# Quarterly Money Market Credit Trends by Sector

January 2025

In what was a recurring theme throughout 2024, the high-grade credit markets remained resilient during third quarter 2024 (3Q24), where the earnings cycle concluded in December 2024 and was reflective of favorable macroeconomic and financial conditions. This backdrop supported a continued trend of good earnings during the most recent quarter for the large best-in-class financial and corporate issuers that are prevalent in the short-term fixed income market. We expect this theme to carry over into the fourth quarter 2024 earnings cycle which begins in mid-January 2025.

Post 3Q24, presidential elections and confidence votes occurred that will bring new administrations into power in several large-advanced economies including the US, France and Canada among others. The changing global political environment will bring about new policy proposals that may or may not have credit implications, such as the potential implementation of tariffs by the US. However, the degree and timing of any new policies remain uncertain and will likely be an area of focus in 2025.

Another development since 3Q24 has been the global adjustment in monetary policy whereby the Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BOE) and Bank of Canada (BOC ) amongst other major central banks lowered policy rates into less restrictive territory while the Bank of Japan (BOJ) has lifted rates further after abandoning its negative-interest rate policy (NIRP). Our view is that central banks have been carefully orchestrating a soft landing, a slowdown that avoids and outright recession, with policy rates approaching a more neutral stance.

Ongoing geopolitical risks, policy changes and higher-for-longer rates are themes likely to prevail in 2025. However, we believe the high-grade corporate and financial issuers that comprise our approved list are well-positioned from a credit perspective. This is primarily due to strong balance sheets aiding their ability to navigate the evolving landscape in 2025. Our observations of the underlying sectors are as follows:

## US Banks

In 3Q24, the large US banks reported a modest increase in profitability on strong revenue, but expense growth limited operating leverage. US banks benefited from active capital markets, lower pressure on deposit pricing and controlled credit costs with several banks sequentially reporting reduced credit costs. Most banks reported solid investment banking activity, particularly in debt underwriting and improved advisory volumes. Investment banking revenue increased solidly helped by healthy debt and equity issuance, albeit still below pre-pandemic levels. Sales and trading revenues grew at a slower pace in line with a normal seasonal slowdown in the latter part of the year.

Net interest income growth was not as robust as muted loan growth, and a Fed rate cut was partially offset by the benefits of security portfolio repositioning into higher yielding assets.

Asset quality remained sanguine despite an increase in net charge-offs due to continued normalization in credit cards and office-related commercial real estate (CRE). US banks have guided for ongoing charge-offs in the CRE book to be uneven while also suggesting that lower interest rates have eased some stress in the sector. Overall CRE exposure for the major US banks was manageable with many banks having reduced exposure and built appropriate levels of reserves.



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Capital levels remained robust and well above requirements as banks await details on the Basel III Endgame re-proposal from the Fed. During the quarter, Moody's and Fitch revised their outlooks on the US banking sector from negative to stable. This was due to the resiliency of profitability and asset quality along with a view that the shift to a more neutral monetary policy stance should help reduce funding costs and improve fixed income security portfolio valuations.

## Canadian Banks

The large Canadian banks ended 2024 with mixed but solid results, with banks benefiting from sound performance across segments as well as favorable impact of add-on businesses for some. The banks enjoyed positive operating leverage as notably higher revenues offset higher expenses, mostly related to efficiency initiatives.

Revenues benefited from higher volumes and margins, higher trading revenue and moderate loan growth aided by improved mortgage and business lending. Wealth management benefited from growth in client assets and higher market levels. Asset quality remained benign despite credit costs and non-performers trending higher. The latter trend is mostly attributed to challenges in the office component of US CRE exposure, but this segment is a relatively small portion of Canadian bank loan portfolios. Overall CRE exposure remained manageable with the well-diversified non-office CRE book performing well.

Residential mortgages, which account for a significant portion of Canadian bank loan portfolios, continued to demonstrate sound credit fundamentals despite an uptick in unemployment with loan-to-values providing a comfortable cushion to absorb any possible house price corrections. A combination of a reduction in the BOC overnight rate in December 2024 to 3.75% and Canadian federal government mortgage reforms are expected to improve demand and affordability for Canadian housing while also providing continued support to overall sound asset quality. Nonetheless, Canadian banks have remained conservative and continued to build loan loss reserves to guard against macroeconomic and geopolitical risks. Similarly, Canadian bank capital and liquidity metrics remained robust with all the major banks operating with buffers well above regulatory minimum requirements.

