Global Credit Research Update

As of Fourth Quarter 2016 | Market Commentary

Global Credit Research Summary

Given where we are in the "credit cycle" (particularly in the US), broad based improvement, or even stability, in fundamental credit conditions in 2017 will be contingent upon: stronger economic growth, central bank behavior, and a political backdrop that is supportive, at best, and non-disruptive, at worst. The likelihood of favorable conditions existing in the near term is uncertain, but the 4th quarter of 2016 gave us some important factors to consider for the near term credit outlook.

Perhaps global central bank intervention has finally peaked? We certainly hope so, and if that is the case, market focus should be on macroeconomic fundamentals and global politics. With regard to politics, there will be implementation risk in the US and UK, and fresh election-related risks in several European countries. Since Donald Trump's election victory in early November, financial markets have rallied strongly on optimism that his administration will support pro-growth and pro-business policies. While this may be logical given the traditional Republican focus on lighter regulation and lower taxes, there is significant uncertainty around these policies. President-elect Trump has publicly prioritized reforming the tax system, devising a new immigration policy, repealing the Affordable Care Act, and improving US public infrastructure. As the world's largest economy, stronger growth in the US would have global impacts, but Trump's policy priorities are complex, and estimates on economic impacts are variable and uncertain.

As it pertains to the Global Cash business, Trump policy impact on US bank regulation will be a major focus of the Credit Research team in 2017. While the Trump administration is unlikely to prioritize the repeal of Dodd-Frank (since it is unlikely to muster the 60-vote supermajority needed to pass in the Senate), it is likely to take measures to weaken its enforcement, through appointments and the budget process. Further, US banks don't favor a full repeal. Rather the preference amongst US bank management teams is to make regulation simpler and less costly, rather than returning banking to the "Wild West days" that preceded the 2008 financial crisis. Bank management teams have acknowledged the benefits of the new rules, noting they have helped improve the way firms manage risks and view their businesses. They also generally recognize that having been forced to hold more capital, and build it quickly after the financial crisis, made their firms stronger than troubled European peers. [Wall Street Journal article, 12/8/16, "Banks to Donald Trump: Don't Kill Dodd-Frank"]. As such, we don't anticipate that the capital component of the US bank regulatory regime will change materially, which is positive for their respective credit profiles.

Outside of US banks, other significant components of the Global Cash investment universe will be challenged by persistent risk factors. European and UK banks will continue to face difficult operating environments. Persistently low interest rates, anemic loan growth, challenging trading conditions, and a re-calibrating of scale in capital-intensive businesses have all materially suppressed the earnings power of these banking sectors. These profitability pressures are ill-timed as they make it more difficult for the banks to build capital to meet regulatory requirements as they are phased in. Deutsche Bank has been the "poster child" for the difficulties facing European banks due to these noted factors, and we expect banks like it to continue to be in the headlines in 2017. In addition, upcoming elections in France, Germany and Holland (and possibly Italy), as well as the beginning of the UK Brexit process, pose risks to bank funding conditions in these jurisdictions in 2017 — although we expect the ECB and the BOE to continue to be exceptionally accommodative in order to support funding dynamics.

Lastly, we'd note that the October US money market reform date proved to be a "non event" for credit issuers, as expected. Despite the +$1 trillion shift in short term investment assets from prime funds into government money market funds, issuers and fund managers used the significant lead time to adjust their funding and investment strategies, well in advance of the implementation date. While credit spreads in the universe widened, the driver behind the move can be attributable to market technicals, rather than for fundamental credit reasons. Indeed, most metrics that are commonly followed as key indicators of market stress demonstrated the continuance of relatively accommodative funding conditions in the short term credit markets.

Financial Institutions

United States

As noted previously, the Trump administration's fiscal policy and its impact on inflation will be critically monitored. Moreover, even if the administration's lofty economic goals are not met, we believe that lower tax rates and a higher infrastructure spending should lower the probability of recession. Regulatory relief is one of the primary pillars of optimism for financial institutions but might be negative for creditors if it results in a higher risk appetite and/or lower levels of capital across the sector. Still, unwinding key aspects of Basel III capital and liquidity requirements is unlikely and we believe that the practical implications of regulatory relief will depend

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on company-specific implementation. US banks are currently on solid footing fundamentally, as indicated in 3Q earnings results, and should benefit from the recent Fed rate hike and a materially steeper yield curve post-election. Indeed, most large banks maintain asset-sensitive balance sheets and have yet to pass higher rates onto depositors.

