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Weekly Credit Brief

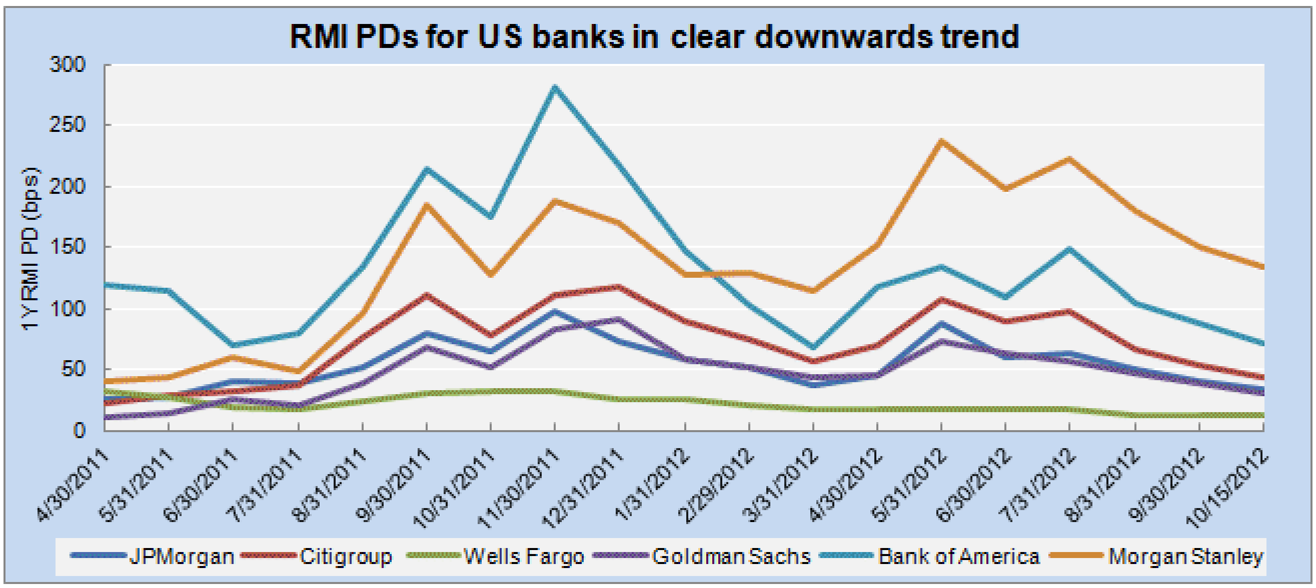
Oct 9 - Oct 15 2012

Story of the Week

RMI PD for largest US banks decline in anticipation of better than expected Q3 earnings

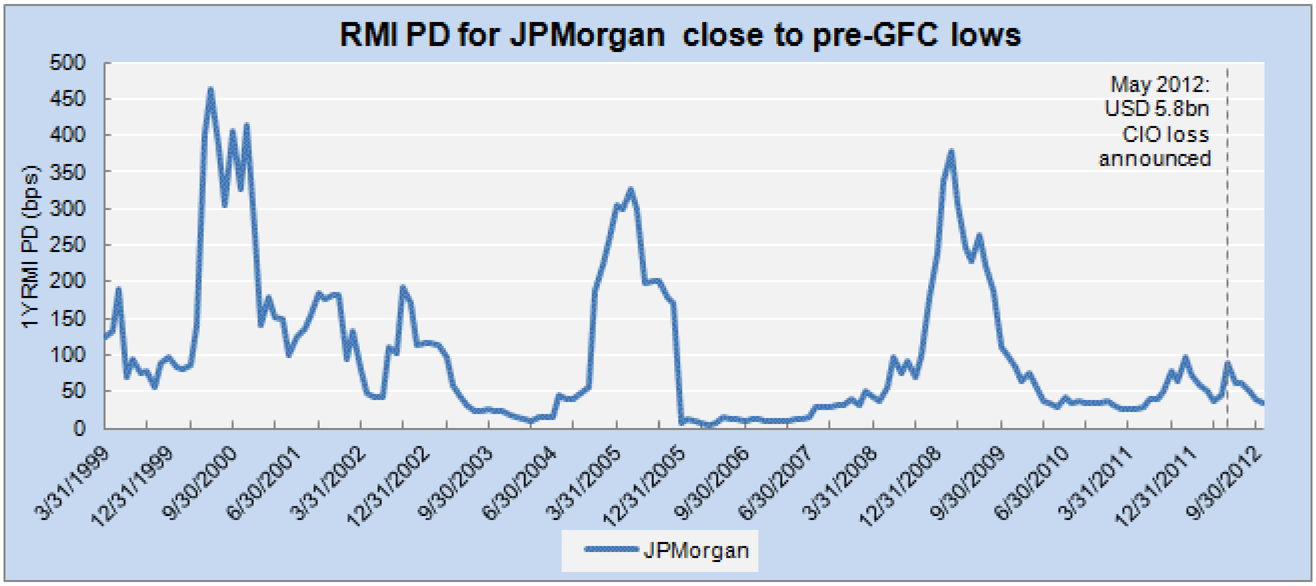
The 1-year RMI probabilities of default (RMI PDs) for the six largest US banks moved lower ahead of their Q3 earnings announcements, as shown in the figure below. Goldman Sachs, Bank of America and Morgan Stanley are expected to report figures this week while Citigroup, Wells Fargo and JPMorgan have reported numbers in line, if not better than the consensus forecast.

