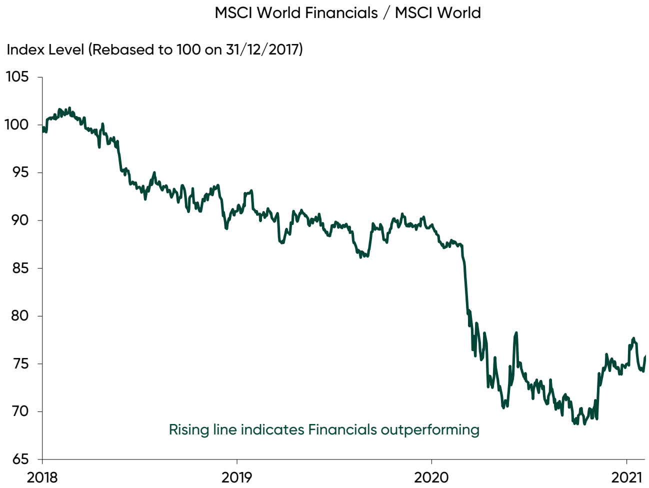
FUTURE HEADWINDS FOR FINANCIALS

When value equities led briefly in Q4 2020 driven by positive COVID-19 vaccine news, some investors presumed it was the start of a longer-lasting leadership rotation that would benefit banks, one of the largest value industries. While that rally has since faded, some suspect it previews what is to come once economies begin to reopen. Presumably, that would increase loan demand, raising bank earnings. We believe this assumption overlooks contrary market data, and too many factors continue to be a headwind for Financials, especially banks.

It is not only their share of the index that makes banks key to value. Value companies typically depend on bank lending to a higher degree to fund their operations. This is especially true for smaller firms unable to utilise the corporate bond market. This, and the yield curve, have a strong influence on value. A steepening yield curve results in banks' loan profitability rising, giving them more incentive to extend credit and fuel economically sensitive firms' expansion with the result of higher margins.

Exhibit 1: Despite Several Countertrends, Financials Have Underperformed for Years

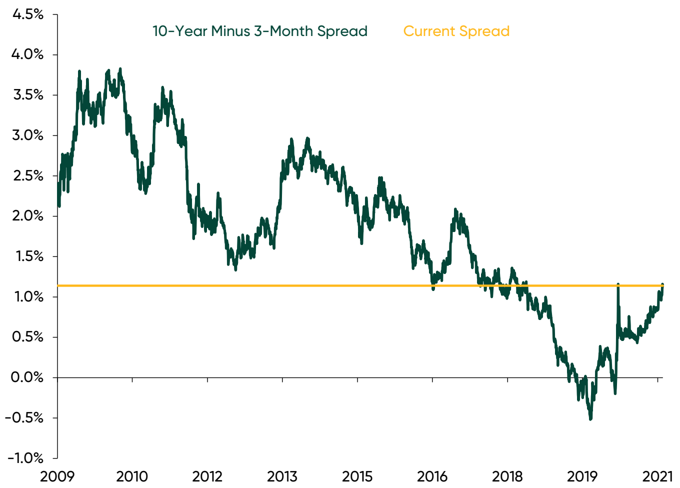


Source: FactSet, as of 9/2/2021. MSCI World Financials and MSCI World, both with net dividends, 31/12/2017 – 8/2/2021. Financials index divided by World index rebased to 100 on 31/12/2017.

As Exhibit 1 shows, Financials have underperformed for years and long before COVID-19. Some market participants suggest a change in leadership going forward because we are in a young bull market and economically sensitive value equities tend to lead early in a market cycle. Financials constitute value equities' largest sector, with banks being its largest sub-industry.[i]

Although the yield curve has improved from its 2019 lows, as illustrated in Exhibit 2, it remains only modestly positive compared to historical levels. As of 8 February, the 10-year Treasury yield exceeded the 3-month Treasury by only 110 basis points.[ii]

