Commentary
Global Cash Management

Q3 2021

Credit Research Update

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At the conclusion of 1H21, we pondered risks posed to the global economy, and to credit markets, given the historically easy financial conditions that existed. For example, Bloomberg's US Financial Conditions Index had eased to near 14+ year highs. Despite the expectation of exceptionally strong growth, global central banks remained dovish and seemed to be explicitly aiming for a high-pressure economy. At the time, we pointed to the risks correlated with this particular policy backdrop including complacency and inflation. We noted that either, or both, could cause tightening financial conditions, and disrupt the economic growth and credit cycles over the medium-term. We believe that those risks have become modestly higher as we come to the conclusion of Q3.

With regard to the global growth outlook, we have seen a slowdown in the pace of growth across the world's major economies since the end of Q2. US, UK, euro-zone and Chinese payroll, PMI (manufacturing and services), and retail sales data have suggested that growth has slowed over the summer. For sure a slowdown in growth was inevitable given that historically high growth rates in the first half of the year had left most economies either at, or close to, their pre-pandemic levels of output. Still, supply constraints and the rapid spread of the highly contagious Delta variant have weighed on global goods and services sectors. The medium- and long-term inflationary outlook remains murky in the eyes of many professional economists. There is clear recognition that the pandemic is responsible for multiple components of the current global inflationary impulse and as such, the transitory impact of these conditions, as related to the pandemic, should fade. Still, it remains to be seen whether the pandemic marks the start of a sustained higher inflationary regime over the medium-term. There are conditions that could lead to a period of stronger aggregate demand and higher prices. Historically, high excess saving at the consumer and corporate levels creates the potential for prolonged period of above-average spending across private sectors. At the same time, a massive build up of global commercial bank reserves over the past year could potentially be a driver for a prolonged credit creation boom as economies recover and both lenders and borrowers become more confident. The backdrop for this is particularly pronounced in the US, where the scale of policy support has been particularly large, excess savings are especially high, and output has already exceeded pre-pandemic levels.[1]

The most immediate concern we have for credit markets relates to the potential vulnerability of financial conditions. We continue to see material impacts on fixed income asset prices from the financial repression that global central banks have created with the persistence of extraordinary policy measures. For example, a recent look at the effective yield for the ICE Bank of America US High Yield Index shows that 85% of the US high yield market is below the current rate of inflation. That proportion has been elevated for a few months but before that had never been above 10%, and rarely been above zero during its history. Although inflation readings will likely descend over the coming months, it could stay relatively elevated for quarters to come. This demonstrates financial repression has reached down the credit quality curve and fixed income investors are increasing levels of risk to earn a rate of return higher than inflation.[2]

The prior example of high yield markets demonstrates how rich asset valuations have gotten in the fixed income markets. In our view, the bullish path for risk assets and tighter credit spreads is very narrow, due to downside growth risk, upside inflation risk, and the potential for near-term monetary policy tightening. While the high yield markets are typically impacted by materially different factors than the term and short-end investment grade credit markets, the signals from the high yield markets can still tighten financial conditions more broadly. Recently, fears of the collapse of the debt-laden corporation, Evergrande Group (one of the largest property developers in China), contributed to broad global financial market volatility and financial condition tightening. Evergrande is one of the largest high yield issuers in the Asian credit markets, and one of the largest Chinese corporations. As we wait to see how the Evergrande situation evolves it may end up being the largest global corporate bond default of 2021, with approximately $20 billion of rated offshore bonds. Whenever a corporate debt issuer of this size and prominence becomes a default risk, comparisons are often made to the collapse of Lehman Brothers in 2008. However, the state-run structure of the Chinese economy and financial system allows for domestic management of these types of situations, which should prevent broad contagion across global financial markets, in our opinion. Evergrande may indeed default, but Chinese authorities will very likely take steps to prevent the property giant's crisis from destabilizing its own financial system. Still, there is material risk of spill-over effects on China's property sector, with negative economic implications for the Chinese and, to a lesser extent, global economies.

We'd note the banking systems of other major economies, including those in our credit research team's coverage universe, have limited direct exposure to Evergrande or the Chinese property sector, in general. We believe that any potential impacts to banks in our coverage universe will be through revenue channels, depending on the behavior of capital markets, opposed to having material impacts on balance sheet and capitalization. The banks with a higher percentage of operating profits generated in Asian business lines are likely to be the most negatively impacted. Still, the event demonstrates the market is focusing on excessive leverage in the non-financial corporate bond market, as well as on valuation perspectives. Investors seem to be asking if fixed income investors are being paid adequately for the risks they are taking. Despite the benefits of central bank-induced financial repression, valuation risks and market volatility will persist, in our view.

