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Global Banks' And Brokers' Securities-Related Businesses Appear To Be Past The Trough, But Improvement Will Be Gradual

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Global Banks' And Brokers' Securities-Related Businesses Appear To Be Past The Trough, But Improvement Will Be Gradual

While U.S. banks in virtually every major market are feeling the severe effects of both the weak economy and their own mounting credit losses, we believe global banks' securities-related businesses have already seen the worst. The current downturn hit these businesses first on several fronts. Among the problem areas were asset-backed securities (ABS), collateralized debt obligations (CDOs), residential mortgage-backed securities (RMBS), and monoline-related and leveraged finance positions. Also crimping the global banks' results were a drastic slowdown in business activity, which began playing out in mid-2007 and accelerated through late 2008.

However, we now think that fourth-quarter 2008 likely marked the trough for these banks' trading operations and that first–quarter 2009 has seen the bottom for their investment banking, asset management, and wealth management businesses.

We've recently revised our 2009-2010 revenue assumptions for these four key business lines. These assumptions serve as starting points in our analysis of the related businesses of the global banks, namely: Bank of America Corp., Barclays Bank PLC, Citigroup Inc., Credit Suisse, Deutsche Bank AG, The Goldman Sachs Group Inc., JPMorgan Chase & Co., Morgan Stanley, and UBS AG. In applying these general assumptions, we take into account these various companies' different strategies and competitive positions.

Our belief that these issuers' securities-related businesses have bottomed out should help to relieve downward pressure on their ratings. However, we anticipate that, in some cases, escalating credit losses will more than offset any benefits from improving securities-related results.

Global Underwriting And M&A Advisory Volume

(Bil. $)	1Q09	4Q08	3Q08	2Q08	1Q08	4Q07	3Q07	2Q07	1Q07
Global equity	66.0	78.8	92.2	134.0	79.3	203.8	139.5	220.9	134.9
Global convertibles	5.7	2.4	11.5	56.7	33.3	49.8	28.4	59.3	41.6
Global equity and equity-related	71.7	81.2	103.7	190.7	112.5	253.6	167.9	280.2	176.4
Global high-yield debt	11.1	2.8	5.3	25.4	5.9	32.1	11.0	74.9	47.7
Global investment-grade debt	557.3	237.9	340.7	843.2	488.4	502.9	465.6	781.5	839.8
Global federal credit agency	190.5	25.7	98.6	129.0	179.1	106.4	88.1	108.6	93.6
Global agency, sovereign, and supranational	653.2	276.4	109.8	249.9	216.3	115.1	110.8	180.4	214.9
Global mortgage-backed securities	40.6	19.4	48.1	84.8	71.8	160.4	274.0	493.5	394.0
Global asset-backed securities	20.8	12.3	46.1	91.3	72.9	139.3	218.4	436.2	393.1
Global long-term debt	1,473.5	574.5	648.7	1,423.7	1,034.4	1,056.2	1,167.9	2,075.2	1,983.2
Global announced M&A	485.6	546.3	915.5	897.0	733.7	1,069.3	933.3	1,490.6	963.3
Global completed M&A	471.0	658.4	637.8	544.8	708.0	1,183.9	869.3	953.2	885.1

Source: Thomson Reuters. M&A—Mergers and acquisitions.

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Trading

Trading revenues swung from near-record lows in fourth-quarter 2008 to surprisingly robust levels in first-quarter 2009. The earlier lows reflected losses on trading strategies and markdowns on dislocated assets such as leveraged finance, commercial real estate (CRE), and RMBS, as well as exposure to monoline insurers. The recent rebound reflects the strength of the banks' fixed-income, commodities, and currencies (FICC) divisions. We believe that the first quarter's revenues are not sustainable but also that revenues over the next two years will remain well above late-2008's lows--whether or not we take into account the impact of any write-downs.

