Commentary
Global Cash Management

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Credit Research Update

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

As we reflect on the one year anniversary of the onset of the global pandemic and the economic disruptions that government-mandated lockdowns have caused, we continue to take comfort in the stability of the fundamental credit profiles of most debt issuers in our global credit research coverage universe.

Of course, major global banks continue to be the largest investment counterparties for our Global Cash business. Despite having endured the worst recession during the middle of 2020 since World War II, the global banking systems have remained quite healthy. Setting aside forward-looking indicators of asset quality, which are still relatively stable despite the pandemic, core balance sheet credit metrics have actually improved since the beginning of the pandemic in many of the banking jurisdictions we focus on. Importantly, after a year of enduring the public health consequences of a global pandemic, there appears to be light at the end of the tunnel. Across many major economies, COVID-19 cases, hospitalization rates and fatalities have declined materially. Further, the pace of vaccinations continues to pick up, particularly in the US, UK and Australia. Assuming a further increase of the pace of vaccinations and warmer weather in the Northern Hemisphere on the horizon, some health experts believe herd immunity is possible by May.[1] As the public health crisis abates, the monetary and fiscal tailwinds for economic growth continue. Indeed, fiscal stimulus in the US is set to increase materially in the coming months, with the recent passage of a new $1.9 trillion stimulus package. The continuance of the global fiscal stimulus impulse has caused many economists to further raise estimates for global growth. For example, JP Morgan's economics team recently increased its annualized global growth forecast to 7.5% during the middle quarters of 2021, with the US consumer segment and Asia's CAPEX cycle being the expected pillars of the anticipated surge in global demand.[2]

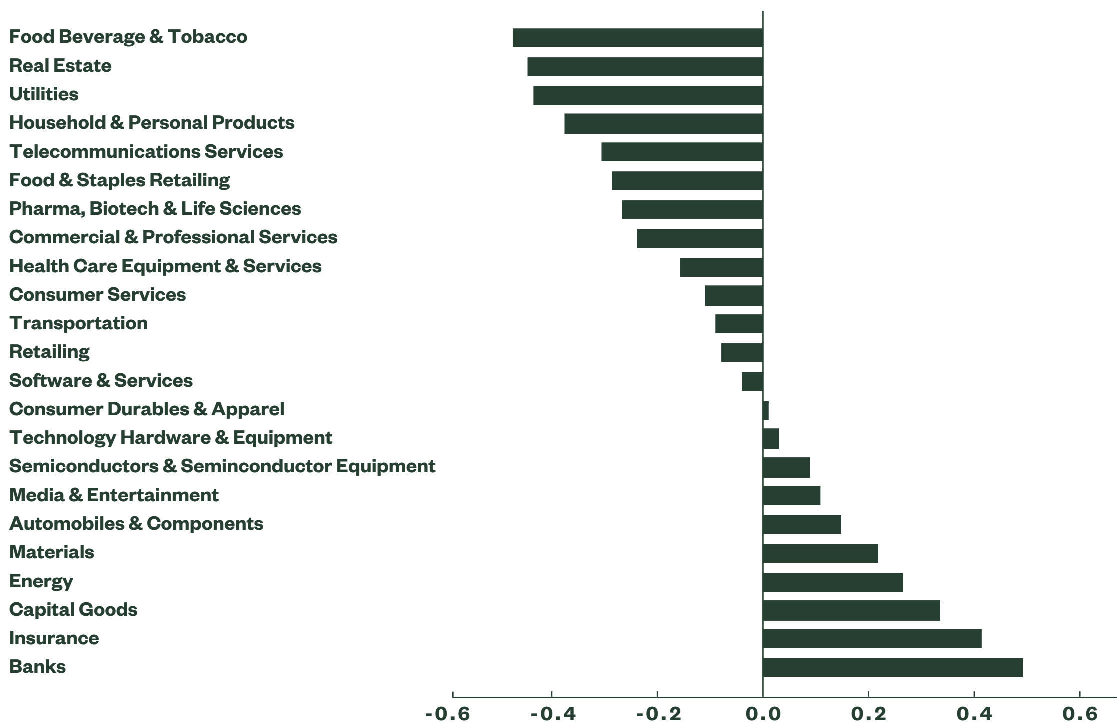
Given the material upgrades in economic growth forecasts (especially in the US), the recent rise in global interest rates and government bond yields make sense from a fundamental perspective. Further, despite recent moves, rates and yields remain quite low by historical standards. Nonetheless, the higher rates/higher yield environment has caused volatility in global equity and debt markets. We need to consider the ramifications of sustainably higher rates on the credit profiles of the global banks in our coverage universe. This consideration brings us to two broad conclusions:

1. Higher rates and more positively sloped interest rate curves are correlated with stronger bank profitability. As we've noted in previous publications, the ability of banks to organically accrete capital through operating profit is an important factor in fundamental credit assessments. This correlation generally holds, unless:

2. The pace and scale of interest rate and government bond yield increases can tighten financial conditions to a level that it begins to impede economic activity. Which in turn, would negatively impact bank profitability by decreasing loan volume and capital markets activities.

Let's first consider the correlation with stronger bank profitability. As noted in the **2021 Global Cash Outlook,** global banks entered the COVID-19 downturn in an exceptionally strong capital position, owing to reforms implemented following the 2008 global financial crisis (GFC), and to the sector is uniquely positioned to benefit from a sharp improvement in global growth in 2021. Bank earnings have a high beta to global growth (for example, loan growth is highly correlated to GDP and unemployment) and rising global bond yields are a tailwind for banks' net interest margins and net investment income. As such, banking sector stock performance[3] has a high positive performance correlation with 10-year US Treasury debt yields as shown in Figure 1.

Figure 1
Correlation with 10-year US Treasury Yields Since 2010



Source: Goldman Sachs Credit Strategy Research; "Cross Asset View on Banks"; 02/24/2021.

The positive impact that higher rates can have on bank profit levels (and thus, bank capital levels) is particularly important to our consideration of the outlook of 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. A period of sustainably higher interest rates should have a significant, positive impact on their respective credit profiles. However, there are also reasons to be skeptical that interest rates in those jurisdictions will stay on a sustainably higher path in the coming quarters. First, European COVID-19 infection and hospitalization rates also continue to be persistently high and vaccine rollouts in Europe and Japan has been underwhelming. These factors will delay the easing of activity restrictions relative to the US and some other developed economies. Further, structural factors that existed prior to the pandemic (sovereign debt concerns, more pronounced workforce demographic challenges and deflation) will make their respective central banks less likely to raise interest rates even after a full economic recovery from the pandemic. In the case of some European banking sectors (France, Ireland, Spain, Italy), there is also the risk of asset quality underperformance versus global banking peers in 2021, due to the fact they have provisioned less conservatively for loan losses. While we have expectations that recent interest rate increases can have sustainably positive impacts on global bank profitability, we expect that impacts will vary by jurisdictions in accordance with local economic performance and conditions.

With regards to the risk of higher interest rates resulting in a degree of tightening financial conditions that materially restricts economic growth rates, we'd note the relatively significant year-to-date interest rate increases have not yet resulted in materially tighter financial conditions. As an example, credit spreads for investment grade issuers have been relatively stable (albeit modestly wider) despite the significant increase in nominal interest rates. In particular, bank sector credit spreads remain at some of the tightest levels of the post-2008 financial crisis period.[4] We view the stability of credit spreads and financial conditions attributable to the consensus market view the rise in interest rates is due to positive economic factors, as cited above. However, a key factor in the consideration of the impact of rising interest rates on financial conditions is inflation expectations. Historically, financial conditions have been supportive of economic growth when rates are rising along with inflation expectations, as they have been recently. However, higher rates with declining inflation expectations are correlated with tighter financial conditions, as are spikes in interest rates driven by fears about the removal of central bank accommodation.[5]