Final rules for "total loss absorbing capacity" (TLAC) were announced in December and have given banks a clearer view on the amount of new debt to be issued over the next few years. Regulators also offered feedback on the re-submissions of resolution plans (i.e. Living Wills) for the five banks whose initial submission was deemed deficient in April. Four of the five banks remediated their deficiencies with Wells Fargo the outlier, adding to its recent string of challenges. Looking ahead to 2017 we expect revised stress-test rules and the finalization of the net stable funding ratio (NSFR) to be key events in 2017, though this could depend on the new administration.

Europe

Third quarter results were fairly uneventful. Restructuring banks (RBS, Credit Suisse, Deutsche Bank) were generally around break-even, from a profitability perspective. Better trading revenues partially offset net interest margin pressure. Continued de-leveraging allowed most banks to report minor growth in their Common Equity Tier 1 capital ratios.

Progress was made in several financial sector 'hot spots'. Deutsche Bank and Credit Suisse settled their DoJ Residential Mortgage Backed Securities investigations. The fines were far lower than initial figures touted by the media. While this modestly decreases their capital ratios, it removes the tail-risk scenario investors feared and reduces uncertainty. In Italy, a referendum to reform the Senate and reduce bill-passage gridlock was defeated at the polls. To some, this dashed hopes of a more efficient law process and Italy's commitment to reforms. However the 'No' vote merely means the status quo Senate structure remains. The Italian government subsequently demonstrated it could function effectively if required. It rapidly passed (another) bail-out of the fifth-largest (and long-suffering) bank in Italy, Monte dei Paschi.

Looking forward, we expect 2017 to be similar to the prior year. Headwinds remain from: right-sizing capital-intensive business units, cost-cutting, litigation, and political volatility. However, as demonstrated in 2016, these look likely to depress earnings rather than threaten senior creditors. While the journey may be uneven, we expect banks to continue to evolve into more stable entities at the expense of return on equity measures. Our greatest concern would be a sudden spike in interest rates., which could threaten European housing markets bolstered from years of low rates. However, the base case expectation is a gradual reduction in the level of accommodation from the European Central Bank.

Canada

The Canadian economy is performing fairly well and should benefit from a stronger US economy and its exporting sectors from a weaker Canadian dollar, but the risks of protectionist US trade policies loom. A record level of household debt is a key vulnerability and has resulted in the implementation of various macro prudential measures. Still, consumers remain susceptible to a rising rate environment.

In the most recent quarter, the major Canadian banks reported stable 4Q earnings despite slowing consumer lending growth and low interest rates. Strong underwriting standards, solid capital levels and robust regulatory oversight underpin bank fundamentals and, in the case of capital, is poised to improve as regulators advance initiatives related to the mortgage market (i.e. lender risk sharing on insured loans). Growth-seeking acquisitions outside of Canada remain a risk for the banks despite a diversification benefit. With regard to the implementation of statutory bail-in regime, we expect final details of a bank resolution framework in early 2017 and believe that downward ratings pressure will result for major banks. Note that we expect all existing debt will be grandfathered under current rules and that future debt inside of 13 months will be exempt from bail-in.

Australia

Australia's economy remains resilient as robust consumption and net exports have offset a pullback in resource investment and higher levels of underemployment. Economic growth continues to outperform many developed countries but the inability to execute upon fiscal consolidation measures is pressuring the sovereign's triple-A credit rating. Australia continues to have several vulnerabilities including growth in household debt, which is being addressed by macro prudential measures, and slower growth in key trading partners such as China. Although pockets of economic weakness have emerged in mining-related regions, they have thus far been manageable.

Recent banking industry results indicate modestly higher nonperforming loans, which have reached an inflection point, and pressure on profitability ratios driven by low rates and higher capital. This is being offset by a keen focus on expenses. Two of the three major rating agencies have a negative outlook on the banking system as a result of a challenging operating environment and, in the case of S&P, a negative outlook on the sovereign. This is partly offset by the cautious stance government officials in implementing a creditor bail-in mechanism. Indeed, support from the government remains a neutral factor with more information expected in 2017. Thus far the government has indicated a more cautious stance, relative to global banking peers, towards implementation of bail-in rules.

Structured Finance

Asset-Backed Securities (Abs) — US

In the primary US ABS market, 4Q16 supply totalled $42.5Bn and the 2016 full year total was $186.5Bn, versus $30.9Bn in 4Q15 and $178.1Bn for the full year 2015. At the end of each of the first three quarters of 2016, total US primary ABS issuance volumes were running 5% to 10% behind the same quarter of 2015. That trend reversed in Q4 2016, as significant YoY volume growth in auto, credit card, and other/esoteric asset classes drove total US ABS issuance 38% higher on a YoY basis. This Q4 surge was enough to drive total 2016 US ABS issuance to 5% YoY growth. The factors that led to such a strong new issue market in Q4 were: benign debt capital markets, pent up demand from a pre-election lull, a heavy credit card ABS maturity schedule (refinancing), and the continuance of strong US auto sales. Issuance activity was depressed in 1H16 (and 2H15) due to broad financial market volatility related to global growth fears and Fed rate hikes.