Healthy earnings from the banks benefit creditors; stronger earnings results place upwards pressure on equity prices, one of the key inputs into RMI's PD model. Moreover, a clear decline in RMI PDs for these six banks reflects lower concerns about eurozone exposures and improvements in the US housing market. The CEOs of both JPMorgan and Wells Fargo said the domestic housing market has 'turned a corner,' as mortgage rates reach record lows and home refinancing surges. However, Citibank executives remain skeptical about the recovery in housing, due to uncertainty about the presidential election and federal budget.



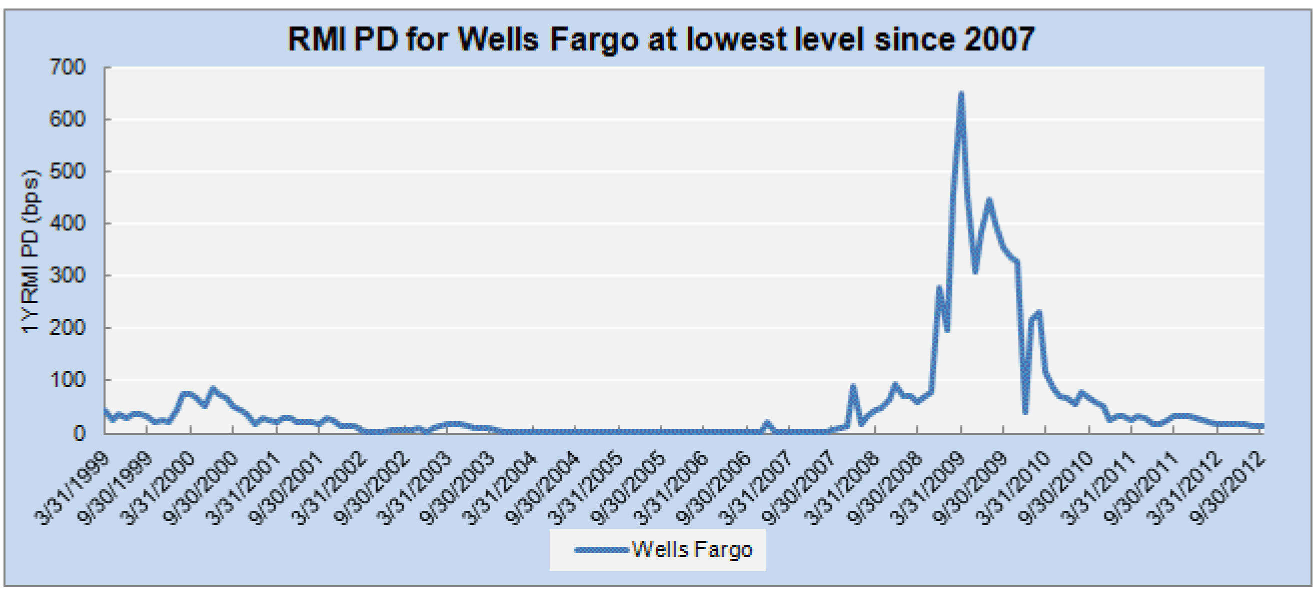
JPMorgan reports early: JPMorgan set the tone for the banking sector after beating earnings consensus for Q3, with earnings per share of USD 1.40. A median survey of analysts by Bloomberg forecasted earnings at the firm to come in at USD 1.19 per share. Strong revenues generated from mortgage origination and investment banking businesses helped push net income to a record high of USD 5.7bn. Month to date, the bank's RMI PD has fallen 6.5bps.

