COVID-19. While banks should be able to provide strength and stability during this recessionary period, given the inherent strengths of their balance sheets, disorderly capital and funding markets limit the potential effectiveness of the credit transmission mechanism. The US Federal Reserve (Fed) and other major global central banks have taken significant action attempting to abate the fear that strained liquidity conditions will lead to a prolonged credit crunch, as efforts have been focused on addressing the flow of liquidity from banks to investors, consumers and businesses. In addition to committing to unlimited quantitative easing (QE), the Fed committed to participating in the term corporate credit markets for the first time in its history, with the announcement of its primary and secondary market investment grade corporate credit facilities, re-launching (also with capitalization from Treasury) programs that were used during the GFC to support the money market, commercial paper and asset-backed security sectors. Other major global central banks have implemented programs with similar focuses.

However, this is not a 2008-style financial crisis, for which central bank liquidity support would be sufficient to materially alter the near- to medium-term macroeconomic outlook. Rather, the shock is a shutdown of the global economy which requires more targeted lending and fiscal measures to bridge the gap between the eventual return of more normal activity. Fiscal responses from governments, focused on consumers, as well as large, medium, and small businesses, are imperative for eventual stabilization. To that end, efforts have been decisive thus far with fiscal stimulus legislation worth 10% to 15% of a country's gross domestic product (GDP) becoming commonplace in much of the developed world, including the US. The main pillars of most stimulus programs are some combination of rebate checks to households, loans to small businesses (which often can become grants if they maintain payrolls), loans or investments in larger businesses, materially increased unemployment benefits and ramped-up healthcare spending. In many cases, fiscal programs are structured to work in correlation with central bank sponsored lending programs, which should better enable scale and speed of cash funding dispersion.

With the commitment of global political leadership to do what it takes to ease financial tensions, and the relatively sound condition of many developed banking sectors, there could be a strong basis for global economic recovery when this exogenous shock subsides. Indeed, stress-testing, liquidity and capital measures that have been put in place have prepared banking systems to be part of the solution versus the basis of the problem, as they were during the last global recession. Still, banks will not be able to fully bridge the gap from a pre-virus economy to a post-virus economy without some help from the government to the impacted sectors and consumers. Companies and consumers need time bought by loans, grants and forbearance, while banks will seemingly be the conduit for these measures. However, banks won't be compelled to use their balance sheets to the fullest extent without conviction that governments and central banks will help limit the costs of needless credit distress for healthy businesses and consumer obligors. Unlike in 2008, systemically important banks don't need capital injections, or direct funding assistance, but they do need to know that their jurisdictional regulators and governments support credit extension, by providing guarantees and regulatory relief. Across the jurisdictions that we follow (North America, Europe, Australia and Asia) loan guarantee and regulatory relief programs have been announced, but the key to their success, in our view, will be the time to full implementation. Especially as it pertains to small- and medium-sized businesses, the near-immediate dispersion of funds is important, as these entities don't generally have months of cash reserves to maintain operations during an economic shutdown. For example, the design of the +$350 billion loan program for US small businesses, as part of the federal response to the COVID-19, is intended to meet this expediency standard. The Small Business Administration (SBA) will offer the loans through banks. However, the banks themselves will incur no capital charge and will take no credit risk (as the loans are guaranteed by the SBA), but will receive an average processing fee of 3% of the loan size. Further, the banks will be allowed to provide funding without any SBA confirmation, with the objective of near-immediate funding.[1] Since the program is due to start during the first week in April, we cannot yet evaluate its efficiency, but the effectiveness of this program and other programs like it around the globe, will be determining factors for how deep the recession is and how quickly recovery occurs when economies are re-opened.

