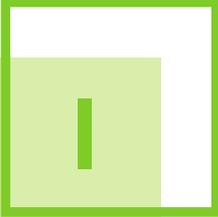




# Investment Note

11 October 2017



For retail use, 11 October 2017

## Conviction in the US Banking Sector Remains High

Despite high hopes entering the year, banking stocks, particularly regional banks, have underwhelmed. The portfolio management team responsible for our Bank Opportunities and Financial Industries strategies believes that investors should stay focused on long-term supportive factors in the sector such as stronger earnings, industry consolidation, regulatory reform, and attractive valuations.

### Summary

The US Banking sector has lagged the market year-to-date in 2017: The S&P returned 13.2% through 26 September, while the S&P Composite 1500 Regional Banks Index gained 1.5%<sup>1</sup>. Although the sector has underperformed over this time period, we believe that four supportive factors will boost the industry's prospects over the long-term: stronger earnings due to higher short-term rates and continued loan growth, industry consolidation, regulatory reform and attractive valuations.

### Stronger earnings due to interest rates and loan growth

- Short-term interest rates have increased on the back of Federal Reserve (Fed) rate hikes. This has boosted banks' profits as the difference between interest earned from lender and paid out to borrowers has increased.
- Steady economic growth has supported loan growth. US second-quarter GDP growth was 3.1%<sup>2</sup>, and economic activity is expected to remain solid throughout the second-half of 2017. As a result, loan growth has increased in every category except home equity; loan growth at small and mid-cap banks has outpaced the industry.
- Sector earnings are stronger: second quarter operating earnings-per-share growth for the median bank was 12.5% year-on-year<sup>3</sup>; second-half earnings are on track to be similar.

### Industry consolidation

- Industry consolidation is a long-term perspective based on the structure of the banking industry. Over the past five years, 250 M&A transactions, on average, have closed in the sector; this year is on track to close a similar number of transactions<sup>4</sup>. The pace of consolidation may continue as banks seek greater efficiency through scale, look to spread compliance and technology costs over a wider asset base, and excess capacity comes out of the system.

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<sup>1</sup> Total returns calculated in US dollar, Bloomberg, as of 26 September 2017.

<sup>2</sup> US Commerce Department, 28 September 2017.

<sup>3</sup> Keefe, Bruyette & Woods, 2Q 2017 Bank Earnings Wrap-Up, August 8 2017.

<sup>4</sup> SNL Financial, 30 June 2017.

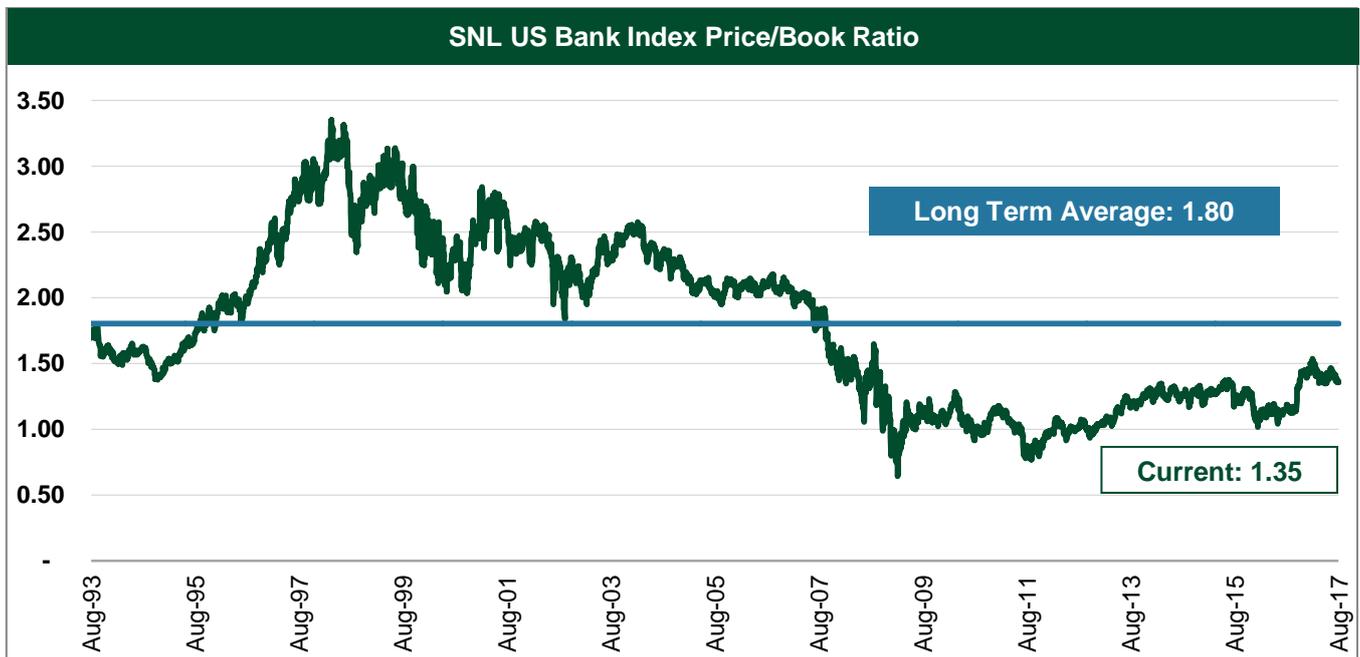
**Regulatory reform**

- In June 2017, the US Treasury Department released a paper that highlighted regulatory reforms to “make regulation efficient, effective, and appropriately tailored”<sup>5</sup>. The report detailed 97 recommendations of changes to the regulatory landscape to improve the banking system: Of these 97 recommendations, only about 1/3 would need Congressional approval and the remaining 2/3 could be implemented by one or more of the regulatory agencies. We have already seen some positive changes for the industry, and we believe this will continue as many of the leaders of the various financial regulatory agencies take over and implement these recommendations.

**Attractive valuation**

- Banks remain attractively valued: they still trade below their long-term book value (Figure 1). Numerous factors suggest that valuations may bounce back to normal levels including increased earnings power, loan growth and operating leverage.

Figure 1: Banks remain attractively valued<sup>6</sup>



**Conclusion**

The banking sector is experiencing improving fundamentals. These trends, coupled with attractive valuations, provide compelling opportunities for long-term investors.

<sup>5</sup> US Department of the Treasury: [A Financial System That Creates Economic Opportunities, Banks and Credit Unions](#).

<sup>6</sup> SNL Financial, Manulife Asset Management, 31 August 2017.

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