Economic View

Since banks were at the centre of the financial crisis, the market has been monitoring the sector closely for signs of improvement. While the share prices of US banks have rallied since their lows, they are some way off their pre-crisis highs.

In this article, we explore developments in key areas such as the US economy and housing market in order to assess the investment outlook for the US financial sector.

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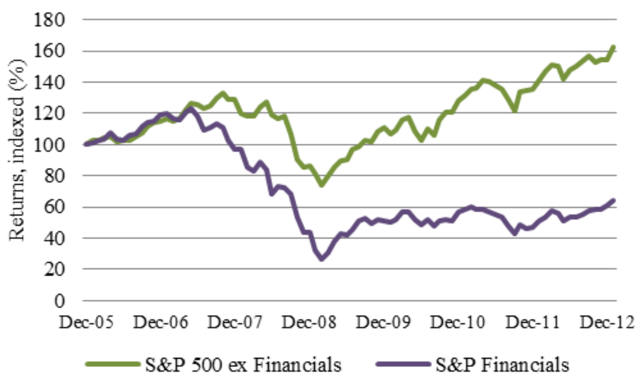
The case for US financials

At the lowest point of the recession, shares in US banks had fallen by a staggering 90% and despite the broader stock market recovering all of its lost ground since then, banking shares remain 60% below their peak. We believe this sluggish progress leaves them attractively valued if, as we expect, economic conditions continue to improve.

Financials recover but are still undervalued



Source: Bloomberg, as at 31st January 2013

We can assess the 'cheapness' of a bank's shares using a variety of metrics such as Price/Book. This measurement compares the current share price to the company's balance sheet, which is comprised of the underlying loans and securities the bank owns.

We would add the caveat that historic Price/Book multiples are unlikely to be seen again anytime soon given the more constrained growth rates and lower returns on equity that have set in because of the higher capital requirements imposed on banks.

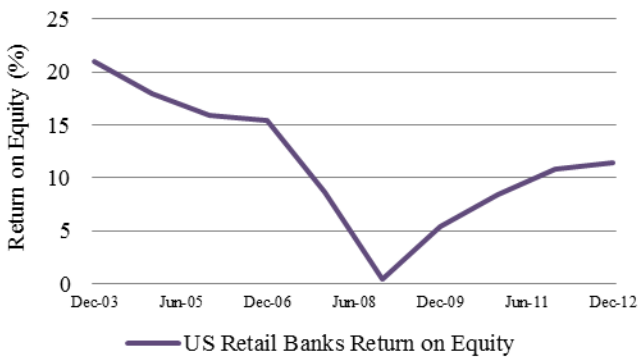
Bank shares cheap on historical basis

Source: Bloomberg, as at 31st January 2013

Set up to reward shareholders

The large returns on equity made by US banks prior to the recession came as a result of them holding far too little capital and the dire repercussions of this have provoked a marked change in the US financial system and its regulations. Banks have been forced to rebuild their capital ratios to safer levels, which has and will continue to affect their profits. In some instances, doubling the amount of capital held in reserve has cut their returns in half.

Returns on Equity recover



Source: Bloomberg, as at 31st December 2012

On the upside, very few banks require further capital retention to meet with new regulatory requirements, which should allow them to pay out more in dividends or buy back shares, either of which is positive for shareholders.

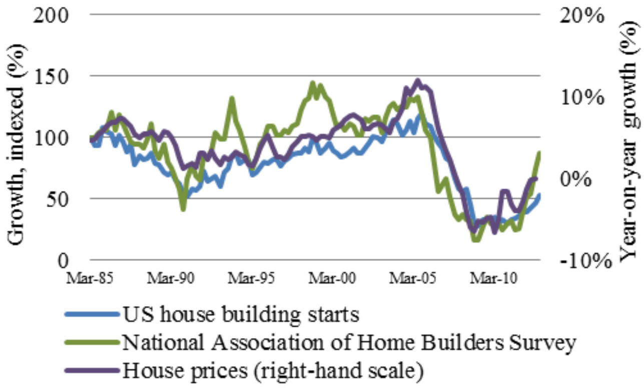
In contrast to Europe, US balance sheets are seeing asset and loan growth, even though in relatively small measures and this balance sheet growth is being funded organically through retained earnings. Above all, the most encouraging trend is the significantly lower level of non-performing loans and write offs, which should be helped by the improving economy.