Despite the expectation of a deep global recession, and the uncertain duration of the impact of the exogenous shock of COVID-19, we remain comfortable with counterparty credit exposures in our Cash funds, based on our position in the creditor hierarchy and the confidence that we have in our approved investment counterparties to absorb macroeconomic stress in the near term. A key difference between the COVID-19 crisis and the 2008 GFC is that the current situation represents an external shock rather than systemic internal issue lurking in banks' balance sheets. Banks on our credit approval list have strong levels of capitalization and liquidity, and are stress-tested every year to test the durability of their balance sheets under both economic and markets distress. We will continue to adjust specific parameters of our credit approval list (most frequently through changes in maturity restrictions for approved investment counterparties) based on the potential for credit profile deterioration over the near- to medium-term. Banks exhibiting higher-risk in their corporate loan books, relatively weaker capital levels, and/or pre-virus challenged business models will continue to be the focus of our program adjustments. The extent to which fiscal stimulus (including government-assisted business loan programs) and central bank support can contain the economic deterioration and market stress in 2020 will be a major factor for our adjustments going forward.

Importantly, we will be acutely focused on the quality of disclosure and reporting during the upcoming bank earnings season, which is set to begin later this month. With regulators encouraging banks to refrain from moving large portions of their loan books to advanced stages of non-performing classifications, even after granting forbearance related to COVID-19, we will be relying on enhanced additional disclosures on asset quality to supplement traditional accounting classifications. Regulatory relief is understandable (as it helps free up bank capital for lending), but we will view disclosure relief punitively, and inadequate disclosure could be the basis for credit approval list adjustments.

Financial Institutions

United States

Though there were signs of optimism to start the year including steady underlying economic trends and decent bank earnings, credit spreads materially widened in the back-half of the first quarter as the impact of COVID-19 and social distancing measures caused massive uncertainty in financial markets and had a material impact on expectations for economic growth. Reflecting this urgency, the Fed aggressively cut interest rates to near 0% in two emergency inter-meeting moves (last done in 2008), embarked on a sizable asset purchase program and re-initiated several crisis-era programs to ensure proper market functioning.

Looking ahead, while the US government will seek to implement substantial fiscal stimulus to help bridge pre-virus and post-virus economic conditions, the cascading impact from COVID-19 across the broader economy should not be underestimated, and the impact could be particularly acute for highly-leveraged borrowers. For US banks, sharp cuts to interest rates will negatively impact earnings but the primary focus for creditors should be on balance sheets. While we expect the government and the banking sector to help private sector borrowers through this time, the ultimate effectiveness remains unclear. If part of this assistance by banks comes by reducing capital and liquidity buffers grow loans, as regulators have urged, this could be negative for standalone credit profiles.

As banks respond to unprecedented and rapidly evolving business conditions, the expectation is that defaults will rise, unemployment will climb and bank earnings will decline. Positively, we believe that US banks broadly enter this cycle from a position of strength with industry levels of capital (tangible common equity) the highest level since 1940, nonperforming assets at levels last seen in 2006 and loan/deposit ratios supporting favorable funding and liquidity dynamics. As well, the largest US banks are now regularly stress-tested by the Federal Reserve under a severely-adverse scenario each year and these tests typically produce losses well-above those experienced during the GFC. As well, the culmination of stress testing and higher capital charges on risky assets also supports the notion of stronger post-crisis underwriting. While there are uncertainties around corporations tapping bank lines and eroding liquidity and asset quality, post-crisis regulations expect this to a degree and there are other mitigating factors including high levels of liquid assets, Fed asset purchases (which support deposit growth) and the availability of secured lending from Federal Home Loan Banks and the Fed's Discount Window.

Europe

The first quarter of 2020 was split into pre- and post-virus chapters. Fourth quarter 2019 earnings' season was predictably disappointing. Retail stood out as weak, demonstrated by a combination of low rates, higher-yielding mortgages rolling-off, and fierce competition for new originations. Large corporate revenues fared better and investment banking performance was decent compared to the low hurdle of fourth quarter 2018 losses. Still, many banks cut 2020-2021 return guidance. The sector was already settling in for a weak 2020, characterized by normalizing loan losses, revenue headwinds, and restructuring charges/ "know your client" spending.

