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Credit Research Update

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Two years after the start of the pandemic, the global economy is dealing with another exogenous shock. The Russia-Ukraine War should have an impact on the global economy via a rise in energy and commodity prices, a disruption in supply chains, a tightening of financial conditions and deterioration in business and consumer confidence, investments and consumption.

Economists and investment strategists have been active in adjusting forecasts for economic growth and capital markets since the beginning of the war. While forecasts are being made with a limited degree of confidence, it is clear that the duration of the conflict and resulting disruptions to supply chains (especially for energy and food) will be the ultimate determining factors.

For example, if the disruptions persist in their current acute form through the year-end, the required markdowns to existing 2022 global growth projections will be material and the risk of stagflation-induced recessions will be pronounced, especially in Europe. Alternatively, if the stresses ease over a couple of months, the global economy will have an opportunity to bounce back and the ultimate cost to global GDP growth could be limited, with effects mainly felt in Europe.

Our Global Cash Credit Research team closely tracks macroeconomic forecast adjustments made by State Street Global Advisors, our major sell-side partners such as JP Morgan, Bank of America, Citigroup, Goldman Sachs, Barclays and Morgan Stanley as well as by research consultancies such as Capital Economics and Oxford Economics. There are some consistent themes and trends across these forecasts:

- As a "base case", global growth forecasts were revised down by 0.50% to 1.5%, leaving most estimates of 2022 global GDP between +3.0% and +3.5%. In these scenarios, stagflationary pressures from inflation and supply disruptions reduce growth but do not result in recessionary conditions (outside of Russia and Ukraine). However, there are a range of downside risk scenarios that economists have outlined, which would push several major economies into a recession, with the risk being most pronounced in Europe.

- Most economists we follow still forecast above-trend US growth as a base case for 2022. Supported by strong labor market conditions and significant "excess" saving through the pandemic, US households seem well positioned to continue spending. Further progress in managing the pandemic should support a rebalancing of spending toward services, which could be another tailwind for the economy. Still, base case US growth forecasts have generally been reduced by 0.30% to 0.50%, with particular concern for lower income cohorts of the population, given the financial stress caused by a material increase in food and gas prices. We note that even downside risk forecasts generally have the United States (US) avoiding a recession, given that the US has become less sensitive to energy shocks in recent years.

- Europe will be the hardest-hit region by the conflict due to its closer trade linkages with Ukraine and Russia. Europe's heavy reliance on Russian gas is a major source of concern as the conflict continues. In addition, factory closures in Ukraine have led to a shortage of key parts for some European car manufacturers. Most economists we follow have cut their 2022 growth forecasts for Europe by between 1% and 2% as a "base case". We note that the growth downgrades are from a base that represented above-trend growth for Europe prior to the conflict, and that these economists are not forecasting a European recession as base case. However, if fighting in Ukraine continues into 2023, sanctions are ratcheted up and/or gas flows are restricted, the eurozone economy will most likely be at recessionary levels in the estimation of most economists we follow.

- Although the United Kingdom's (UK) direct exposure to Russia is fairly modest, a spike in energy prices due to the crisis will materially impact the economy. UK GDP forecasts have generally been reduced by about 0.50% for 2022 by economic forecasters, but again, a 2022 recession is not a base case at this time.

- Impact on Asian economies is expected to be modest. While oil is the largest component of Asia's commodity trade deficit and Asian consumers will feel the pinch from inflationary pressures, the region is well positioned with regard to macro stability buffers and fiscal room.

Impact of the Conflict on the Cash Investment Universe

The global cash investment universe is concentrated in debt issued by large global banks and financial institutions. Therefore, our credit research team has performed detailed analyses that consider the implications of the Russia-Ukraine War for our coverage universe.