Ultimately, the risk of rising interest rates leading to tighter financial conditions, and lower economic growth, hinges upon the ability of global central banks and the US Federal Reserve (Fed), in particular, to convince markets that they can balance accommodation and inflation risks until economies' fully recover from the pandemic. To date, interest rates have been far more volatile than credit spreads, with credit markets anticipating more orderly, albeit fiscally accelerated, reflation. As noted above, orderly reflation dynamics are unquestionably positive for economics, global bank profits and credit profiles. However, a disorderly rise in real yields could periodically tighten financial conditions. Interest rate volatility may be more difficult to suppress for central banks if it becomes clear that inflation rates will overshoot stated targets for a sustained period. Most recently, Fed officials aggressively revised up US growth and inflation forecasts, but still showed no rate hikes through the end of 2023 in their dot plot forecasts for interest rates. This is consistent with a Fed that plans to stay accommodative and look through temporary overshoots of their inflation target. However, longer term Treasury yields hit new one-year highs after the March Fed meeting, evidence that markets anticipate interest rate policy tightening sooner than 2023. Some Wall Street economists now expect the Fed to begin tapering its asset purchases this year, and interest rate hikes in 2022 a full year sooner than the Fed is trying to guide markets into believing.[6]

We are still probably a few quarters away from being able to assess these future inflationary conditions accurately, but we'd also caution those that point to the lack of inflationary pressure in recent years as evidence that such pressures are unlikely to exist after the pandemic subsides. The major differences between the general post-GFC and post-pandemic policies is the scale of the global fiscal response. The economic orthodoxy in the early years of the 2010s soon moved to fiscal austerity, spurred by the European sovereign crisis. Today, the economic orthodoxy is much more skewed towards the bigger danger being withdrawing fiscal support too early and there doesn't appear to be a serious short-term sovereign credit risk fear with central banks being so omnipresent. This orthodoxy is far more inflationary than the preceding one.

Financial Institutions

United States

Despite a challenging operating backdrop for banks coming into the year as they braced for zero interest rate policy (ZIRP), an anemic loan growth outlook and uncertainty around the future path of the pandemic, signs of optimism that emerged in the fourth quarter carried into 2021. While intermittent lockdowns in certain parts of the country caused labor market metrics to soften, positive news around vaccine distributions and an acceleration in certain leading economic indicators has improved confidence looking across the remainder of the year. Importantly, this is even before contemplating the potential benefits related to the booster shot of a $1.9 trillion fiscal stimulus package signed in March. Given a positive tailwind in the macro backdrop, bank equity prices and credit spreads have performed admirably year-to-date with credit spreads now tighter than pre-pandemic levels. We believe that this reflects stronger balance sheet fundamentals and renewed confidence in the sector. Indeed, strong results from the Fed's COVID-19 stress test in December, the toughest in its history based on loan loss assumptions, only adds to this sentiment.

Bank earnings released in January were generally above expectations reflecting lower-than-forecasted credit loss provisions and resilient results in fee income businesses such as capital markets and wealth/asset management. Perhaps more important, was cautiously optimistic forward-looking commentary as management teams remained upbeat around asset quality trends and through the cycle loss expectations. On the other hand, many banks also trimmed their already-weak loan growth projections. While we remain cautious on commercial real estate asset quality in the near- and intermediate-term given structural changes that have occurred in certain sectors, bank exposures appear manageable and the mix has improved meaningfully since the last recession (i.e. less construction). It is also noteworthy that the largest concentrations are with smaller lenders. On the consumer front, meanwhile, strong underlying trends reflect lending standards, which have tightened materially post-GFC (supported by regulatory stress-test results), the impact of stimulus measures and stronger household balance sheets coming into this crisis.

Looking ahead, a steepening yield could prove beneficial for banks given the sector's largely asset-sensitive balance sheet positioning. On the other hand, the Fed's balance sheet expansion (quantitative easing) is set to flood the system with cash and will be a drag on margins. While a number of important happenings under the new administration are worth watching, including tax policy, we do not anticipate major near-term bank regulatory changes absent expected (permanent) changes to the supplementary leverage ratio calculation. Still, the banking sector is ripe for consolidation and we do expect for mergers and acquisitions to remain a theme as banks seek to become more efficient, enhance scale and improve/enhance technology.