Central banks find themselves in a difficult situation: attempting to sustain economic recoveries while maintaining a commitment to monetary and financial stability against a backdrop of elevated inflation with high and rising asset prices. In the midst of these developments, we'd note that much of the high quality credit universe has fully recovered to respective pre-pandemic credit profiles. Certainly the universe of global banks that make up the majority of our investment universe are, in many ways more than recovered, having demonstrated their resiliency to the pandemic and the "sudden stop economy". But just as we were during the onset of the pandemic, we are prepared to adjust the parameters of our suitable cash investment universe in our approval list, and/or maturity restrictions for approved credits, if conditions and macroeconomic developments evolve in a manner that make it prudent to do so.

United States

The US economy continues to rebound well from the pandemic but the virus' reemergence has hurt confidence and caused 2H21 growth estimates to be revised lower. The Federal Reserve (Fed) has begun to signal its intent to start tapering its asset purchase program as early as 4Q21 but expectations of rate hikes remain geared towards early 2023, as the debate around inflation rages on. Under this backdrop, US banks continued to perform well with credit spreads still comfortably inside of pre-pandemic levels. Most recently, 3Q21 earnings were ahead of expectations as strong asset quality spawned reserve releases, which may begin to wane. While low rates and slow loan growth are a challenge, results indicate a very strong US consumer as well as improving credit performance across commercial clients, each of which benefit from the lingering impact of stimulus. There is still uncertainty around certain asset classes including commercial real estate — namely office, hotel and retail — but the timeline for issues to emerge has a longer tail and should allow banks to build incremental reserves and capital, if needed.

In terms of key themes revealed from the recent industry conference season, loan growth outlooks continue to be varied with tepid near-term trajectory due to low utilization rates, loan payoffs (including Paycheck Protection Program loans) and disintermediation from the capital markets. While there is optimism around utilization rates bottoming out in corporate lending, deposits are expected to remain elevated with anemic loan growth, which will hamper net interest income, offset by positive trends in equity market-related categories such as asset/wealth management and asset servicing. Looking ahead, with banks struggling to find places to absorb excess cash, we are mindful of the potential for emergence in risk taking and more aggressive capital actions. However, we also believe that regulations mitigate this risk considerably. In addition, we are carefully watching the potential for asset bubbles to emerge amidst ongoing stimulus.

Finally, there remain lingering concerns related to the impact of various capital regulations on short-term funding markets as we approach year-end. Recall that some of the largest US banks must proactively manage their year-end balance sheets under the constraints of the supplementary leverage ratio (SLR) and a capital add-on for systemic importance (G-SIB buffer). The Fed foreshadowed modifying the SLR earlier this year but it increasingly seems unlikely that changes will be finalized by year-end. Rather, modifications could be announced part of a more comprehensive proposal at a later date. Banks have so far mitigated the impacts of nominal balance sheet growth by issuing preferred stock and pushing institutional deposits off their balance sheets and into money market funds. Short-term secured funding markets, which often also feel the impacts of bank mitigation tactics, have not yet been materially impacted. While there is some optimism around year-end funding pressures due to greater flexibility from banks to operate in higher G-SIB categories and abundant liquidity in the system, this remains to be seen.

Europe

After setbacks in 1Q21 from new virus cases, 2Q21 economic data was better than expected. The easing of mobility restrictions and return of activity was reflected in banks' 2Q21 results. Most European banks handily beat estimates from material loan loss reversals. Pre-provision earnings were mixed. Low rates continue to constrain net interest income, but the re-openings are increasing customer activity, boosting loan demand and fee income for some banks. This partly offset a moderation in investment banking revenues from exceptionally high recent levels.

Bank earnings results were fairly uneventful but positive; an acceleration of the recovery trends from 1Q21. The recovery in bank earnings is continuing forward due to government support, vaccine adoption, and increased mobility/service sector activity. As they continue to generate positive earnings and internal capital, downside risk has declined for European banks. Government support programs have artificially suppressed bankruptcies. Banks warn that when most of this support expires in fall of 2021, non-performing loans will rise. However management is confident that this risk is captured in existing provisions.

The decrease in risk and uncertainty was affirmed by rating agencies and regulators. S&P and Fitch acted on the improved operating and economic environment, removing most of their negative outlooks with no downgrades. The European Central Bank announced it will not extend the ban on bank dividends that expires on September 30th, supported by the resilient performance of the banks stress test results from July 31, 2021. The Bank of England has only disclosed the aggregate results of its stress test, stating that the stressed capital levels further support allowing UK banks to resume dividends and buybacks.