We see limited implications from the war in terms of first-round effects on banks on our approval list. Foreign banks' exposure to Russia was reduced substantially following the 2014 sanctions in response to Russia's annexation of Crimea. Globally, for banking systems in Bank for International Settlements (BIS) reporting countries, exposure to Russia as of September 2021 amounted to US$104.7 billion, representing just 0.1% of total assets.[1]

Within our credit approval list, and our investment universe, exposure to Russia is small, both in monetary terms and as a proportion of total assets. However, we will summarize our thoughts on the impact of this geopolitical event on our investment universe by geography:

- **European Banks** The macroeconomic impact of the Russia-Ukraine War on the European economy will be vast. However, it will not directly lead to an asset-quality crisis for European banks in general and even for banks that had a presence in Russia and/or Ukraine in particular. In recent weeks, European banking groups with any footprint in Russia's and Ukraine's banking landscapes have provided details on their relevant exposures. These disclosures show that the exposures, even if totally written-off, would not materially harm the parent banks' credit profile. There are large European banks with more significant footprints in Russia's retail and commercial banking landscape, namely, Société Générale, UniCredit, the Raiffeisen Banking Group (Austria) and OTP Bank (Hungary). A few others, such as ING and Intesa (Italy), focus mostly on business and wholesale banking in Russia.

In all instances, and especially in regard to banks that are relevant for our current investment universe (which are Société Générale and ING), they have capital buffers that are very sufficient to absorb potential Russian-related losses. For Société Générale, the Russian credit exposure is notable in absolute terms but account for a negligible share of the banks' total credit exposures and earnings. While a significant negative, these exposures are more of a threat to the banks' earnings rather than their capital and credit profiles. More broadly, there are additional European banks that have small Russian exposures in investment and private banking operations, but again, those exposures should be a manageable earnings (not capital) event. Given these factors, credit rating agencies have kept a relatively benign view of the impact of the Russia-Ukraine War on European banks.

- **North America** US and Canadian banks have minimal direct exposure to Russia and Ukraine. In the US, no bank listed Russia or Ukraine on a regulatory filing that requires disclosure of country exposure exceeding 0.75% of assets. Disclosure data indicates exposure to Russia was under 0.1% of assets in the US banking sector. Citigroup has the largest exposure to Russia of any bank in North America in our estimation, but even then the exposure it has reported (including corporate and consumer loans, local government securities, and deposits) equated to only about 0.3% of its assets. We also analyzed indirect exposure related to counterparty risks in derivative transactions or other off-balance sheet arrangements, as well as the credit extended to borrowers whose creditworthiness might be materially challenged by the happenings in the region, including for rising cost from commodities, or input costs from commodities.

  For commodity market borrowers that are bank clients, higher prices lead to greater cash needs due to margin calls on derivative transactions and fixed dollar asset-based loans not going as far as they previously did. Providing us comfort, bank commodity counterparties in derivatives are often involved in the underlying asset class (i.e., looking to lock-in or hedge prices), so as risk rises in the derivative transaction, counterparty credit risk should theoretically benefit from rising prices of the commodity the counterparty is long on. In summary, dimensioning worst-case losses in the context of capital and pre-provision earnings for Russia-related exposures leaves us with comfort as it pertains to potential impact on the North American banking sector.

- **Asia-Pacific** For banking systems in Asia-Pacific, direct exposures to Russia and Ukraine are very low. The Japanese banking system, which includes three systemically important banks in our investment universe, has limited direct exposure to Russia. The total exposure of Japanese banking to Russia was a paltry US$9 billion as at 30 September 2021, according to regulatory data, or about 0.2% of total assets. Exposure in other relevant jurisdictions in our investment universe, including Australia, is similarly negligible.

Across our coverage universe, we are more concerned about indirect impact from the war, namely, slower economic growth, inflation, persistent high commodity prices and financial market volatility. At the very least, we anticipate that slower economic growth will negatively impact bank profitability and lead to a drag on spending and investment activity across global economies. In summary, we expect the Russia-Ukraine War to be an earnings event and not capital or liquidity event for banks in our coverage universe.

Importantly, short-term bank funding markets have not shown signs of stress. Investors have not been shunning specific bank credits due to counterparty concerns. We believe that heightened issuance activity and wider credit spreads in bank CP/CD markets partly reflect banks being prudent by actively raising precautionary liquidity, many with a focus on term (to mitigate the future impact of rising interest rates on funding costs). We also interpret the rise in funding costs as a repricing of credit risk, from historically cheap levels, for issuers.