Europe

Nordics led the way for year-end European bank earnings, supported by above-average economic growth. For non-Nordic banks, it was a poor end to 2020 caused by a mix of "everything and the kitchen sink" charges (restructuring, goodwill, subsidiary impairments), retail revenue strains, and a moderation in fixed-income, currency, and commodities revenues from mid-2020 highs. These more than offset improved fourth quarter 2020 loan loss provisioning. However, net income expectations were so low that most banks beat consensus estimates.

Asset quality concerns continue to recede and are not the existential threat they were one year ago, thanks to regulators altering IFRS9 accounting rules, a massive flood of government support for consumers and business, a recovery in oil prices and dovish rating agencies hesitant to downgrade sovereigns and banks. Bank management teams are confident that loan losses peaked in 2020, but this year's cost of risk is still guided to be above historical averages. Reduced asset quality concerns have largely been replaced with revenue troubles. Struggling with low rates, banks are still restructuring to adjust to this environment of digital banking, branch reductions and layoffs. A repeated theme by management is 2021 will be a transitional year before they hope to achieve decent returns from 2022, 2023 and possibly onward. The base case is that the vaccine roll-out and re-openings will be successful, paving the way for a 2H21 rebound in economic growth. If this recovery path falters, it would further push banks' ambitions of normalized earnings out past 2022.

Canada

Even as Canada is trailing the US in vaccine distribution and has had to contend with the recent lockdowns to key provinces, the banking sector is performing quite well from a credit standpoint. Note that this is despite the knee-jerk reaction that occurred a year ago as the energy market was collapsing at the onset of the pandemic. Recent earnings from the major banks have been underpinned by solid diversification of revenue sources including in capital markets. This has helped to offset mixed results in net interest income despite decent trends in mortgage volumes. While some banks with larger non-domestic exposures have been struggling a bit more than others in recent periods, results for the sector at large remains enviable in comparison to international peers.

Most importantly, earnings have been driven by better than expected credit provisions which reflects the impact of ongoing support from both government and bank programs. Looking ahead, management teams sound optimistic about the second half of the year despite the operating environment remaining challenged by low rates, a moderating economy and slowing employment growth. With banks sitting on large excess capital and restrictions from regulators still in place, we believe that some banks may eventually be interested in mergers and acquisitions to expand their footprint in the US region.

On the macro front, a poor streak of employment data due to the second wave of COVID-19 ended in February as both Quebec and Ontario eased the sanitary measures put in place to control the virus spread, recovering 97% of the 266,000 jobs lost in December and January. The housing market is very hot once again, with home prices up over 25% year-over-year (YoY) in February as the Bank of Canada continues to hold the policy rate steady and quantitative easing helps the public sector. While an improving housing market has impressively occurred despite the growth impulse of immigration, it remains a concern because of the large debt burden of Canadian consumers, in our view.

Australia

One of the largest Australian banks reported their half year results in 1Q21 while others reported more abbreviated trading results. Performance was resilient in the face of a difficult operating environment, particularly as Australian banks have ~80% of revenues tied up in net interest income and rates have declined. Most notably, revenues surprised to the upside, driven by markets income, some resurgence in lending (though businesses are reluctant to take on debt) and net-interest-margin benefits from mix shift and lower wholesale funding costs. Asset quality has been especially resilient including in non-housing portfolios, which has proven to be a trouble spot in past downturns (i.e. GFC, early-90s).

As the banks now maintain historically strong balance sheets by many metrics, they appear poised to begin progressively returning some of this strength to shareholders via reserve releases and excess capital distributions, barring the go-ahead from regulators. While this is not positive for creditors in isolation, it reflects outperformance of Australia and New Zealand relative to other global countries in containing the virus, as echoed in recent employment metrics. Still, management teams remain cautious as they contemplate these actions and are reticent to act given residual risks of the crisis.

Like Canada, housing markets in Australia and New Zealand are rebounding considerably which has already caused New Zealand authorities to impose macro-prudential measures to cool price growth. In Australia, we believe that regulators would need to see a sustained period of high house price growth, a strong pickup in investor activity and a material increase in the proportion of higher-risk lending before re-introducing macro-prudential measures. Still, low rates, high household debt, strong competition in the housing market and accelerating credit growth bear monitoring, even as banks are well-protected. Given the outsized importance of housing on Australia's economy and its banking system, the implications of a large mishap in the market are very important to monitor and particularly given the low rate environment.

