Market Update – Financials

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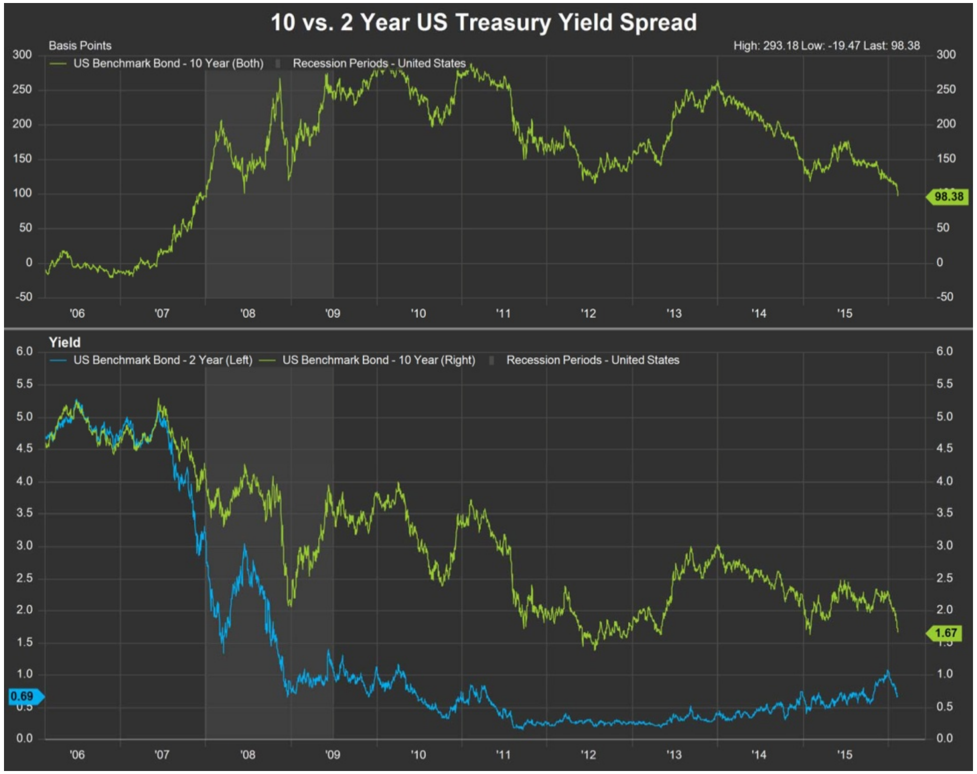
February 12, 2016

To understand the rationale for the decline in US financial stocks, we think it is important to establish the backdrop. As we closed out 2015, investors tended to be overweight banks based on the outlook for steady economic growth, low credit losses and rising interest rates. Many Wall Street strategists picked financials as their top-performing sector.

As fourth quarter 2015 earnings were reported, results generally met expectations, especially among the high-quality companies that we recommend. Commercial and consumer loan growth was in a steady 3 to 5% range, credit quality (outside of energy-related loans) performed as expected, and net interest margins were steady or expanding following the December rate hike from the Fed. The outlook for 2016 appeared favorable.

One month later, the risks to global growth have picked up, crude prices have been in steady decline, China growth is uncertain, high-yield spreads have widened, and the yield curve has flattened, with the 10-year Treasury now yielding 1.67%. The outlook for the Fed to continue raising short-term interest rates remains much more uncertain.

Financial stocks have reacted to these uncertainties dramatically, with many declining over 20% in just a few weeks. Some investors, with the 2008 financial crisis still on their minds, have decided to "shoot first and ask questions later". However, we believe US banks are in a much different position than they were pre-financial crisis. For many banks, reserves are twice as high as they were then. Also, rules under Dodd-Frank have been enacted that prevent bank proprietary trading and require banks to have a certain level of liquidity on hand (LCR). Large banks are required by the Fed to undergo annual stress tests based on severe market and economic assumptions, and the OCC is much more active in reviewing bank loan exposure. Banks already have operated in a low-rate environment and are prepared to manage through this backdrop again.



Source: FactSet

Regarding energy lending, China concerns and emerging-markets exposure, our recommended banks have limited exposure. For US banks, the magnitude of this exposure is much less than that of mortgages during the financial crisis. Banks have begun to build reserves for oil loan losses, while credit concerns outside of energy remain benign. The outlook for the US consumer is solid, due to positive employment numbers and steady wage growth, while the loan-loss outlook remains favorable.

We believe that many investors in financial stocks are beginning to price in a recessionary environment, but we have yet to see data that support the US entering a recession. It is our opinion that at some point the higher-quality financials with superior fundamentals and attractive valuations will be rewarded. Our focus continues to be on recommending those companies with seasoned management teams (that have lived through many periods of uncertainty), above-average capital levels, and a culture of strong risk management.