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INVESTMENT NOTE **13 JANUARY 2015**

Hermes: US banking giants becoming more credit-friendly

By Filippo Alloatti, Senior Credit Analyst

Positive signs for JP Morgan bondholders

There are unlikely to be any surprises in JP Morgan's fourth quarter results, after the group's largely pre-announced its numbers at December's Goldman Sachs conference.

We are set to see more of the same: lower core expenses, as well as challenging trading and investment banking revenues. More preferred share issuance is also likely, after JP Morgan issued $9bn in 2014. With net interest income broadly flat year-on-year, at circa $43bn, revenues will be down from $99.7bn as a result of lower fee income.

Once again, JP Morgan organic capital generation was strong in 2014 and higher equity retention is positive for bonds.

Large capital shortfall is manageable

In December, the Fed released a proposal to further strengthen the capital position of the largest globally systemically important banks (GSIB), which is fully effective in 2019.

Estimated surcharges for GSIBs currently range from 1% to 4.5% of a firm's total risk-weighted assets. JP Morgan constitutes the majority of the shortfall, at circa $22bn, following an increase in its buffer to 4.5%. This is potentially positive for JP Morgan bondholders.

While the Fed's proposal appears onerous, it may result in more equity capital beneath bondholders and a lower amount of short-term wholesale funding, both positive for credit in the medium term. In addition, JP Morgan still needs about $5bn of non-common equity to hit 150bps of risk weighted assets, by our calculations. JP Morgan had common equity of $200bn as of the end of 2013.

Opportunity for attractive carry

We are still bullish on the subordinated part of JP Morgan's capital structure, where we can get a yield of 3.7% for 10-year paper.

Overall, we still prefer the large money centre banks – instead of US regional banks – given the strong, credit-friendly changes to have occurred over the past few years. In addition, the US recovery is picking up speed and we finally saw signs of loan growth in 2014.

Near-term headwinds could be larger-than-expected new supply and conduct costs. This was $30bn in 2014, or 7.5% of the combined revenues of the top six banks.

We see this as a carry opportunity, rather than a meaningful prospect of capital appreciation.

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