Asset Type (in millions)	Q1–Q4 2016 ($)	Q1–Q4 2015 ($)	Δ (%)
Credit Cards	34.5	27.1	27.3
Autos	86.8	90.5	-4.1
Student Loans	14.4	13.2	9.1
Equipment	9.4	11.7	-19.7
Floorplan	8.5	9.2	-7.6
Other	32.9	26.4	24.6
Total	**186.5**	**178.1**	4.7

Source: JPM BAS Weekly Volume Data Sheet; 12/23/16.

US ABS credit spreads ended 4Q16 at the tightest levels of the year, with AAA card and prime auto ABS spreads pretty much fully recovered back to the tights of 2015. 2016 will be the first year since 2012 where these spreads ended lower at year end than at the start.

Source: Citi Research: Securtized Products, 12/27/16

US Consumer ABS Spreads to LIBOR

	As of 12/31/15	As of 12/31/16	52 Week Δ
2 Yr AAA Auto	45	25	-20
2 Yr AAA Credit Card	40	22	-18

Source: Citi Research; Securitized Products; 12/27/16.

Collateral credit performance for US ABS has remained relatively strong throughout the year. There was a continued focus on the performance of subprime auto loan collateral, but results were generally within expectations. We are already seeing some cyclical adjustments with various subprime auto lenders taking a more cautious stance in an increasingly competitive industry.

Source: JP Morgan North American Fixed Income Strategy: Asset-backed Securities; 11/23/16.

Corporate / Industrial — Global

During 3Q16 earnings season (the most recent at the time of this publishing) fundamental data showed a modest slowdown in the recent investment grade (IG) credit metrics deterioration, particularly for US-based companies. Across the universe, revenue and operating profits showed slowing YoY declines. Indeed, excluding "energy" and "metals/mining" sectors, IG companies, on average, reported small YoY revenue and operating profit growth for the first time since 2Q15. For US-based IG companies, gross leverage levels continued to increase marginally, but gross leverage, excluding commodities-related companies, has been range bound between 2.4x and 2.5x since 2Q15. There has been a continuing trend of companies deleveraging post M&A. This is a welcome development as companies are following through on their guidance to delever after M&A transactions have closed.

Source: JP Morgan North American Credit Research: High Grade Fundamentals 3Q 2016, 12/2/16

Looking forward to 2017, stronger economic growth should lead to better revenue and profit trends for companies, especially in the US, but foreign exchange stability and oil prices are key variables that will influence results. We do not believe that a marginal upturn in revenue and operating profit will be enough to offset the trend of rising leverage in recent years, but a change in the rate of deterioration of credit metrics, driven by stronger operating profit growth, would be positive.

Lastly, we'd note that there is the possibility that a Republican-controlled government in the US could alter issuance expectations in the IG credit markets. Specifically, an element of Republicans' planned tax reform could impact the size of the corporate bond market. President-elect Donald Trump and congressmen from his party have both suggested cutting corporate tax rates. To pay for those reductions, the House Republicans' plan calls for eliminating a key tax benefit associated with companies' borrowing, namely the right to deduct interest payments from income. Eliminating that benefit would essentially raise a significant amount of revenue for the government, but it would also give companies less incentive to issue debt. For IG companies, eliminating the deduction for interest expenses while cutting tax rates to 20 percent (the level that the House Republican plan calls for) would boost net income by an average of about 11%, according to Morgan Stanley estimates. This dynamic would effectively increase the cost of debt capital and decrease the cost of equity capital, on a relative basis.

Source: Bloomberg article, 12/16/16, "Republican Tax Reform Seen Shrinking US Corporate Bond Market".

Glossary

Credit Spread is the difference in yield between a U.S. Treasury bond and a debt security with the same maturity but of lesser quality.

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders' equity.

Asset Backed Security (ABS) is a security backed by a loan, lease or receivables against assets other than real estate or mortgage-backed securities.

Investment Grade (IG) refers to the quality of a company's credit. In order to be considered an IG issue, the company must be rated at 'BBB' or higher by Standard and Poor's or Moody's. Anything below this 'BBB' rating is considered non-investment grade.

Gross Leverage A leverage ratio is meant to evaluate a company's debt levels. The most common leverage ratios are the debt ratio and the debt-to-equity ratio. The debt-to-equity ratio is a measure of the relationship between the capital contributed by creditors and the capital contributed by owners. It also shows the extent to which shareholders' equity can fulfill a company's obligations to creditors in the event of a liquidation. The use of the term "gross" simply denotes that the companies' cash, on hand, is not being factored into the equation, to reduce debt levels, as it would if you were calculating "net leverage".

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