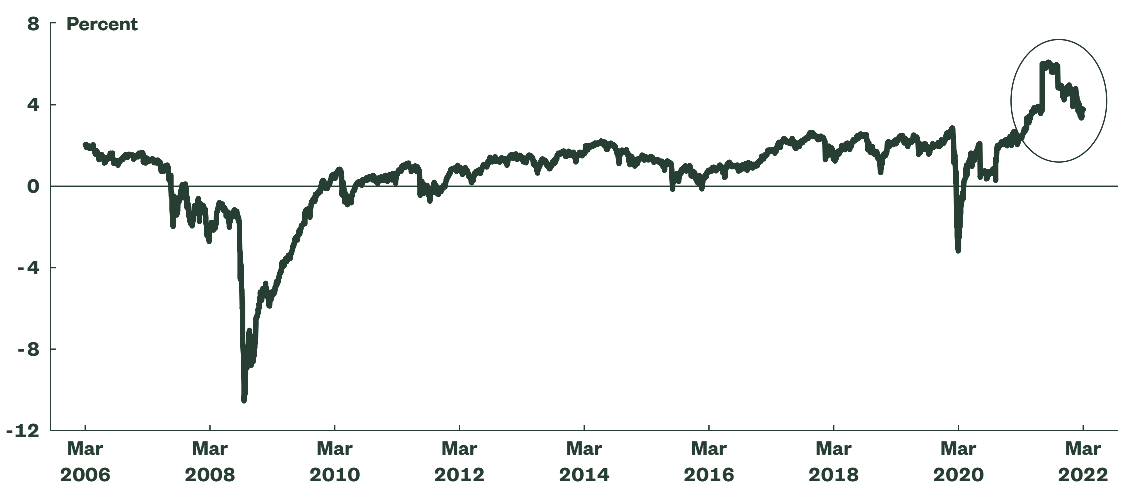
The Central Bank Policy Dilemma

In response to current challenges, central banks must consider a variety of factors. Global inflation was already running hot before the war triggered shocks that affected multiple important commodities. However, central banks must also consider the dampening effects on growth from inflation as well as confidence declines and financial condition tightening. At present, the war has not appeared to have deterred central bankers from their plans to tighten policy. Central banks remain focused on bringing down inflation and mitigating the risk that this inflation becomes entrenched, meaning more policy tightening might be needed in the future.

Some economists expect central banks to be able to engineer “soft landings” for economies while tightening monetary policy, which has been tricky to manage, historically. For example, while the JP Morgan Global Economics team looks for a pronounced rebound in 2H22 global economic activity, as “anticipated tension between healthy growth and tight labor markets should build, limiting the unwind of elevated inflation and generating pressure for an anticipated synchronized global monetary policy normalization”, the team also recognizes that the downside risks of this forecast have increased materially.[2]

In January, our team’s “2022 Credit Market Outlook” was published and in it we outlined the risk that central bank policy tightening could threaten financial conditions to a degree that could disrupt or end the macroeconomic and credit cycles. This was a risk even before the onset of the war and the war has only increased its merits. However, it is worthwhile to revisit a gauge of financial conditions in the US that we highlighted in January (Figure 1).

Figure 1
Bloomberg Financial Conditions Index Plus



Source: Bloomberg, State Street Global Advisors, as at 25 March 2022.

While conditions have tightened since the beginning of 2022, financial conditions are still at strong (i.e., “easy”) levels. In addition, “real yields” remain well below levels of inflation, which is another indication that cost of funds for debt issuers and borrowers is non-restrictive. Historically, financial conditions at these levels have encouraged borrowing and lending activity within economies.

Quality Credit Investments Should Offer Protection

In closing, we would reiterate one of the key themes of our “2022 Credit Market Outlook” — that global banks’ financial performance is highly correlated with economic growth and financial conditions. While we have outlined the reasons why we believe that the Russia-Ukraine War is most likely an “earnings event” for global banks in our coverage universe, we are cognizant that recent events have put significant upward pressure on inflation, which has made it more challenging for central banks to engineer a soft landing. Modest inflation, even if persistent, could benefit economic growth and financial conditions (especially for banks, whose profitability would increase from an upward slopping yield curve), but the opposite would be true if inflation and inflation expectations overwhelmed personal and corporate incomes in major economies.