This was all before the coronavirus was declared a Public Health Emergency on January 30, 2020, reversing the outlook for global growth as well as disrupting movement and consumer spending, and with additional pain-points of an Italian country-wide quarantine and drop in oil prices. The intensifying negative outlook for European banks should not be downplayed. However much of this looks limited to profitability in the near-term. Banks have seen some of these challenges before. They endured an oil shock in 2015-2016 and Italian spreads have been a constant source of volatility over the past decade. Italian loan books are in their best shape in ages; non-performing loans (NPLs) of the top 5 Italian banks are down 65% from the 2015 peak. Our base-case is that the virus-induced global downturn is largely limited to significant profit and loss deterioration and that capital bases remain resilient for Credit Research team-approved banks. The progress made since the 2008 crisis is reflected in building-up loss-absorbing capital, reducing NPLs, increasing liquidity, stress testing and credit conditions are further supported as well by the increasing fiscal and monetary support being deployed.

It is important to note that this is an external shock (global growth and market value decline). Rather than a systemic internal issue lurking in banks' balance sheets (i.e. past crises of subprime residential mortgage-backed securities, Greek sovereign debt, wholesale funding reliance, etc.). Post-reforms, banks have been structured to moderate financial shocks, not amplify them. For instance, in Norway, Sweden and the UK, banks had to set aside capital as a countercyclical buffer. Now that economic growth is threatened, central banks have released these buffers. The European Central Bank (ECB) has also relaxed its capital conservation and Pillar 2 regulatory guidance capital requirements. Based on European Banking Authority transparency data this represents capital relief of potentially €465 billion for European banks, providing them increased capacity to continue lending and support the economy while establishing increased loan loss provisions.

Canada

Canadian banks' first quarter results were generally in-line or better than expected, driven by robust performance in capital markets. While asset quality had shown very modest weakening in the prior period (i.e. normalization) in certain commercial lending categories, first quarter results were largely stable except in select cases. At the time of the earnings announcements, most management teams described concerns around supply chains and the impact on Chinese consumption from COVID-19, but shortly thereafter it became clear that the impacts are much more significant to the Canadian economy. Like the Fed, the Bank of Canada undertook emergency rate cuts during the quarter and bank regulators made numerous changes to rules including reducing the domestic stability buffer (to encourage bank lending) and placing a freeze on share buybacks and dividend increases. Prime Minister Trudeau indicated months of potential economic disruption from COVID-19 and the government announced an initial C$82 billion fiscal package in mid-March, focused on combatting recession.

Looking ahead, Canadian banks enjoy leading return on equities relative to international peers but will feel strain from the impacts of COVID-19 including lower net interest margins and higher credit losses. While we are hopeful that Canadian authorities and banks can provide solutions to short-term challenges from borrowers, we are also cognizant of elevated private sector debt dynamics, both in consumer and commercial lending, as well as an elevated pace of commercial lending growth in recent years. While there are concerns about oil/gas exposures for the major banks, the good news is that the banks went through a stress test just a few years earlier, including a significant slowdown in Alberta, and fared well. Since then, the banks were granted the opportunity to sharpen their pencils on risk management, pare their riskiest exposures and improve their lending mix, which is positive. However, oil prices snapped back quickly in 2015-2016 and this cycle could be different.

Australia

One of the four major Australian banks reported its half-year results during the first quarter while the others submitted trading updates. The key takeaway was that the sector was continuing to experience more of the same leading up to the shock from COVID-19 with balance sheet growth slow, asset quality benign (with some improvement in mortgage delinquencies) and profitability hampered by elevated, though declining, environmental costs including those related to the Royal Commission. Australia's close ties to China are in focus because of COVID-19 and its menacing impact on the country's supply chain and exports, both commodity- and service-related (i.e. tourism, education). In response to a very major impact from COVID-19, the Reserve Bank of Australia (RBA) sharply cut interest rates and implemented a yield curve control, QE program. For the banks, the RBA announced funding relief in the form of a term funding facility to provide access to 3-year term funding at a low fixed rate of 0.25%. Like the US and Canada, Australia's bank regulator also announced that banks may utilize some of their large capital and liquidity buffers as needed to support lending. In addition to fiscal stimulus measures being undertaken, Australia's banks indicated that they also would be reducing interest rates and deferring mortgage payments to cushion the blow to consumers, despite the revenue implications.

