SPECTRUM
Asset Management

Global Financials are Well Positioned for the Macro Challenges

In last Friday's monthly report, we discussed the extraordinary move up in the US treasury markets as being economically symptomatic of the COVID-19 (coronavirus) pandemic. The historic negative price shock to the oil markets over the weekend added further insult to already nervous and conflicted market moods. We expect related news flow to move fast over the near term – for example, Italy has commanded itself into virtual lock down and the Trump Administration is seeking a targeted payroll tax holiday. Ultimately, we doubt that US rates will go negative because the pendulum of pain seems to have swung far enough past the horizon that politicians are motivated to settle on solutions. US Treasury Secretary Mnuchin and House Speaker Pelosi today met to discuss fiscal planning – equities zoomed up on the news and UST 30yr bonds dropped 8pts. Ultimately, yields are still likely to remain low (but positive) because of the deflationary oil slick, Fed rate cuts, and fiscal stimulus, primarily. The spread benefits to owning junior subordination are back to elevations last viewed in 2016 & 2018 (marking our two prior highs). This time though at yields under 1% on the UST 10yr, the choice to own treasuries is far less compelling than owning junior subordinated credit for income. The prospect of more fiscal spending is apt to tighten spreads as growth improves in response because like a regulator, "the market gets what the market wants" these days – that is, rate cuts and fiscal expansion (one way or another). Below, our credit team talks more broadly on some of the credit concerns these health and geopolitical issues raise.

Global leadership is paramount in containing the coronavirus, which could become worse before it gets better. Containment and recovery measures by doctors and scientists, in coordination with professional health groups like the World Health Organization and the Center for Disease Control, are underway and finding success. Furthermore, the US and other sovereigns and central banks are planning fiscal and monetary stimulus to help limit economic damage.

Importantly, financial credit is fundamentally better today than prior to and during the Great Financial Crisis (GFC). Since the GFC, bank regulators have materially tightened rules and supervision, and regularly conduct testing to ensure a bank remains solvent under varying stress scenarios. These measures have reduced systemic risk, especially in Europe. Over the past decade, global banks have successfully strengthened their asset quality, capital and liquidity. And banks are poised to weather stressful headwinds such as COVID-19 and collapsed oil prices due to OPEC/Russia discord.

Recent drops in oil prices could strain many energy-based businesses. However, as in the early 2016 energy crisis, banks and insurers do not have outsized exposures to energy. For example, large international banks tend to have diverse loan books, often in low risk trade finance. Insurance holdings of energy-related bonds are manageable within large and diversified, mostly fixed income general account portfolios. Furthermore, these exposures are predominantly investment grade-rated and diversified within energy subsectors.

Low rates and the flat yield curve are perennial challenges for bank revenues. For P&C insurers, falling rates reduce investment income, while for life insurers these can result in larger charges to strengthen reserves. Life insurers maintain sound asset-liability and cash flow matching principles, resulting in a more gradual impact from declining rates. Insurers are also supported by strong capital.

US banks continue to exhibit stronger profitability than European banks. That said, in Europe we focus on national champions with sound earnings and solid capital. Insurance earnings have varied across life, P&C and geographies, though remain broadly sound in the context of rate pressures for life/annuity insurers and recent catastrophes/rising tort costs for P&C companies. P&C companies can rely heavily on pricing/underwriting and are less exposed to macro pressures. European insurers' mark-to-market capital ratios under Solvency 2 regulation have held up well to recent stresses (falling rates, equity sell-off).

Insurers' balance sheets are in good shape, due to strong regulatory capital and sound asset quality. Property and casualty insurance companies have significant excess capital to cushion against natural disasters and other losses that may come from COVID-19. Business interruption insurance is typically triggered by weather events, and often contains exclusions for communicable diseases.

Alarming macro concerns notwithstanding, we remain constructive on the quality of our selected credits and on the entry point for spreads in junior subordinated capital securities.

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