## European Banks

European banks continue to report sound quarterly results. For 3Q24 there was a pause in the general downward sequential trend in net interest income (NII) with the majority of the large European banks enjoying either higher or stable NII quarter-over-quarter (QOQ) as an increase in loan demand coupled with interest rate hedging strategies helped offset net interest margin (NIM) compression.

Going forward, recent rate cuts by the ECB and BOE may serve to reduce funding costs and support lending growth. Fee and commission income, driven by positive market performance, growing assets under management (AUMs), and a focus on fee-generating activities was a bright spot for most banks, helping to maintain high overall revenue levels.

Regionally, the rebound in the Dutch housing market has supported revenues of the domestic banks, while Nordic banks were successfully navigating a slowdown in corporate lending. NII has developed positively for French banks throughout 2024 as they were late to benefit from higher rates due to their sizeable, regulated deposit bases which repriced more quickly compared to international peers. The latter underscores the sound credit fundamentals currently in place for the major French banks. At the same time, we are mindful that operating conditions in France may be more challenging in the medium term given the contentious political climate following a non-confidence vote that has delayed budget negotiations.

Expense growth related to inflation, new labor agreements and ongoing IT investments continued to be a headwind. Nevertheless, several banks in differing regions raised their fiscal year 2024 earnings guidance given the positive performance over the first nine months of the year. While asset quality remained resilient, non-performing loan levels and credit costs continued to drift upward at a moderate pace given normalization in credit cards and select increases related to manageable CRE exposure. The United Kingdom (UK) banks appear well provisioned for any potential losses stemming from an ongoing regulatory investigation into auto finance commissions.

Capital levels across the universe of European banks were solid with all easily meeting regulatory requirements. With the impending introduction of Basel IV, the latest rollout of the Basel Accords, several banks disclosed pro forma ratios, all of which appear to show a slight improvement in their common equity tier1 (CET1) ratios based on their interpretation of the revised regulations.

## Japanese Banks

The three major Japanese banks reported record results in the first half of 2024 driven by growth in net interest income, fee income and gains on sale of strategic equity shareholdings amid strong equity market conditions such that major banks increased earnings expectations for the FY2024. As a sign of confidence in their medium-term business prospects and capital strength, bank management announced dividend increases and share buybacks. Banks are benefiting from robust demand for loans, particularly from large corporates that are using proceeds for capital expenditures and acquisitions. Loan yields increased in Japan resulting in higher net interest income.

Japanese banks will likely continue to benefit from higher interest rates via NIM expansion and improved spread income following the BOJ decision to abandon NIRP. Asset quality continued to be solid with low credit costs and manageable nonperforming loans. Capital ratios improved from prior quarter and were well above regulatory requirements. Major banks had significant net unrealized gains in their securities portfolios, resulting from unrealized gains on Japanese stocks, which were partially offset by unrealized losses on domestic and foreign bonds.

Liquidity was strong with significant holdings of cash and high-quality liquid securities as well as low domestic loan-to-deposit ratios. Japanese banks benefited from large and stable domestic deposit bases, which offset confidence sensitivity related to foreign currency funding, particularly US dollar funding.

## Australian Banks

For the reporting period that ended September 30, the Australian banks announced good but softer profits from the prior year impacted by higher expenses and weakened net interest margins. Net interest margin compression was attributed to the mix of deposits with higher funding costs on term deposits, which more than offset the benefit of moderate lending growth and higher interest earning income in a higher interest rate environment. Results in the second half of 2024 were better than the first half, as net interest income improved and intense pricing in the home mortgage market eased while Aussie banks focused more on non-residential lending.

Fee income was mixed but overall positive as higher fixed income and capital markets revenue offset lower income from foreign exchange and rates. Asset quality largely remained benign with an overall decline in impairment charges despite an uptick in arrears and delinquencies attributed to normalization.