The four major banks have limited exposure to oil/gas lending and are mostly exposed to residential mortgages, which have historically had very low loss rates. The banks also have large corporate and small and medium-sized enterprise portfolios. While the expectation is for this cycle's losses to increase from historically low levels in non-housing, Australian corporate borrowers come into this cycle in better standing as it pertains to interest coverage and leverage metrics compared to several other global economies. Still, several industries remain impacted by social distancing and the fear, like Canada, that higher unemployment strains borrowers with high debt burdens, potentially leading to a collapse in the housing market and negative wealth effect. Historically low interest rates should help matters alongside government stimulus and actions taken by banks to support customers.

Asia

Major Japanese banks reported anemic profitability metrics in their latest set of results, with one of the majors reporting a large impairment charge. Net interest revenues continue to decline alongside net interest margins in Japan. While non-core realized gains from large securities portfolios have been helping profitability of late, though that source of profit and capital is fleeting especially given recent pricing trends. Capital levels remain satisfactory yet unspectacular excluding unrealized securities gains. The upshot is that asset quality metrics remain solid even as they did seem to be pointing to a bottoming-out of an improving trend, based on loan loss provisions.

For major Japanese banks, the operating environment is extremely challenging as competition from smaller lenders is fierce, loan growth is slow and rates are low. Moreover, the country appeared to already be on the doorstep of a recession even prior to the outbreak of COVID-19, driven in part by a sales tax hike in late 2019. We are also watching for stress in oil/gas portfolios, which caused higher provisions a few years ago for the major lenders, as well as any stress away from Japan given aggressive offshore expansion over the past decade.

Structured Finance

Figure 1
Asset-Backed Securities — US

Asset Type (in millions)	YTD 2020 ($)	YTD 2019 ($)	Δ %
Credit Cards	2.3	9.2	-75.0
Autos	27.7	30.5	-9.2
Student Loans	5.4	4.0	35.0
Equipment	3.2	4.1	-22.0
Floorplan	0.4	1.4	-71.4
Unsecured Consumer	1.9	2.6	-26.9
Other	6.0	6.1	-1.6
Total	**46.9**	**57.9**	-19.0

Source: JPM BAS Weekly Volume Date Sheet; 03/27/2020.

The asset-backed securities (ABS) primary market continues to be shut down, with no new issue over the last few weeks. On March 23, the Fed announced the (re)establishment of the Term Asset-Backed Securities Loan Facility (TALF). TALF will serve as a funding backstop to facilitate the issuance of eligible ABS after March 23, 2020. With economists revising their GDP, employment and spending forecasts significantly downward in recent weeks, sell-side research units have concurrently revised down new issue forecasts for 2020 by a material amount.[2] Still, TALF-sponsored deals should come to the market during April. As a reminder, under TALF the Fed will lend on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. The Fed will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS. Terms and conditions are based off of the terms and conditions used for the 2008 TALF program. Eligible collateral include AAA-rated auto loans and leases; student loans; credit card receivables (both consumer and corporate); equipment loans; floorplan loans; insurance premium finance loans; certain small business loans that are guaranteed by the Small Business Administration; and eligible servicing advance receivable. Improving market conditions for certain benchmark ABS sectors could lead to new ABS deals before the launch of the 2020 TALF, but these deals will likely be limited to benchmark sectors issued by top-tier sponsors.

Figure 2
US Consumer ABS Credit Spreads

US Consumer ABS Credit Spreads (in bps)	As of 03/27/2020	As of 03/27/2019	YTD Δ
2 Yr AAA Auto	100	23	(+)77
2 Yr Credit Card	70	18	(+)52

Source: JPM Research — ABS Weekly Spreads; 04/03/2020.

