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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Endurance run

The outperformance of the U.S. Financials sector is more than just a post-election bounce as the rally is built for distance.

Kelly Bogdanov

For important and required non-U.S. analyst disclosures, see page 6.
All values in U.S. dollars and priced as of January 31, 2017, market close, unless otherwise noted.

RBC Wealth Management

Endurance run

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Already on the rise before the election, the Financials sector's performance burst ahead of the pack since Trump's victory, helping to pull the market up to all-time highs. And with a number of catalysts to sustain it, investors should be able to bank on more outperformance as we think the rally has plenty of stamina.

The Financials sector has been the best-performing sector of the U.S. equity market since the November elections. While a pullback could unfold after such an energetic rally, we believe the sector has staying power over the medium and long term. We would continue to Overweight U.S. Financials in portfolios mainly due to potential catalysts associated with Federal Reserve interest rate policies and President Donald Trump's election.

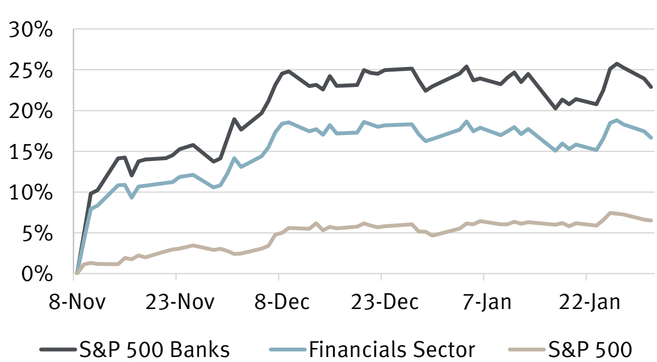
Rate hikes a boon for banks

The biggest boost to Financials sector profits in 2017 should come from interest rate hikes. After raising rates only once each in 2015 and 2016, RBC Capital Markets, LLC's bank analyst Gerard Cassidy sees the potential for two to three Fed rate hikes in both 2017 and 2018.

Future hikes, combined with a steeper yield curve, could provide a much-needed lift for banks' net interest income (revenue) and net interest margin (gross profit). For example, Bank of America, a financial institution particularly sensitive to changes in interest rates, expects to gain about $600 million in net interest income in the first quarter of 2017, a 5.7% sequential increase, due to the Fed's rate hike last December and the recent steepening of the yield curve.

The domestic banking industry would benefit meaningfully from projected hikes this year and next, in our view, and we do not think such increases are fully factored into the current consensus bank earnings forecasts.

% change in U.S. indexes since presidential election



Banks and the broader Financials sector have outperformed the S&P 500 since the election.

Source - RBC Wealth Management, Bloomberg

Fiscal policy to boost GDP

Economic momentum improved recently with U.S. GDP growth accelerating to 2.7% annualized in the second half of 2016, above the 2.1% average since the Great Recession ended. In December, consumer confidence sprinted to its highest level since 2001 at the same time CEO confidence, manufacturing sentiment, construction spending, home sales, and auto sales rose.

This lays a strong foundation for above-trend GDP growth if the president and Congress deliver on promised tax cuts for corporations and individuals. We expect a tax cut package to be introduced sometime this year.

RBC Capital Markets' chief U.S. economist anticipates 2.6% GDP growth in 2017, excluding fiscal policy changes. He believes tax cuts could boost GDP by another 0.4%–0.6% in 2017 and 0.7%–0.9% in 2018, lifting growth above 3% for both years.

An improved economy would likely fuel stronger lending activity. We have observed that bank executives have been upbeat on recent earnings conference calls, particularly about the prospects for economic growth, wage growth, consumer spending, credit quality, and growth of loan portfolios.

Deregulation back in vogue

One of the underappreciated catalysts for the Financials sector is the potential rollback of bank regulations.

Rollbacks should boost bank profits and we doubt this is fully factored into earnings estimates or stock prices.

Regulation of the financial services industry increased significantly following the global financial crisis. We expect the incoming administration to revisit the capital requirements for U.S. banks, which are well above what is laid out in the global regulatory framework (Basel III). U.S. banks currently have capital levels as high as in the 1930s Depression era, and above that of global peers, which is a source of competitive disadvantage, in our view.

We also believe the Trump administration and Congress will revisit some elements of the Dodd-Frank Act. We don't expect a repeal of Dodd-Frank, but signals from the Trump administration and proposed cabinet members suggest some rollbacks are likely.