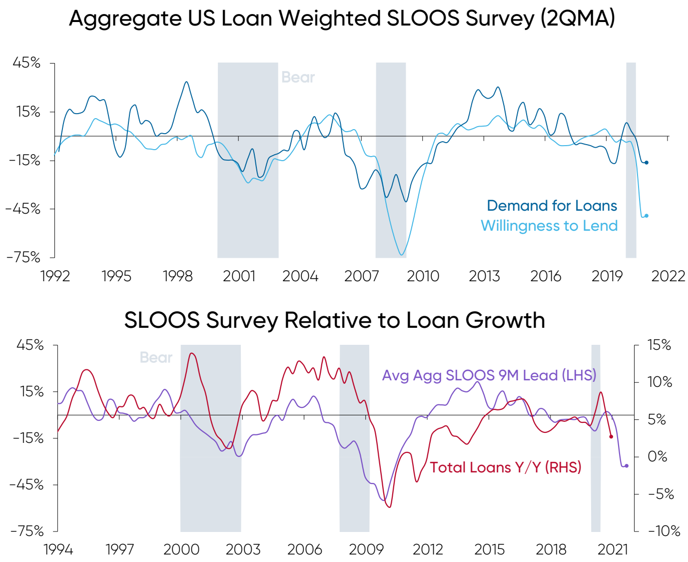
Exhibit 2: The Yield Curve Remains a Challenge



Source: FactSet, as of 9/2/2021. 10-year minus 3-month Treasury yield spread, 1/1/2009 – 8/2/2021.

While interest margins have modestly improved for the banking industry, loan growth remains very challenging. According to the Federal Reserve's latest Q1 survey, banks' senior loan officers continue to see challenging conditions for loan growth ahead (as Exhibit 3 below shows).[iii] They expect delinquency and default rates to worsen throughout 2021. This implies banks still need to provision, limiting the reserves they can release and negatively influencing their willingness to lend. While some loan improvement is likely as vaccinations continues and further reopening, this is widespread news and largely priced in.

Exhibit 3: Lending Conditions are Strained



Source: FactSet, Federal Reserve. US Senior Loan Officer Survey (SLOOS), as of 31/12/2020. A survey reading above 0% implies access to credit/demand for credit will get better in the coming quarters, a reading below 0% implies access to credit will tighten in the coming quarters, or demand is expected to decelerate. Total loans based on monthly data to 31/12/2020. SLOOS data in bottom chart based on average of demand and access to credit, shown with a 9-month lead as of 31/12/2020.

With 59 out of 65 S&P 500 Financials companies reporting as of 9 February, Q4 earnings have increased 17.2% y/y versus expectations for a -9.4% decline at 2020's end.[iv] Outside of the United States, global developed world Financials tell a similar tale, with Q4 earnings up 17.1% y/y against initial expectations for a -27.2% drop, albeit with only about a quarter of reports in.[v] Some analysts also discuss US banks' potential to buy back shares with the Federal Reserve's approval after they passed December's stress tests. Some believe the extra demand and reduced share count will further boost equity prices. While these can be seen as positives, we don't believe they have a long-term future to continue driving equity prices higher.

Without greater fundamental improvement in the lending environment, banks' primary driver, we don't expect sustained outperformance. Banks' positive earnings surprise stemmed largely from trading activity and the release of loan loss reserves[vi] rather than higher loan growth or meaningful larger net interest margins.[vii] The financial sector, and especially the capital markets industry, benefited from last quarter's record equity trading. Meanwhile, loan delinquencies and defaults for banks haven't been as dire as forecasted.

Lastly, while we technically started a new bull market on 24 March, 2020, fundamentals such as economic growth (post COVID-19 recovery), low inflation environment, low loan growth, narrow yield curve and high investor sentiment all suggest a late stage market environment. This is not ideal for Financials and the sector will likely face additional challenges in the year ahead.

[i] *Source: FactSet, as of 9/2/2021. Statement based on MSCI World Value Index sector weights, 8/2/2021.*
[ii] *Source: Federal Reserve Bank of St. Louis, as of 9/2/2021. 10-year minus 3-month Treasury yield spread, 4/8/2020 – 9/2/2021.*
[iii] *"Senior Loan Officer Opinion Survey on Bank Lending Practices," Staff, Federal Reserve, 1/2/2021.*
[iv] *Source: FactSet, as of 9/2/2021.*
[v] *Ibid. MSCI World Index ex. USA Financials Q4 earnings, 9/2/2021.*
[vi] *"Wall Street Traders Propelled Bumper Quarter for Biggest Banks," Shahien Nasiripour, Bloomberg, 20/1/2021.*
[vii] *"How Wall Street Reflects the Economy Biden Inherits," Andrew Ross Sorkin, Jason Karaian, Michael J. de la Merced, Lauren Hirsch and Ephrat Livni, The New York Times, 21/1/2021.*

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