For investors in senior debt, the strong condition of fundamental credit profiles for our bank credit approval universe, at present, provides a basis for some fundamental deterioration, without materially altering credit profiles. This is true for even the European banks on our credit approval list. However, given the more direct impact of the Russia-Ukraine War on European economies, we view the European banking system as the most likely to be subject to maturity restriction reductions within our investment complex in coming months.

One risk mitigant for European banks during this period of uncertainty is the European Union’s (EU) pro-growth fiscal stance, which sits in stark contrast to the austerity-focused policies of the past. The recent institutionalization of joint fiscal support mechanisms, as well as the persistence of European Central Bank’s support for specific sovereign spreads within the EU, decreases the likelihood that the European financial system will have to endure the types of systemic stress it experienced during the 2008/2009 global financial crisis and the sovereign debt crisis that followed it.

Financial Institutions

United States

The US economy (and US banks) came into the year on solid footing despite lingering effects from the pandemic. The market’s focus prior to 24 February reflected macro developments such as rising inflationary pressures and evolving monetary policy. On 24 February the Russia-Ukraine War broke out and the focus shifted to the potential effects of the war and associated fallout from economic sanctions and supply chain disruptions. Even as direct US banking sector exposure to Russia/Ukraine is manageable, the impact on global supply chains, commodity prices and market volatility is notable, especially considering pandemic-related disruptions are still being dealt with. Overall, the combination of the war and recent economic data has caused more pronounced concerns around inflation and second-order financial and economic repercussions.

While sentiment around US banks improved following a hawkish March Fed meeting (rising rates should materially benefit bank revenues), bank credit spreads have underperformed, particularly for those with large global operations. For US banks, the prospects of higher rates and an economy on the verge of fully re-opening (not really seen in two years) are beneficial as pent-up demand to spend, travel and consume will likely drive loan growth.

On the other hand, second-order impact from the war across counterparty risk and funding markets is in focus. Moreover, some believe that the Fed is raising interest rates while recession risks are increasing citing not only inflation/oil prices and geopolitical tensions but also tightening yield curve, negative real wage growth, declining consumer confidence and the overhang of COVID-19. While North America appears better placed than Europe, the wearing off of post-pandemic stimulus combined with inflationary pressures leaves us closely watching low-end consumers for any potential acceleration in credit normalization.

Overall, the US banking sector is well-placed from a credit standpoint to combat potential future challenges, should they manifest. Fourth quarter results were sound, a continuation of a strong FY21 performance, and company guidance held positive during 1Q22. Asset quality remained stable with charge-offs at historically low levels, though some incremental weakening was expected over the year. Liquidity was elevated even as the Fed prepared to shrink its balance sheet. While capital levels were trending lower and banks had been busy in M&A activities, these were consistent with expectations following a large build-up during the pandemic. In general, loss absorbing resources were well-placed and banks generally held reserves at levels above pre-pandemic levels.

Europe

Par for the course, European Banks ended 2021 on a weak note after a strong 3Q22. This included the usual year-end kitchen-sinking of restructuring, goodwill impairment and litigation. Revenue trends were generally positive, led by continued strong mortgage originations combined with rate increases (the UK, Norway, Central and Eastern Europe). However, consumer unsecured and corporate lending demand was soft. Expenses, reported and underlying, disappointed, a result of high inflation plus resumption of expenses not present during the pandemic (travel, conferences, etc.). Dutch and Nordic banks also experienced continued growth in anti-money laundering/compliance expenses related to their past misconduct. Loan losses remained below historical averages but were increasing. Net-net, bank management foresaw revenue tailwinds more than offsetting expense setbacks and loan loss normalization, with many revising up their 2022 profitability forecasts (prior to the war).