The Australian housing market remained in good shape with increased house prices supported by strong loan-to-value ratios. Capital levels remained strong with CET1 ratios well placed against requirements.

The bank regulator, the Australian Prudential Regulation Authority (APRA), recently confirmed that it will be proceeding with changes to the capital framework for banks to strengthen their crisis preparedness. The new rules will go into effect on January 1, 2027, and seem neutral for bank capital adequacy and manageable for the banks, especially given the extended implementation timeframe. Rating agencies have noted that this proposal is unlikely to result in any ratings changes.

## Insurance

Life insurance companies reported strong results during 3Q24 supported by rising equity markets, high interest rates and solid underwriting profitability. Life investment portfolios benefited from strong asset quality and high reinvestment rates as well as improved alternative investment returns. Life insurance sales were stable while annuity sales continued to be robust this quarter, led by very strong growth in fixed indexed annuities and registered index-linked annuities. Underwriting profitability was driven by strong results in group benefits and favorable mortality trends. Annual actuarial assumption updates had mixed impact with some companies releasing reserves and others adding to reserves, with no significant effect on credit quality. Life insurers had sizeable exposure to commercial mortgage loans, including the office sector. While these holdings are conservatively underwritten, we expect CRE losses to rise but remain manageable for the large, highly-rated insurers.

Health insurers reported weaker-than-expected third quarter results driven by operating challenges in the government business. Medicaid enrollment continued to decline due to members losing coverage as a result of the redetermination process. Medicaid plans' profitability was lower due to higher medical costs of the remaining members. Medicare Advantage plans' profitability was negatively affected by lower reimbursement rates and higher utilization of benefits. Commercial medical insurance business continued to perform well supported by membership growth and manageable medical costs. The healthcare services business was a bright spot in the quarter with strong revenue growth and margin expansion.

Property and casualty insurance companies reported strong 3Q24 results driven by higher investment income, improved profitability in personal lines and stable performance in commercial lines. Net investment income continued to increase driven by higher interest rates, while investment portfolio credit quality was solid. Solid quarterly earnings allowed large insurers to absorb significant catastrophe losses incurred as a result of Hurricane Helene. Commercial lines reported strong underwriting profitability with margins at historically high levels, but pricing has likely peaked in most business lines. Personal auto and homeowners' insurance profitability continued to improve following significant premium increases.

High-grade insurance companies benefited from solid balance sheets with high-quality and well-diversified investment portfolios, strong capital and liquidity levels with the US insurance sector being highly rated with broadly stable outlooks. While insurance companies hold large bond portfolios, their stable funding levels and sound asset liability management practices may allow them to hold bonds until maturity and potentially avoid selling at a loss due to interest rate increases.

## Corporates

The high-grade corporate sector continued to post strong credit fundamentals with solid revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) growth, especially in the non-commodities sectors, and conservative balance sheet metrics. Corporate sectors with the highest year-over-year (YOY) EBITDA growth in 3Q24 were diversified media, technology, consumer products, non-food retail, utilities and food/beverages. Improved EBITDA and slower growth in both debt balances and funding costs have stabilized leverage metrics and interest coverage ratios. The favorable economic backdrop and good corporate earnings have allowed corporate issuers to increase shareholder payouts, increase capital expenditures spending and moderately reduce cash balances through 3Q24.

We believe high-grade corporate issuers have significant flexibility to adjust these financial policies with several issuers adopting a more cautious tone following recent elections. This is driven in part by policy uncertainty under the new administration, such as the impact of potential tariffs on global supply chains as well as increased global geopolitical risk in the Middle East, China and Russia/Ukraine among other regions.

### Pharmaceuticals

Large pharmaceutical companies reported strong 3Q24 results with revenue and earnings growth exceeding consensus expectations. Companies benefitted from increasing sales of new innovative medicines and stable growth of well-established branded drugs, partially offset by a decline in sales of drugs subject to loss of exclusivity and generic competition. Pharmaceutical companies are focused on managing patent expirations in the coming years by increasing investments in research and development and pursuing acquisitions to enhance their product pipelines. Investment-grade pharmaceutical companies maintained strong credit profiles supported by robust profitability, strong cash flow generation and moderate leverage.