Spreads for short-dated prime auto loan and credit card ABS tightened another 90–100 basis points (bps) during the week ending April 3 and are now approximately 250 bps from near-term wides reached on March 23 (100–110bp versus 350 bps). We would note, if spreads for benchmark sectors (auto loans, credit cards, etc.) continue to tighten at the current pace, depending on the terms and conditions of the TALF 2020 program, the returns for TALF trades could be inside investors' thresholds. Recall that the 2008 TALF program allowed the new issue market for ABS to reopen and contributed to 275 bps and 175 bps of spread tightening in the auto and credit card ABS markets, respectively, from the date of announcement to the date of the first note subscription.[3] Away from the auto and credit card ABS sectors, spread movements were mixed over the week. Spreads for both retail auto lease and device payment ABS tightened by 180 bps, the best spread performance over the week. Senior tranches of subprime auto loan ABS tightened 50 bps. Subordinated tranches of prime and subprime auto loan, however, widened 50 bps and 150 bps, respectively. The subordinated market will like remain under pressure due to credit and rating concerns.[4]

The deterioration in the US economy has caused increasing concern for consumer credit. The unprecedented surge in unemployment will negatively impact the credit performance of consumer-related ABS and we expect deterioration in credit performance could reach or exceed the 2008–2009 recession experience. Further, history has told us that consumer borrowers experiencing financial difficulty will try to prioritize payments to retain the lending products with greatest future utility: mobile device payment plans (communication), autos (transportation), credit cards (future purchases, rewards), residential mortgages/rents (shelter), and student loans (future education, payment options, non-dischargeable).

While much remains to be seen on duration and magnitude in terms of economic growth impact, we would note that US consumers and the ABS market are both starting from positions of strength. The US labor market is starting at the lowest historical unemployment rate. ABS structures are stressed with data from all the previous recessions and have robust credit enhancements, including near-record high levels of excess spread (partly due to record low interest rates, which is now heading even lower). Top tier ABS sponsors generally have healthy balance sheets and liquidity cushions to weather market disruptions well before this event with management teams that have worked through many previous crises. For example, banks, financial institutions and automakers are generally much better capitalized now than they were heading into the 2008–2009 recession. Deferrals and forbearance on ABS portfolios will likely pick up due to COVID-19 similar to that observed in the wake of natural disasters. For ABS pools, April reporting for the March performance month will provide the first indications of the magnitude of deterioration. However, we expect that servicers may be granting temporary relief to borrowers, which may not be evident in the ABS reports.

Given the generally solid ABS fundamentals to date, we do not expect material stress in consumer ABS credit from a temporary/short-lived economic contraction, though lower tier sponsors, particularly down in the capital structure, remain more vulnerable, in our opinion. We believe the credit quality of the underlying receivables in the prime auto, bank credit card market and structural protections should weather the pending recession. Lastly, we'd note that during the 2008–2009 recession, top tier sponsors of benchmark ABS asset classes provided support to their respective ABS programs, to help maintain credit ratings and protect ABS investor bases from fundamental credit volatility. We expect similar behavior, if necessary, from sponsors, with the duration and magnitude of the recession to be the determining factors in the type of support needed and the ability of the sponsors to provide it.

Non-Financial Corporate/ Industrial — Global

On March 23, the Fed announced new facilities, through special purpose vehicles, allowing it to purchase corporate bonds from, and provide loans to, eligible issuers. While other major global central banks, including the ECB, have participated in the corporate credit market in recent years, these facilities represent new ground for the Fed. The Primary Market Corporate Credit Facility (PMCCF) can serve as a funding backstop for corporate debt issued by eligible issuers –US companies headquartered in the United States and with material operations in the United States rated at least BBB-/Baa3– with a maturity of four years or less. The Secondary Market Corporate Credit Facility (SMCCF) will purchase bonds issued by eligible issuers with the same set of eligibility criteria as the PMCCF, but securities with a remaining maturity of five years or less will be eligible. In addition to bonds, the SMCCF may also purchase US-listed ETFs whose investment objective is to provide broad exposure to the market for US investment grade corporate bonds. The potential purchasing power of each facility is significant based on the eligibility criteria and the amount of capital the US Treasury is supporting them with. As they currently stand, relative to the size of the eligible universe of bonds, the Fed's corporate credit facilities look to be smaller than the ECB's Corporate Sector Purchasing Programme (CSPP), but there is scope for the Fed facilities to expand.