While the returns previously made by banks are unlikely to be seen again, profitability is nonetheless improving as the amount they have to set aside to provide for bad debts reduces and, therefore, helps to offset the pressures on net interest margins.

Improving property market

Since December 2008, US interest rates have been at record low levels. Currently, you can get a 30 year fixed rate mortgage at 3.5% in the US, making the purchase of property very affordable, especially with house prices 30% lower than their peak. This supportive environment has finally led to signs of recovery in the property market.

US housing market starting to recover



Source: Bloomberg, as at 31st December 2012

The building of new houses, which fell by 75% during the financial crisis, is closely correlated with house prices and, encouragingly, has also started to recover. We believe it still has further to grow, as new housing starts are still 60% below their 2005 peak and prices are starting to pick up.

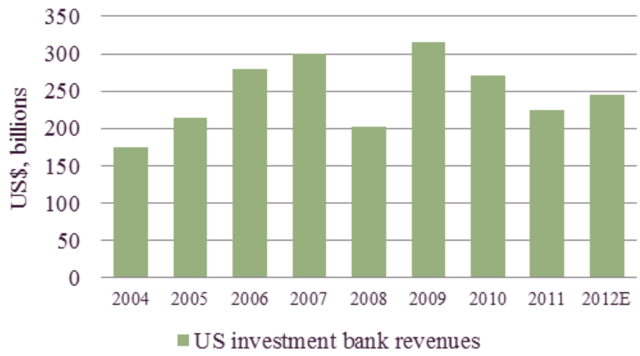
These factors should benefit US banks as lower loss provisions and high re-mortgaging revenues will provide a boost to earnings. The stabilisation in house prices also makes it much easier to reach agreements on legacy mortgage issues as illustrated by Bank of America's recent mortgage repurchase settlement with Fannie Mae and Freddie Mac, the two large government-sponsored mortgage entities.

Stable or rising house prices should help to reduce uncertainty and cap costs associated with past misbehaviour. Good progress is also being made in reducing the large expenses associated with servicing delinquent legacy mortgages.

A supportive economic environment

In a broader world view, the improving global economic outlook that we have seen recently, and expect to continue, should lead to increased trading activity and therefore improve capital market revenues for the US investment banks.

Improving investment bank revenues



Source: Morgan Stanley, 14th November 2012

Further cost cutting and restructuring by US banks could improve returns on equity. We think large US investment banks are relatively well placed to capitalise as smaller players adjust to the new market and regulatory environment.

While the reactionary tightening of regulation after the crisis demands that banks now must have a higher capital base and more conservative funding, US financials in aggregate are already in better shape on both of these fronts compared to their European peers.

Tighter regulation following the Dodd-Frank Act aims to prevent another financial crisis by, among other things, restricting certain speculative activities such as proprietary trading operations of US banks. The new rules that have been applied to derivative clearing remain a challenge for the investment banking industry, but the recent amendments to the Basel Liquidity Coverage Ratio, which is due to be introduced in 2015, are likely to enable them to reduce their liquidity pools and, in turn, boost the yield earned on these assets.

Our investment decision

Although it was specifically banks that lay at the core of the financial crisis and suffered the most, the last four years have seen a decline in share prices of the US financial sector as a whole. We believe there is an opportunity to exploit the attractive valuations across the entire sector, including asset management and brokerage firms, and we have chosen a fund that will grant us a broad financial exposure.

As the domestic economy improves, we believe we will see US financials outperform the wider American stock market.

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