Several factors supported the first quarter's soaring FICC trading results--most notably, the generally strong activity in interest rates and money-market products. Repositioning of clients' investment strategies in response to high market volatility bolstered trading volumes. In addition, we think trading operations have been able to profit from steep yield curves and declining short-term rates. Such conditions usually enable investment banks to generate carry profits on their fixed-income inventory positions.

Moreover, these global banks reported that margins (such as bid-ask spreads) have widened significantly. They attributed that in part to lower competition in the sector as a result of consolidation and some players' reduced risk appetite. We understand that highly volatile markets and investors' need to hedge or reposition investment strategies contribute to wider margins (but also to risk) for sales and trading operations. But we are not yet fully convinced of the argument about reduced competition-–nor the sustainability of these conditions. The simple fact that the FICC divisions of almost every bank in this peer group reported strong earnings appears to contradict this point. Only a few banks, such as Morgan Stanley, reported curtailed risk appetite in those activities. While U.S. brokers have disappeared as independent firms since mid-2007, their trading operations are now part of other banks in this peer group. Thus, we are reluctant to regard first-quarter results as indicative of a permanent change in the banking industry's competitive dynamics.

Judging from our discussions with industry participants, we gather that FICC trading results have remained exceptionally strong in the second quarter, though not to the same extent as in the first quarter. We believe FICC revenues will continue to weaken from first-quarter levels through the rest of the year. However, the gradual strengthening of equities trading revenues versus that category's very weak first-quarter results should somewhat mitigate matters.

Setting aside the impact of any additional write-downs, we currently assume that trading revenues over the rest of 2009 will trend downward from first–quarter levels. We also assume that full-year 2010 revenues will be about the same as for full-year 2009--before write-downs. This would imply that full-year 2009 and 2010 revenues would each be up about 80% and 5% from 2008 and 2007, respectively.

We expect losses on securities write-downs to continue, but with less magnitude, given reductions in legacy trading positions via sales and past write-downs. We anticipate the pain will shift from RMBS to securities and positions linked to corporate credit (including CRE). In particular, deteriorating CRE conditions (which appear in declining market indices for commercial mortgage-backed securities) and continued difficulties at the monoline insurers could lead to additional losses at firms with exposure in these areas.

We also believe that the default rates of corporate creditors are set to increase further (see "U.S. Corporate Default Rate Forecasted To Reach 14.3% By March 2010," published April 24, 2009, on RatingsDirect)--and some of the

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global investment banks hold quite sizable corporate loan books. On top of this, we can't rule out the possibility of unforeseen, high-impact market disruptions affecting, for example, interest or foreign-exchange rates.

Both in the U.S. and the EU, various regulatory bodies have been working to establish central counterparties or clearinghouses for over-the-counter derivatives in an effort to improve transparency and liquidity, increase the monitoring of overall leverage in the markets, and decrease the systemic impact of counterparty defaults. However, as derivative pricing becomes more transparent and standardized, derivatives dealers' profit margins will surely decline. Yet, plans for clearinghouses are still evolving, and we believe it could take several years before they have any impact.

Investment banking

We now believe that fourth-quarter 2008 marked the nadir in investment banking activity. As the credit markets seized up during the last four months of 2008, debt issuance reached its lowest level since late 1999. Issuance has picked up considerably since then. Thomson Reuters says in first-quarter 2009, new-issue volume reached its highest quarterly total in two years, reflecting increased debt issuance by corporates and large financial institutions, with government support programs bolstering the latter.

First-quarter 2009 global debt underwriting totaled $1.7 trillion, a 23% increase from a year earlier and up 157% since the troubled fourth quarter of 2008. Securitization activity was still very weak, and we think this could be the case for some time to come. There were signs of life, however, in the corporate high-yield market spurred by a dramatic improvement in pricing. 'B' trading spreads narrowed by more than 10% since the end of 2008 (according to Standard & Poor's Leveraged Commentary & Data).