From a fundamental credit perspective, the COVID-19 crisis is already inflicting damage in areas of the corporate credit market with pre-existing weaknesses among over-leveraged and structurally-challenged non-financial corporations. The Fed and ECB's corporate bond facilities help reduce the tail-risk of a full-blown credit crunch for investment grade companies, but other than corporations in distressed industries that might receive direct government aid, there is unlikely to be much relief for the most fundamentally challenged parts of the credit markets. A material increase in defaults for leveraged/high-yield companies seems inevitable. For example, Barclays estimates that the US high-yield bond default rate will surge to 9%–10% this year, from a revised prediction of 2.5%–3.5%, pre-COVID-19.[5] While expectations aren't widespread for defaults in credits that were investment grade-rated prior to COVID-19, there will certainly be a significant amount of rating's downgrades. As noted in previous publications, the risk of fallen angels was already pronounced, prior to COVID-19, partly due to the fact that +50% of the US corporate investment grade indices was rated BBB. While past experience shows many management teams for companies in danger of losing their coveted investment grade status typically fight hard to retain it (methods including slashing dividends, suspending share buybacks and selling assets) the conditions brought on by the COVID-19 crisis have the potential to exceed the capacity to adjust financial policies fast enough. Indeed, the pace of rating downgrades has already accelerated over the past few weeks. The amount outstanding of fallen angels in the US corporate bond market jumped to $149 billion by the end of March, a higher amount than the previous peak reached in the second quarter of 2009 (though comparable when scaled back by the overall size of the investment grade market). We'd note that the downgrades have been quite concentrated, with three issuers out of seventeen (Occidental Petroleum, Kraft Heinz and Ford) accounting for roughly three-quarters of the overall amount of downgraded bonds.[6]

Despite these definitively negative developments in the investment grade markets, the outlook for the higher quality segment of the investment grade markets is not dire, especially given the prospects for significant central bank support in the near term. Indeed, since the announcement of the PMCCF and the SMCCF, investment grade issuance volumes in the US and Europe have been significant. High-quality issuers paid a hefty price for issuing in March, as new issue concessions hit historically high levels, but new issues have also attracted a great deal of interest, as order books were 4 to 5x oversubscribed for deals that printed in recent weeks.[7] Issuance has been concentrated in companies willing to print large offerings to demonstrate capital raising, with high investment grade ratings and with liquidity capabilities in the current environment. Many of these borrowers are also regular funders in the commercial paper markets. However, as cash was suddenly in high demand during the economic slowdown, the commercial paper market became distressed, prompting companies to issue longer out the curve, where stronger investor demand existed. In our view, when the corporate debt market focus shifts from liquidity-driven considerations to the cyclical impacts of the COVID-1 crisis, the higher quality segment of the investment grade market should outperform, especially after Fed corporate bond purchasing begins in earnest.

The Bottom Line

For the last two years, our Credit Research team motto has been: "Don't worry about the end of the credit cycle: be ready for it." For us that has meant continuing to select cash investment counterparties that are best-equipped to maintain their fundamental credit profiles through a downturn.

Endnotes

1 "Banks stand to make billions from US small business rescue"; Financial Times; 04/01/2020; by Brendan Greeley and Robert Armstrong.

2 Bank of America Global Research; Consumer ABS Weekly; 04/03/2020.

3 JP Morgan Securitized Research; Asset Backed Securities; 03/27/2020.

4 JP Morgan Securitized Research; Asset Backed Securities; 04/03/2020.

5 Barclays Credit Research; "Preparing for a Storm"; by Bradley Rogoff; 04/02/2020.

6 Credit Suisse Research; "CS Credit Strategy Daily Comment"; 04/02/2020.

7 Credit Suisse Research; "CS Credit Strategy Daily Comment"; 04/02/2020.

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