European banks are recovering from COVID faster than previously expected. Worst-case scenarios of capital deficits have been avoided. The sector is still hampered by: low rates, lack of a banking union, above-average legal risk, weaker risk controls, and over-concentration. Banks are restructuring and divesting low-returning/lack of scale business to improve returns. The individual banks vary greatly on their progress in this area. Deutsche Bank is turning a corner, HSBC and NatWest are still finalizing unwanted subsidiary sales, and Credit Suisse is just starting its internal strategy review.

Canada

Canadian banks continued to show resiliency in their operating fundamentals in 3Q21 as the macro environment improved. Similar to US banks, the sector reported strong quarterly results as better profitability was driven by an ongoing improvement in credit quality. Performance has remained buoyed by robust business line diversification across retail/commercial banking, wealth, insurance and capital markets. While excess capital remains considerable and grew higher this quarter as regulators have yet to give the green light for larger capital returns, this may be forthcoming with the recent increase in the Domestic Stability Buffer, a capital add-on required by regulators. Note that the major banks continue to be valued at a premium in both debt and equity markets relative to global peers.

Looking ahead, an ongoing wave of COVID transmissions should be manageable amid high vaccine penetration but a return to normal for activity and employment is not yet in view. While we expect that easing sanitary measures will drive pent-up demand that feeds through to the broader economy, this could take over time as supply chains normalizes. In the meantime, there is emerging political uncertainty for banks to contend with given promises related to a snap election in September, though outcomes should be manageable from a credit standpoint. Economically, broad-based strength in August's employment figures provide some reason to look through some weaker activity of late including a second quarter GDP contraction, though jobs in the high-touch service sectors continue to lag. Even as the market sees the Bank of Canada raising rates in early 2023, the tapering of income support and evidence of a "fiscal cliff" impact could prompt additional assistance, as needed. This is important given that the pre-pandemic private sector debt dynamics that existed in Canada remain in place today.

Australia

The banking sector has long been a political topic in Australia but it built significant goodwill during this crisis by being a source of strength in the economic recovery, which has recently lost its footing. Coming into the quarter, Australia's relatively successful containment of COVID infections resulted in much less economic pain than in other countries. The economy had been performing very well as evidenced with 2Q21 GDP, which beat expectations on the backs of household consumption. A rapid recovery and iron ore prices also helped. However, recent disruptions from the Delta outbreak have resulted in a return to lockdowns across Australia's two largest states, New South Wales and Victoria, which will hamper GDP growth in 2H21 and push out the recovery. While vaccination coverage is improving, restrictions are unlikely to ease until later this year once vaccinations reach herd-immunity thresholds. In September, the Reserve Bank of Australia (RBA) struck a balance between tapering and maintaining support for the economy, reducing the amount of bond-buying as planned but extending its purchases until at least mid-February 2022. It also left interest rates unchanged. Overall, we expect authorities to ready additional incremental assistance if needed.

Despite this backdrop, Australian banks that reported during the quarter continued to show strong trends in underlying fundamentals. Profitability remains sound and benefitted from the release of loan loss reserves on better asset quality, though rising home prices are being watched closely. Capital ratios are holding strong and are top quartile globally, even as regulators contemplate modifications to existing rules. Some banks have announced capital return plans as loss absorbing resources remain well-placed. Still, there continues to be a cautious undertone given trends related to the virus and lockdowns. On funding, banks have benefitted from deposit growth and the full drawdown of low-cost funding provided by the RBA's Term Funding Facility, which was created during the pandemic. However, with maturities set to roll off in coming years and with recent rule changes to the liquidity coverage ratio requiring banks should no longer rely upon the RBA's Committed Liquidity Facility as of year-end 2022, incremental wholesale funding is expected.

Asia

The Olympic games, hosted in Japan this summer, coincided with an ill-timed re-emergence of COVID. Japan's economy is staging a two-speed recovery as resilient external demand supports capital expenditures and exports while intermittent emergency measures control the virus weigh on household spending. While activity measures slowed sharply in mid-August as virus containment protocols were applied to more regions, there remains pent-up demand from consumers. However, persistent Delta variant outbreaks in 2H21 would increase risks and push out the recovery. This is already reflected in the market's expectation for third quarter growth to retrace on slowing household demand and softening exports (partly due to China's slowdown). Beyond the third quarter, progress in administering vaccines and a new policy package should boost consumer confidence. As well, note that Japan is slated for near-term elections to replace outgoing Prime Minister Suga.