This rosy 2022 outlook was before geopolitical tensions reached a tipping point. European economies and banks have the most exposure to Russia and Ukraine. However, unlike the 2020 COVID-19 pandemic, this represents a negative shock rather than a complete derailment of the outlook. The surge in energy prices and commodities is causing economic growth to be revised down. However, economists are not forecasting a 2022 recession. Bank exposure to Russia has been reduced since the 2014 Crimea invasion.

There will eventually be high loan impairments and/or losses from walking away from Russian banking subsidiaries. However, the scale of the exposure is not significant enough to represent a material problem for bondholders. Importantly, capital buffers were still historically high, to the extent that regulators greenlit banks to resume dividends and share buybacks, which were banned during the pandemic. The slowdown in Europe's recovery and eventual Russian losses are an earnings event and not a capital shortfall issue for European banks on the cash approved list.

Canada

Canadian banks ushered in a strong start to FY22 as earnings rose nicely even when adjusting for credit costs, evidencing solid organic trends and robust revenue diversification including in capital markets. Trends reflected resurgent loan growth and lower credit costs, as forward-looking credit indicators mostly held steady or improved. Reserves also remained above pre-pandemic levels relative to loans, which was favorable. On loan growth, retail momentum fueled growth though commercial balances picked up materially and guidance for FY22 looked pretty strong. Importantly, capitalization remained solid.

Looking ahead, while banks are poised to benefit from volume growth and higher rates (as margins appear to have troughed), a gradual normalization of asset quality trends should be expected as capitalization trends lower with an uptick in deployment opportunities. An important mitigating factor is very strong levels of excess savings in the consumer segment, though it is clear that household debt remains a financial sector vulnerability. We continue to also closely watch the housing market.

In recent months, two major Canadian banks made deals to expand into the US market. This has long been anticipated and could continue as the banks seek to gain scale and diversify. These deals have generally been neutral to credit profiles. Moving forward, while risks from the Russia-Ukraine War do not appear to have direct implications for Canadian banks, the banks do have large capital market operations (and derivative books), which are beneficial for revenue diversification but could also cause periodic volatility. From a macro standpoint, the backdrop looks pretty favorable given pent up private sector demand. We are watching rising inflationary pressures carefully and the impact on lower-end consumers, given consumer indebtedness.

Australia

One large Australian bank reported formal half-year results during the quarter while other banks provided trading updates. Operating performance remained solid from a credit standpoint as reflected in improving asset quality statistics and elevated capital levels. Profitability was sound benefitting from the release of loan-loss reserves and positive emerging trends on loan growth. As an above-average proportion of income is generated from net interest income compared to fees for a number of similarly sized global peers, a brighter uptick on net interest margins was the key takeaway.

It is worth noting that while the banking sector's return on equity has been on a declining trajectory in recent years, there are signs of stabilization. The fact that lower returns are being partially driven by higher levels of equity is a positive credit factor.

Looking back, a "super-cycle" for the Australian banking sector that began in the early-1990s ended in the mid-2010s and gave way to more onerous capital requirements, slowing loan growth, falling rates, higher investment needs and heightened regulatory/political scrutiny. While this has not been a conducive environment for above-average risk-taking, asset growth is now set to re-emerge and should be monitored.

On the economic front, Australia's unemployment rate hit the lowest level since August 2008 in February (4%). Elevated household savings, which maintain a high deviation from the long-run average, should continue to support consumer spending while business investment is accelerating and fiscal settings remain expansionary (albeit trending down). On the flip side, inflation pressures are building as spending intentions rise, staffing shortages creep up and rising business costs are passed through. On the housing market, the monthly pace of price gains is moderating despite solid new lending. Population growth should slowly return to pre-pandemic levels once borders open, which should help spur demand.

Asia

Japanese banks reported decent quarterly results in February and through three quarters of their fiscal years are between 90%–102% of forecasted profit. Some one-time provisions for a few large borrowers emerged this quarter but were manageable. Exposure to Russia generally looked small, though not zero. While there were better underlying signs of business momentum of late, global markets revenues were choppy.

