Global Banks

Is there still conviction with Financial Bonds?

Yes, we have conviction in financial bonds not based purely on faith but the crucial role they play in the effective functioning of the economy.

We have seen that in the very early stages of the response to this human and economic crisis the policymakers' aim was to ensure that the banking system remained safe and sound, announcing:

- A massive liquidity injection
- Repo lines to address USD liquidity issues
- Loan lines to businesses
- Easing of regulatory buffers to free up potential balance sheet strains

The prices of subordinated debt were buffeted by a number of elements

CAUSE	RESULT
Equity market weakness	This will take time to bottom
Jump in credit spreads (largely due to elevated market volatility)	QE action is beginning to have a positive impact but will take time to have a sustained effect
Fear that Non Performing Loans' would explode, ballooning Risk Weighted Assets, undermining banks' balance sheet strength	Significant credit lines from governments and support for banks to support companies will alleviate the worst hit
Sudden four day jump in government bond yields	This hit all risk markets and will remain an intermittent threat
Lower bond yields and ceasing of activity would impair earnings	The key here is how long this lasts
	The fact that the government bond yield is shifting (steepening) is positive
	Underwriting (equities & bonds) will be hampered through to Q3Exxon and Verizon issued bonds successfully this week
	But there will be an earnings hit

Therefore we have to revisit why we have favoured bank debt and whether anything has materially changed, either tactically or strategically

FEATURE OF BANK DEBT	CHANGE
Deleveraged banks	This is unlikely to alter significantly as fiscal policy will take the strain
Increased quality buffers	These will be lowered but will remain resilient
High liquidity on balance sheet	Will be enhanced further by Central Bank action
Diversified funding	This is crucial and there is no adverse change
High CET1 ratios	These will come down but under stress but should still remain in mid-to high single digits
Coupon skips	Regulators are giving maximum flexibility, especially as the "Minimum Distributable Amount" buckets have been significantly increased, allowing greater coverage to pay coupons Non-G-SIFIs may face hurdles

We are revisiting all banks under the criteria set out above and we will make tactical changes to optimise the returns when the bounce comes.

Because some of the banks on our radar boast stronger balance sheets than others, once some market stability returns to markets we will aim to partially reduce exposure to the less strong entities. This will allow us to deploy such allocations to banks whose debt will react quicker in an improving market environment.

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