Asia

The Japanese megabanks reported quarterly earnings in early February with all three banks booking credit costs which were much lower than originally expected at the start of the fiscal year in May 2020. While earnings were in-line with expectations and saw no real surprises with revenues up year-to-date versus 9-month 2020, each bank has already met its full-year profit targets. This not only reflects strong central bank and government support initiatives, but also growth in markets-related businesses. Looking ahead, while banks remain cautious on the outlook and especially with respect to Japanese small and medium sized business portfolios, asset quality risks generally look manageable. As well, another potential round of stimulus as well as election year politics could keep support flowing.

Japan has had relative success containing the virus despite recent setbacks in Tokyo and is now playing catch-up with vaccine rollout compared to other developed nations. Still, the economy is benefitting from robust levels of fiscal support which is the largest as a percentage of GDP of G20 nations. Under this backdrop, the major banks continue to have good capitalization and benefit from sovereign support assumptions. However, the operating environment is perpetually challenged by low to negative rates (which have persisted for the past two decades), a declining population, overbanking and structural challenges in reducing costs. This could cause banks to look for inorganic growth outside of Japan as securities gains inevitably taper over time. Though this is a risk factor for creditors, we expect the banks to remain disciplined.

Structured Finance

Figure 2
US ABS Volume and Credit Spread Update

Asset-Backed Securities (ABS) — US

Asset Type (in millions)	YTD 2021	YTD 2020	Δ%
Credit Cards	1.0	2.3	-56.5
Autos	29.4	27.7	6.1
Student Loans	4.3	5.4	-20.4
Equipment	6.5	3.2	103.1
Floorplan	0.0	0.4	-100.0
Unsecured Consumer	2.9	1.9	52.6
Other	9.2	6.0	53.3
Total	**$53.3**	**$46.9**	13.6

Source: JPM BAS Weekly Volume Data Sheet; 03/12/2021.

US Consumer ABS Credit Spreads (in bps)			
	As of 03/18/2021	As of 12/31/2020	Δ
2 Yr AAA Auto	6	7	(-)1
2 Yr AAA Credit Card	4	3	(+)1

Source:JPM Research- ABS Weekly Spreads; 03/19/2021.

Year-to-date primary market US ABS volume is up modestly on a YoY basis but recall the new issue market shut down from March 12, 2020 to April 16, 2020, which likely means new issue volume will exceed last year's volume from this point forward. The equipment and other ABS sectors have experienced significant YoY new issue volume increases, while the credit card sector has experienced the steepest decline. Recall credit card ABS issuance is somewhat arbitrary, given the plethora of unsecured funding options available to large banks that typically sponsor ABS.

Spreads for benchmark ABS (prime auto loan and credit card ABS) have generally been unchanged year-to-date, despite significant interest rate volatility in the US Treasury markets. Meanwhile, spreads for short dated corporate bonds has modestly widened in recent weeks, leading to a slight widening of the basis between corporates and benchmark ABS. However, the basis is now near two-year average levels, suggesting that benchmark ABS are fairly priced versus corporates.[7] While we expect that ABS spreads will follow corporate spreads wider (if corporate spreads do, indeed, go wider from here), we also believe the safe haven status for benchmark ABS (AAA-rated auto and credit card ABS) likely means spread widening should be relatively contained.

