

TAM INTERNATIONAL INVESTMENT NOTE

Why we're banking on banks



The financials sector has had a volatile start to the year following strong performance towards the end of last year as prospects of growth and inflation from a stimulative economic agenda from the Trump administration buoyed the sector. Despite this, the sector is up nearly 8% for the year to date and in our opinion, poised for further strong performance into the second half of the year. Arguably, it had been a popular trade since early last year, so it is fair to say we were not the first people on the dance floor with our addition of a US financials investment in January, but neither have we been sitting on the sidelines.

It's important to note that the valuation gap between financials and the broader market is still at extreme levels, while the quality of the financials sector has dramatically improved since the financial crisis in 2008. Banks are now being seen as the most sought after value play and we believe they will be at the forefront of a comeback in the global value rally, which has had a setback in recent months after taking off towards the end of last year.

After experiencing some weakness in mid-March, US financials shifted into rally mode in June following the Federal Reserve's decision to increase the key interest rate by 25 basis points to bring it to 1%-1.25%, strengthening major financial stocks. In addition to this, the Fed conducted a bank stress test, which confirmed that 34 major banks have adequate capital to face financial difficulties, with surplus cash for dividends and share buybacks. So banks have strengthened their capital cushions and cleaned up their balance sheets and according to Fed chair, Janet Yellen, we might not see another financial crisis "in our lifetimes". Now that has to be a comforting statement, if ever we heard one!!

The Fed's June meeting also concluded with plans to begin winding back its \$4.5 trillion balance sheet later in the year, which had built up to unprecedented levels after the 2008 financial crisis in an effort to stimulate the economy. This would contribute towards rising interest rates and reaffirms that the target fed funds rate is still top of the monetary policy agenda.

We have highlighted a rate environment poised to become more favourable for financials, however we believe further support for the sector will come from market sentiment. At this point, the market has almost entirely priced out President Trump's ability to get anything done. Therefore, if and when we get more clarity on US fiscal and economic policy and see policies such as softening of bank regulation, lower corporate taxes and infrastructure spending come through, we could see sentiment returning to pre-crisis levels, driving a huge recovery in bank share prices.

As we enter into second quarter earnings season in the US, banks are indeed taking the lime light with initial earnings announcements from the likes of JP Morgan and Citi Group far exceeding analysts' projections. This is largely attributable to an increase in both commercial and consumer lending, with significant earnings upgrades beginning to feed through from those first interest rate rises back in 2015.

For TAM, this latest set of earnings results comes as no great surprise but rather a welcome vindication of our conviction in the US financials sector, of which TAM has been steadily building a position on behalf of our clients since the end of last year.

Favourable conditions for financials are by no means confined to the US, with European banks leaving the struggles of 2008 behind them and continuing to raise capital and build out their commercial and consumer loan books. In spite of this improvement in health, European banks remain comparatively cheaper than their US counterparts, but stand to benefit from exactly the same factors. To us, all this suggests a pop in European financials is on the cards. In anticipation of this, TAM has been investing in a European equity fund with a heavy bias towards the financial sector.

Of course, we are cognisant that this trade is still in its infancy, as discussions continue on when the unwinding of stimulus measures in the Eurozone will begin. Furthermore, investing in something as specific as financials is not without its risks, including regulatory and operational risks, however we believe at this point in time, the return potential overrides.

There are multiple factors at play which each individually have the potential to drive the financials sector higher. Whether or not they align, we will have to wait and see...

Nonetheless, at present we are indeed banking on banks!

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