Bond markets also reflect a renewed improvement in the bank's credit profile. JPMorgan issued USD 2.85bn worth of 3-year bonds at record low yields on October 15, including USD 2.25bn of 1.1% bonds priced to yield just 77bps over similar maturity US Treasuries.



CIO unit loss likely immaterial: A major trading loss in JPMorgan's Chief Investment Office (CIO) unit caused the firm to lose USD 5.8bn in May, pushing its 1-year RMI PD to 88bps, the highest level since November 2011. The loss is unlikely to affect the firm's balance sheet in a material way going forward. However, it does highlight the risk that large proprietary derivative positions pose to any lender. Moreover, revenues from mortgage fees have helped shield the bank from CIO related losses. The latest figures show that mortgage fees and related income increased 72% from a year ago

Wells Fargo reports in line with consensus: The RMI PD for Wells Fargo approached historical lows after the company reported record high earnings of USD 4.9bn and revenues of USD 21.2bn for Q3, in line with analysts' expectations. The firm's RMI PD is the lowest since October 2007, reflecting the fact that the bank is in a stronger shape than it was before the GFC.



Results from Wells Fargo did cause some concern amongst investors. Despite strong mortgage origination revenues, US banks are replacing higher yielding pre-GFC assets with lower-yielding assets as the affects of QE3 continue to drive down interest rates. This will likely impair profitability going forward.

Citigroup earnings stronger excluding MSSB write-down: Citigroup's Q3 results were also above expectations. Both net income and revenues beat forecasts, even as the firm took a USD 4.7bn write-down related to the sale of its stake in the Morgan Stanley Smith Barney joint venture. Excluding the write-down, the bank reported a 27% increase in earnings from a year earlier, to USD 3.27bn. Citigroup's RMI PD improved to 42.9bps on October 15 from 54bps at the end of September, partly due to healthy revenue gains and improved sentiment over the company.

Morgan Stanley is the most vulnerable to shocks: Morgan Stanley has the highest RMI PD among the six banks, suggesting that the bank is most susceptible to an earnings or financial shock. Morgan Stanley lacks a core deposit base, and has a higher dependence on fixed income businesses sensitive to counterparty credit quality. In addition, the firm's higher RMI PD may reflect concerns about its ability to integrate Morgan Stanley Smith Barney into its current operations. Morgan Stanley experienced losses in a similar brokerage joint venture with Mitsubishi UFJ during tough market conditions in 2011.

Sources:
JPMorgan and Wells Fargo: housing on mend (WSJ)
Dimon says US housing has turned corner (FT)
JPMorgan gets record-low coupon in USD 2.85bn bond offering (Bloomberg)
Citigroup earnings plummeted in Q3 on write-down (New York Times)

In the News

S&P cuts Spain credit rating to near junk

Oct 12. In a move largely anticipated by the market, Standard and Poor's cut the sovereign ratings of the Spanish government to near junk status, downgrading the nation to BBB- from BBB+. The downgrade came on the back of persistent high unemployment and an ongoing recession. The agency said that receding tax revenues and a dismal job outlook for the economy would impede the government's efforts to reduce its deficit target to 6.3% of GDP by the end of the year. (Reuters)

UK relaxes capital rules for its banks

Oct 11. The Financial Services Authority (FSA) is easing capital requirements for the nation's banks and has postponed an earlier directive for banks to meet Basel III capital ratios. Furthermore, banks would be given access to their emergency reserves held at the Bank of England. Banks will consequently be examined on an individual basis on how much capital they should hold. The decision by the FSA drew criticism from analysts, who argued that the measures would make banks harder to value, thereby making it more difficult for investors to invest in financial companies. (WSJ)

China injects CNY 265bn into money markets

Oct 10. The People's Bank of China infused CNY 265bn into money markets in a bid to lower lending rates. The central bank's action drew mixed reactions as some said that the move was needed to support continued growth in the economy. A number of market participants suggested further moves could be warranted after an initially tepid market response to the changes. Further action could include a reduction in the reserve ratio requirement, which is said to have a more permanent effect on liquidity. (FT)

Companies feast on cheap money

Oct 9. US investment grade companies have better access to funding, thanks to the Federal Reserve's loose monetary policy, which has helped narrow the spread between 30-year US-Treasuries and 30-year corporate debt. The spread fell to 1.83% on October 11, the lowest since August 10, 2011. Companies including General Electric, Comcast and United Parcel Service have seen healthy investor demand for their bonds. In fact, Dealogic asserts that corporations have issued more 30-year bonds in 2012 than any preceding year since 1995. (WSJ)

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