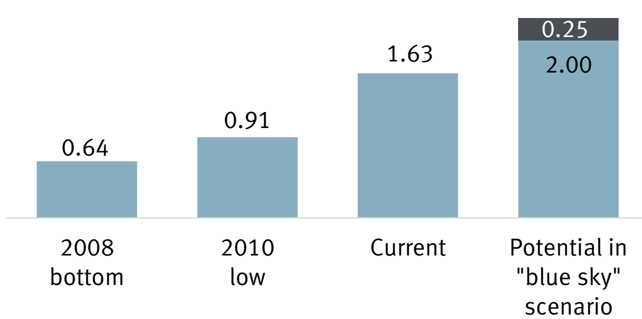
We believe prudent rollbacks would be another boost for bank profits and we doubt this is fully factored into earnings estimates or stock prices.

Valuations still reasonable

Even though valuations are not as cheap as they were in 2010 or even months ago, we believe there is still room for price-to-book (P/B) multiples to expand.

The P/B value of the S&P 500 Banks Index is 1.63x, up from 0.91 in 2010 and 0.64 at the depth of the financial crisis. RBC Capital Markets estimates the group has the potential to rise to a P/B ratio of 2.0x–2.25x in a "blue sky" scenario—in other words, if fiscal stimulus, GDP acceleration, and deregulation take place.

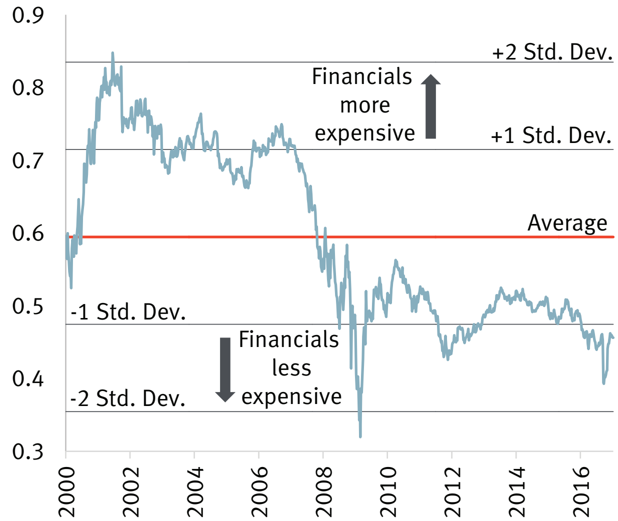
S&P 500 Banks Index price-to-book values



Despite the rally, there is upside to U.S. bank valuations.

Source - RBC Wealth Management, RBC Capital Markets Quant Team, FactSet

S&P Financials sector vs. the S&P 500
on a price-to-book valuation



Despite the rally, U.S. Financials sector valuation is still below historical levels.

Source - RBC Wealth Management, Bloomberg; weekly data through 1/13/17

The P/B ratio of the Financials sector is still well below the long-term average on an absolute basis and compared to the S&P 500 (see chart). This suggests the Financials sector may enjoy the twin tailwinds of stronger fundamentals and valuation expansion.

We would buy bank stocks on pullbacks, as we believe they should have performance staying power.

Banks seem underowned

From our vantage point, anecdotal evidence suggests large institutional investors (mutual funds, pension funds) are underexposed to the Financials sector and may try to increase positions in coming months given the important catalysts cited above.

Equity traders and analysts indicate large institutions had low exposure to the Financials sector before the election. After years of headwinds from the Fed's ultralow interest rates, some institutional investors shunned Financials in favor of defensive, dividend-boosting sectors (Consumer Staples, Utilities, and Telecom) and Technology.

It could take months for investors to right-size Financials sector positioning. Large institutional investors are like supertankers—they usually can't or don't make major portfolio changes quickly.

Not done yet

The Financials sector has led the market by a wide margin since the election. While it could face a period of further consolidation or pull back over the near term, we believe there is more to come.

Catalysts related to Fed rate hikes and Trump's election would boost bank and Financials sector earnings and expand profit margins beyond what is factored into analysts' 2017 and 2018 consensus estimates, in our view.

We would continue to Overweight Financials, which translates into holding an allocation above 14.7% within the U.S. equity segment of portfolios. Specifically, we would buy bank stocks on pullbacks, as we believe they should have performance staying power.

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