The fundamental credit performance for the major US consumer ABS asset classes continues to exhibit strength. For example, the major US credit cards the ABS sector trusts recently released their data for February and it's quite clear that the effects of government stimulus and consumer loan forbearance continued to aid results. Although expiring payment deferrals likely contributed to the modest increase in charge-off rates throughout the peer group, those rates remain well below historical levels.[8]

We continue to see evidence that the 2020 US recession was very different than past recessions. First, it is rare that US consumer balance sheets begin a recessionary period with such strong and healthy balance sheets (i.e. high savings rates and relatively low debt levels). During and after the recession (the assumption being it is over) US consumer savings has increased materially. The mountain of savings the consumer is sitting on will only get bigger now that Biden has signed the $1.9 trillion fiscal stimulus into law. In addition, the Fed's Flow of Funds report was published in March and it showed that US household balance sheet positions continue to get incrementally better from already very healthy levels. Household liabilities relative to net worth is ~13% or the lowest level in the ABS/securitization era (which began in the late 1990s). Further, household deposits covered 97% of liabilities on the US consumer balance sheet — the best level since 1990 — and this ratio will only go up when the last two rounds of stimulus checks are captured in the data, since these readings do not include both the $600 checks delivered in 4Q20 and the latest round of $1400 checks.[9]

Non-Financial Corporate/Industrial — Global

The strength of the economic rebound after last year's recession was seen in company earnings reports during 1Q21. Aggregate US S&P 500 revenue growth turned positive on a YoY basis in the most recent earnings reports, a remarkable turnaround given the depth of the recession in the middle of 2020. Within the investment grade (IG) universe of companies', the specific sectors that have demonstrated the strongest YoY revenue growth have been: metals & mining (highlighting the strength of reflation, particularly in commodity prices), sectors on the forefront of COVID-19 responses (medical products, pharmaceuticals, and hospitals), and sectors that benefitted from lockdown measures (food & beverage, IT). Sectors in IG with YoY revenue contractions were led by those sensitive to travel, including aerospace & defense and gaming.[10]

Global business equipment spending CAPEX has fared remarkably well since the start of the global pandemic, despite the significant economic growth shock. In contrast to the recoveries from the past two recessions, global capex nearly recovered its prerecession level within just two quarters. As the pandemic set in, global CAPEX was held back by businesses' reluctance to invest with so much uncertainty around the pandemic, weakened profits, levered balance sheets, and limited free cash flow available for investments. However, since mid-2020 profits have surged back quickly, and uncertainties have abated with the rapid discovery of a suite of vaccines. The fast recovery in CAPEX owes in large part to very generous liquidity support to businesses. As the pandemic raged, a flood of fiscal and monetary liquidity helped to boost bank credit to businesses by 80% annualized, in sharp contrast to the credit crunch that followed the GFC, when credit growth slumped for nearly a year.[11]

On the new issue front, year-to-date US IG issuance of $413 billion is off to its strongest start on record and 11% above the previous high set in 2017. Perhaps even more surprising, however, is that activity in the US IG primary market has remained so heavy given 2020's record-breaking new issue volumes. Attractive debt funding costs have encouraged issuers to continue to opportunistically raise liquidity and proactively pre-fund upcoming maturities. That said, much of the year-to-date USD IG supply (~70%) has been issued for general corporate purposes, leaving issuers with flexibility as to how they ultimately deploy proceeds. If a large portion of cash raised over the past year is diverted away from debt service and liquidity raising, and towards shareholder returns and debt-funded mergers and acquisitions, this would pose risks for fundamental credit quality and credit-ratings trends for non-financial corporates.[12] We continue to view re-leveraging of non-financial corporates as a key risk in 2021 (and beyond), especially as elevated non-financial corporate leverage and the build-up in BBB-rated credit in major bond indices were key risks to the late phase of the last (pre-COVID-19) cycle. The persistence of those risks could certainly limit the duration of this new credit cycle.

Endnotes

1 JP Morgan Global Research Digest; "Summing it up: The road ahead from the COVID-19 pandemic"; 03/07/21.

2 Morgan Stanley Global Macro Research; "The Moment of Recognition"; 03/07/21.

3 Based on the MSCI AC World Indices GICs classification.

4 Citi Research North America; US High Grade Credit Strategy; 03/04/21.

5 Morgan Stanley Global Macro Research; "Getting Real on Rates"; 02/28/21.

6 Citi Research Economics; The Daily Flash; 03/18/21.

7 Bank of America Global Research; ABS Weekly; 03/12/21.

8 Barclays Equity Research; Financial Services; Feb 2021 Card Trust Receivables; 03/15/21.

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