In contrast, equity issuance reached what we expect will be the trough in the first quarter. According to Thomson Reuters, global equity and equity-related underwriting volume in first-quarter 2009 totaled $69.6 billion--the lowest since 2003 and a 46.6% decline from first-quarter 2008. Issuance in the second quarter has so far received a boost from banks' global recapitalization efforts. That's especially the case in the U.S., where companies have issued common stock to satisfy the equity-raising requirements of the government's Supervisory Capital Assessment Program and/or to redeem the preferred stock that had been issued to the U.S. government under the Troubled Asset Relief Program (TARP). However, we believe the stock market rally that began in March will lay the ground for a more broad-based recovery in equity issuance.

Merger and acquisitions (M&A) advisory opportunities remain scant. According to Thomson Reuters, worldwide M&A totaled $473 billion (announced deals) during first-quarter 2009, a decrease of 29.3% from one year earlier and the lowest for a quarter since third-quarter 2004. M&A activity is closely correlated with economic growth, and so, we would not expect a meaningful recovery here until the economy rebounds.

We currently assume that overall 2009 investment banking revenues will be about equal to 2008's, meaning they would be off 30% from 2007. We do see some potential for at least modest improvement in 2010 over 2009--about a 10%-15% increase in year-to-year revenues.

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Asset management

The performance of the investment banks' asset management businesses is very closely tied to the overall, broad performance of the market. On the heels of the 38% decline in the S&P 500 stock index over full-year 2008, the benchmark fell a further 14% in the first quarter, reaching a 13-year low in early March. Stock market weakness contributed directly to lower assets under management (AUM), exacerbated in some cases by net outflows of investor funds, which in turn resulted in further pressure on management fees. The mix of AUM also shifted adversely, as investors hoarded liquidity and changed their asset allocations to lower-yielding defensive products (for example, money market funds and government bonds). Performance fees remained negligible.

However, the U.S. stock market has rallied nicely in the following months, and the S&P 500 is currently up 40% from its recent low--and up 2% year-to-date. This gives us some cause for optimism. While we believe a more significant recovery could take a while to unfold, we now view the late-2008 through early-2009 period as the likely low point for asset management. We anticipate at least broad stability over the next few quarters compared with the weak first-quarter 2009 results. We currently assume that asset management revenues will be down about 30% in full-year 2009 versus 2007's peak, or about 13% compared with 2008. We expect that revenues in 2010 will still be only about even with 2009.

Wealth management/private banking

We view wealth management (including both retail brokerage and private banking) revenues as being on a similar trajectory as asset management. Retail investors remained largely on the sidelines during the first quarter, following the tumultuous market developments of late last year and amid further erosion in market pricing. However, the better market environment, including rising stock prices and narrowing credit spreads, of the past few months should help provide the basis for a return to more normal conditions. Again, we currently assume revenues will be down about 30% and 27% in full-year 2009 from 2007 and 2008, respectively. We also assume that revenues in 2010 will be about the same as in 2009.

Retail brokerages' longer-range profit potential could benefit from the recent industry consolidation. With the formation of the Morgan Stanley Smith Barney joint venture, plus Bank of America having acquired Merrill Lynch and Wells Fargo buying Wachovia, the sector is now more concentrated than ever, offering potentially significant cost savings and greater pricing power. Over the next few quarters, though, profit margins could be constrained, in our opinion, by the cost of special incentives to retain top-performing financial advisers and their clients.

Related Research

- "Central Counterparties May Have Positive Impact On the Credit Default Swaps Markets," June 9, 2009.
- "Industry Report Card: Global Asset Managers Have Another Rough Quarter, But Have Room For Cautious Optimism," June 2, 2009.
- "Industry Report Card: First Quarter Affords Glimmer of Sunshine Amid Continuing Storm For Global Investment Banks," May 11, 2009.
- "Industry Report Card: Tough Times for Global Investment Banks and Brokers," Nov. 13, 2008.

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