### Industrials

Industrials reported mixed 3Q24 results amid lower volumes and pricing that continues to normalize. Weaker demand in construction and agricultural equipment sectors was partially offset by higher infrastructure spending and healthy demand in energy and transportation end markets. Higher tariffs on US imports, if implemented by the new administration, will likely affect the industrials' global supply chain and increase costs for the sector. Event risk may be rising in the industrials sector as some companies are pursuing acquisitions and strategic repositioning.

### Energy

Major integrated energy companies reported in-line third quarter results as oil prices and refining margins declined while natural gas prices rose during the quarter. The oil majors continue to allocate the majority of cash flows to significant share repurchases, capital expenditures and acquisitions. The companies have maintained robust share buyback programs despite lower cash flows due to weaker oil prices and more challenging market conditions. As a result, leverage has increased for some companies, and credit metrics could weaken from their current strong levels.

## Automotive

Third quarter earnings results showed weakness in the global automotive markets, albeit with regional divergences. The North American market stood out as the most resilient, with strong performance of automakers during the quarter driven by resilient pricing. In contrast, European automakers' performance weakened materially during the quarter, given increasing losses in China, as well as softening European and US demand, particularly for battery electric vehicles. This led to an acceleration in restructuring actions, including cost and capacity reduction.

Profitability for battery electric vehicles remained a challenge at a time when most automakers ramp up their electric vehicle offerings to comply with tightening emissions regulation, particularly in Europe. In the US, the potential relaxation of the tighter emissions standards under a second Trump administration may be beneficial for the durability of the automakers' profit streams, because it would slow the transition to lower-margin electronic vehicles (EVs).

The recent announcement of potential trade tariffs on imported vehicles from Mexico and Canada adds some uncertainty on US automakers, as higher prices in the US from higher tariffs could further slow consumer demand.

The Chinese market could continue to pose significant challenges for legacy automakers in 2025, as many local automakers prioritize volume over profitability. Chinese automakers are expected to gain additional market share in both their home market and in Europe, although the latter will likely be somewhat mitigated in the near term by the recent implementation of import tariffs in Europe on Chinese electric vehicles.

## Consumer

Consumer-based companies had mixed earnings during 3Q24. Growth remained in the low- to mid-single-digit range, while margins were generally trending higher. Consumer goods companies have been shifting their focus from price- to volume-driven organic growth as inflation has trended lower and the ability to raise prices further has become more limited. Positive volume growth has been elusive despite an increase in promotions during 3Q24. As a result, companies have been adopting a range of strategies to appeal to discerning consumers.

Despite continued value-seeking behavior, a meaningful pullback in consumer spending is not expected next quarter unless employment weakens more significantly. A key challenge for consumer goods companies going forward may be to maintain margins given a more promotional environment and the need to invest in their brands. However, the carryover effect of the previous pricing actions and lower input costs can help consumer goods companies maintain margins. For most consumer-based companies, balance sheets appear still well positioned to absorb margin compression if it materializes.

## Technology, Media and Telecom (TMT)

Results were generally strong across TMT during the quarter, albeit with a clear divergence in growth between segments that have benefitted from Artificial Intelligence (AI)- related demand and those that have not. AI continued to dominate every facet of the technology landscape, spurring growth across cloud services providers, semiconductor manufacturers, and, to a lesser extent, enterprise IT spending, hardware and software.

Demand for AI services has accelerated public cloud growth rates and caused capital expenditure to skyrocket. Some TMT issuers have signed deals for new nuclear electricity to ensure consistent power supply for data centers. While enterprise IT spending remained cautious during 3Q24 amid tight budgets and ongoing macroeconomic uncertainty, the broadening of AI adoption and product refresh cycles may spur stronger growth for IT spending in 2025.

The personal computer (PC) market was showing signs of stabilization, and demand has begun to return. Software companies are pursuing various strategies to potentially monetize AI capabilities, but so far it has been limited. Strategic partnerships have started to form to enhance AI capabilities. Key risks for the industry include protectionist trade policies and export restrictions, which could result in inflationary pressures and/or further investment needed to localize production.

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