Japanese banks reported quarterly results which were relatively in-line with expectations, though profitability remains low compared to global peers. Japan's largest banks showed improvements in net interest income and fee/commission income this quarter offset by lower markets income. While a large reduction in provisions was particularly helpful, full-year guidance was left unchanged. On the balance sheet, asset quality remained benign and capital levels held firm even as a gradual tapering of securities' gains present a headwind. Some of the banks are looking to international M&A to offset slowing growth in Japan, which is worth monitoring. While the major banks in Japan benefit from operating in a large and diversified economy with various competitive industries, these positives are offset by structural weaknesses including an aging society, slow economic growth and persistently low interest rates. As a result of these factors, profitability is pressured and the ability of banks to invest in future banking technology is limited. The banks have been increasingly focus on rationalizing cost structures and shifting retail clients to a digital environment but has remained a challenge.

Structured Finance

Figure 1
Asset-Backed Securities (ABS) — US

Asset Type (in millions)	YTD 2021 ($)	YTD 2020 ($)	Δ (%)
Credit Cards	9.4	2.5	276.0
Autos	101.2	72.3	40.0
Student Loans	19.3	12.7	52.0
Equipment	15.3	12.2	25.4
Floorplan	0.5	3.5	-85.7
Unsecured Consumer	10.5	6.9	52.2
Other	32.2	21.1	52.6
Total	**188.4**	**131.2**	**43.6**

Source: JPM BAS Weekly Volume Data Sheet; 09/16/2021.

US Consumer ABS Credit Spreads (in bps)	As of 09/16/2021	As of 12/31/2020	Δ
2 Yr AAA Auto	4	7	-3
2 Yr AAA Credit Card	1	3	-2

Source: JPM Research — ABS Weekly Spreads; 09/16/2021.

2021 year-to-date, primary market issuance volume continues to be strong. While the 2020 COVID market disruption makes year-over-year comparisons less relevant, we'd note that 2021 new issue volumes are still running 5% to 10% higher than comparable 2019 levels. ABS (particularly at the senior part of the capital structure) continues to receive strong execution in the primary market, as evidenced from deal upsizing and final spreads printing through initial guidance. While ABS credit spreads remain historically tight, we have started to see some widening for non-senior bonds and in esoteric asset classes. A number of esoteric asset classes are now trading wider than their 24-month trading ranges, including private student loans, and auto dealer floorplan ABS.

We still believe consumer credit performance will be stable to modestly weaker over the next six months, despite the recent end of certain federal COVID-related programs (federal unemployment insurance and the CDC eviction moratorium). We expect any modest weakening in consumer credit performance to be concentrated in loan products that are catered to less-credit worth borrowers, such as subprime auto loans, student loans, and unsecured consumer loans.

Non-Financial Corporate/ Industrial — Global

The fundamental credit trends seen in the US investment grade (IG) bond market continue to be positive. According to Bank of America's global research database, US non-financial IG gross leverage declined significantly in 2Q21, and has now retraced all of the increase during last year's recession (2.69x vs. 2.69 in 4Q19). At the same time, elevated corporate cash levels leave net leverage at its lowest average level since 4Q18 (1.94x vs. 2.18 in 4Q19). Leverage improvement was driven by +8.4% quarter-over-quarter jump in the last 12-month EBITDA as well a 2.6% year-over-year decline in gross debt. Operating margins were flat to improving, as cost rose slower than revenues across the US non-financial IG universe.[3] It is logical to expect that corporate management teams will start using the cash stockpiles built up during the pandemic to reward shareholders and restart stock buyback programs put on hold during 2020. As a credit research team, we will be paying close attention to the way in which shareholder reward programs evolve, and continue to analyze credit profile impacts of specific companies, to the extent it is relevant.

Shifting focus to the European non-financial corporate IG universe, we see many of the same trends observed in the US market. Revenue and operating profit growth was significant on a year-over-year basis, and there was strong evidence of corporate pricing power. In this universe, EBITDA was up 24% versus Q2 2019, despite limited revenue growth. As a result, typical seasonal corporate borrowing patterns were not observed. The first half of the year normally sees a sharp rise in net debt, as companies expand working capital and increase discretionary expenditures, like dividends. However, in H1 2021 earnings rose so sharply that European corporations ended up fully funded through internal means. These developments drove continued improvement in aggregate credit metrics. Citigroup research reported that gross leverage in the non-financial European IG universe has declined to 2.3x in Q2, which is the lowest since 2014. Further, interest coverage ratios of more than 13x in Q2 are the highest ever observed.[4]

Endnotes

1 Capital Economics; Chief Economists Note, 09/20/21.

2 Deutsche Bank Research; "Should We Rename High Yield", Craig Nicol, 09/07/21.

3 Bank of America Global Research; "US IG Fundamentals Update", 09/14/21.

4 Citigroup Research; European Corporate Fundamentals, 09/10/21.

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* Pensions & Investments Research Center, as of December 31, 2020.
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