Overall, the major banks continued to have good capitalization and benefitted from sovereign support, but the operating environment was hampered by structural challenges, such as low rates, a declining population, overbanking and cost challenges. The banks were also struggling to shift retail clients to a digital environment. A gradual tapering of securities gains was another headwind. Return metrics remained decent but were still subpar.

Downside risks reduced since the onset of the pandemic and the banks should report better profitability in the year ahead helped by economic recovery, ongoing low credit costs (which could normalize, especially overseas) and efforts to reduce expenses. Asset risk is expected to remain low with non-performing loans below a long-run average given risk appetite, but credit cost trends bear watching. While there would be a benefit to net interest income from higher rates, should that manifest, this could be offset by lower gains from securities holdings.

As management teams face pressure to show higher returns, this could result in more selective new business growth, continuing to downsize/exit less-profitable businesses and accelerating digital transformation. While one area to watch would be credit-negative idiosyncratic risks including one major bank working to sort out faulty IT systems and another dealing with market manipulation charges at securities unit, these risks should be manageable. Looking ahead, overseas loan growth is likely to be a focus, particularly for Southeast Asian countries.

Non-Financial Corporate/ Industrial — Global

Heading into 2022, we expected the continuance of a benign corporate default backdrop in advanced economies. This view was underpinned by the record-high levels of cash on corporate balance sheets and the expectation of robust economic growth. The war introduced new downside risks to growth, adding to headwinds from the persistently high inflationary backdrop and a hawkish path for monetary policy from global central banks. These developments caused some market participants to question whether the USD and the EUR corporate bond markets could experience an uptick in near-term default activity.

The growth backdrop unquestionably became more challenging, especially in Europe. Additionally, the supply-demand imbalance that was driving the global inflation surge was exacerbated by the conflict. However, we believe that credit profile vulnerability is still far more pronounced in the high-yield (HY) corporate credit universe than it is in the investment grade (IG) universe. In general, IG companies have stronger pricing power to offset margin erosion from rising input costs. Importantly, firms are entering this period of decelerating growth from a position of strength.

Due to the compressed timeframe of the most recent economic cycle, many corporate borrowers have not had sufficient time to deploy large amounts of excess cash on their balance sheets, and/or add significant amounts of leverage. Even leverage and coverage metrics for the median HY-rated firm in North America and Europe are at the strongest in the post-financial crisis era, which provides comfort that the corporate default backdrop may not change materially from earlier expectations.[3]

Financial reporting from the 4Q21 earnings season demonstrated the strong fundamental credit basis of most IG corporations in our coverage universe:

- For US IG rated companies, 4Q21 Credit metrics showed continued improvement across most metrics, a reminder of the strong financial position in which most companies entered the more uncertain 2022 environment. Aggregate revenue and operating profit levels were well above pre-COVID-19 levels after growing materially on a YoY basis. Profit margins improved YoY but declined modestly QoQ and dispersion in margin trends by sector highlighted an uneven ability to pass on inflation-driven cost pressures.

  Debt outstanding was flat YoY and increased only modestly QoQ. After two consecutive quarters of declines, this increase was unsurprising as companies largely managed to pay back the precautionary borrowing they took on in mid-2020. Gross leverage remained flat, the same level as last quarter and at year-end 2019, reversing all of the Covid-driven increase.[4]

- The European economy faced a number of headwinds over the fourth quarter, including rising energy costs and omicron. However, this did not appear to have a drag on corporate earnings for IG issuers. Revenues and operating profit increased materially QoQ and YoY. Looking forward, earnings growth will decelerate (regardless of how the situation in Ukraine evolves), but companies in this space continued to expect positive growth as of February. Higher raw materials and wage prices are likely to put some pressure on margins, although we note that our corporate analysts believe that most sectors have the ability to pass through the bulk of these rising costs to consumers.[5]

Endnotes

1 How The Conflict in Ukraine Is Affecting Financial Institutions Ratings. (2022, March 4). S&P Global.

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5 Bailey, M., Lamy, D., & Sriram, M. (2022, March 24). High Grade Themes 4Q21 Credit Fundamentals. J.P.Morgan Europe Credit Research.

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