News & Views

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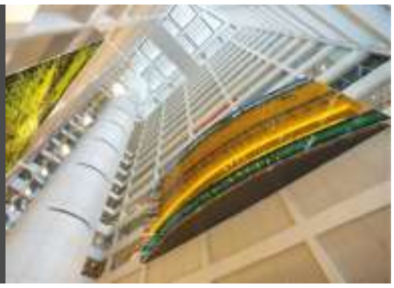

US BANKS VERSUS THE WORLD

After the recent pullback, US Financials look cheap relative to other sectors of the market, according to Jim Boyd, a senior analyst at The Boston Company Asset Management.[1]

Boyd says the group sustained a tough first quarter, pressured by a worsening interest-rate outlook, with Federal Reserve rate policy lower and slower than previously expected. Boyd, an analyst on the BNY Mellon US Opportunities strategy, notes the sector has also been hit by recessionary worries as investors fear a global slowdown will push the US into a far slower-growth environment.

Investors do have valid reason for concern about the global financials sector, as non-US banks face a range of challenges to their business models and operations, such as Japan's negative interest rates and Europe's weak earnings and rising tide of bad loans. However, Boyd says US banks are in much better shape than their overseas counterparts, given strong capital bases and lower levels of leverage.

After returning an annualized 15.87%[2] over the seven years since the global financial crisis, stocks of US financial companies hit a rough patch early this year, although they have rebounded some in March. In fact, financials has been among the worst-performing sectors in the Standard & Poor's 500 so far in 2016. As of the end of February, the sector's 11.85% year-to-date drop trailed even the beleaguered energy sector, which is down a relatively modest 5.55% over the same time period. Indeed, to find a sector that has performed worse, one must look to the financial sector in the MSCI World Index, where the sector tumbled 13.21% through the end of February.

The reasons behind the poor performance of US financial stocks can be traced to concerns about forward earnings growth, as the market adjusted to the outlook of a Fed that can only raise the fed funds rate at a very slow pace.

"Back in November and December, the Fed was preparing to hike and we were considering how much more profitable banks could be if the Fed were to institute a modest rate-normalization policy," Boyd explained. "Since then, investors have become haunted by the spectre of negative interest rates, which has made them wary of Financials stocks. Within eight weeks, investors went from expecting higher rates to fearing negative rates -- but the underlying realities did not change."

US financials now carry the lowest average P/E of any S&P 500 sector at 13.04x as of 29 February. However, underlying fundamentals are still relatively strong when looking at demand for credit, credit quality, and an abundance of capital on balance sheets. Plus, Boyd says, he has many potential opportunities to consider, given the tremendous diversity among US financial-services providers. For example, there are more than 6,000 commercial banks in the US alone.

"We try to understand these companies' businesses, and we look out two or three years to determine what a gradual increase in rates does to a company's intrinsic value," Boyd explains. "We consider what Fed policy

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[1] **Investment Managers are appointed by BNY Mellon Investment Management EMEA Limited (BNYMIM EMEA) or affiliated fund operating companies to undertake portfolio management activities in relation to contracts for products and services entered into by clients with BNYMIM EMEA or the BNY Mellon funds.**

[2] All data MSCI, S&P, as of 29 February, 2016

could mean for earnings and how we value that. When we factor in price targets and risk, interest rates are certainly one part of it."

Another notable factor is that US financial companies are operating in an environment with room for consumer lending to grow. "Consumer liabilities as a share of assets is low," says Boyd. "While debt has risen in the US, assets have grown a lot faster. Consumers are saving quite a bit, and nominal wages are growing at about 3% including overtime."

Despite the appeal of relatively healthy consumers and the modest valuations of financial stocks, there are some clouds in Boyd's sector forecast. He remains mindful of earnings pressures from capital markets and the interest-rate environment, avoiding some business models, like insurance, that are hurt by ultra-low rates.

He is also concerned about banks that have lent significant amounts to fund the expansion of US oil and gas production over the past decade. "I would be worried about the commodity-centric areas of the US economy. I would be worried about Texas and the upper Midwest where there's been a lot of direct lending. We're also concerned about Canadian banks and some of the global banks that have a lot of exposure to this type of lending."