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DECEMBER 2015

Prospects for the financial sector

With expectations of a rate rise by the Federal Reserve high, what can we expect from the global financial sector? Despite recent weakness in emerging markets, global economic conditions are relatively supportive for financial sector profits. While banks and insurers are expected to be beneficiaries of US rate rises, other financial subsectors benefit during periods of economic growth. There are also exciting financial business opportunities in emerging markets, which should benefit from long-term structural growth.

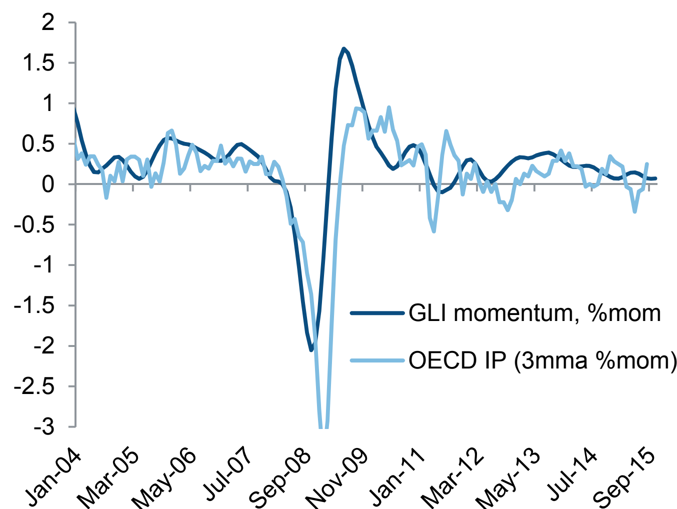
AT A GLANCE

- Banks and insurers should benefit from US interest rate rises, even if rate rises are modest.
- Banks have successfully adapted to the bulk of new post-financial crisis regulations.
- Conditions in emerging markets are tougher, but there are still good opportunities in certain financial equities in EMs.
- Subsector opportunities include transaction processing, wealth management, real estate and alternate payment methods.

CURRENT GLOBAL CONDITIONS

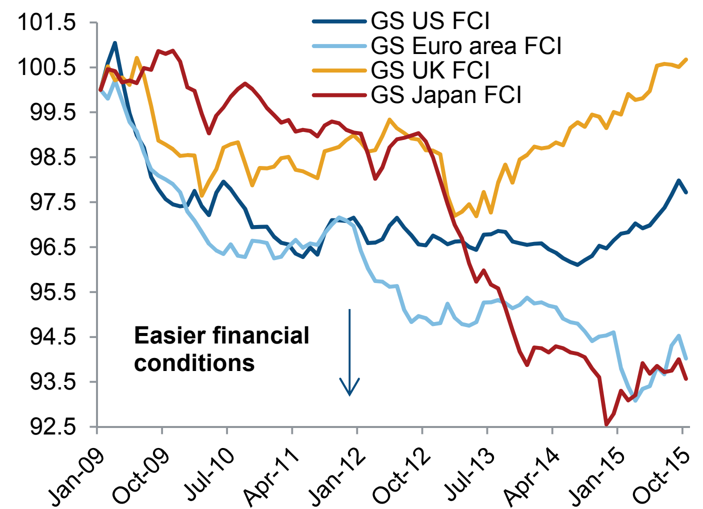
Despite the slowdown in China and other developing economies, the global economy remains in expansionary territory (Chart 1) – though developed and emerging market (EM) fortunes are diverging. The recovery in developed market (DM) economies is for the most part continuing, albeit at a slower pace. Monetary loosening in Europe, China and Japan will likely continue, and will probably be supportive of asset prices.

Chart 1. Global Leading Indicator momentum is still positive



Source: Goldman Sachs Economics Research, Haver Analytics, October 2015

Chart 2. DM Financial Condition Indices since 2009



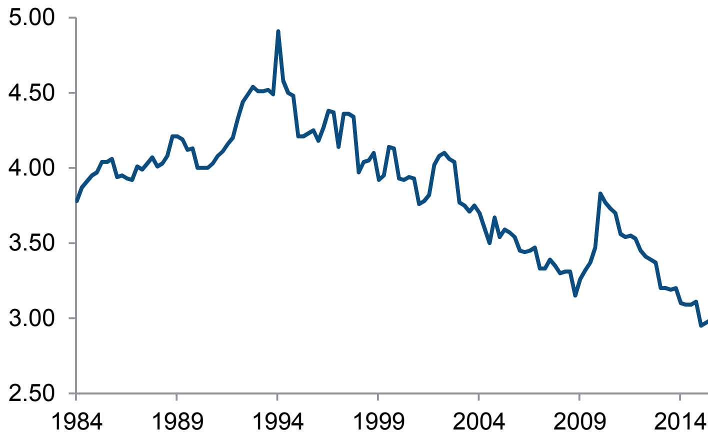
Source: Goldman Sachs Economic Research, October 2015

RISING RATES, RISING MARGINS

With a high probability of a Fed rate rise this year, investors are debating whether tougher funding conditions will place a strain on banks and the broader financial sector, as defaults from individuals and companies increase, leading to asset impairment for lenders. However, data from a 2012 Fed study[1] indicates “that changes in interest rates affect bank profit margins primarily through their impact on net interest income. An increase in the general level of interest rates results in significantly higher interest margins”. It also notes that the “steepening of the yield curve is also associated with higher interest margins, with the size of the effect increasing in the degree of the mismatch between the maturity or re-pricing intervals of bank assets and those of bank liabilities, a result consistent with conventional wisdom.”

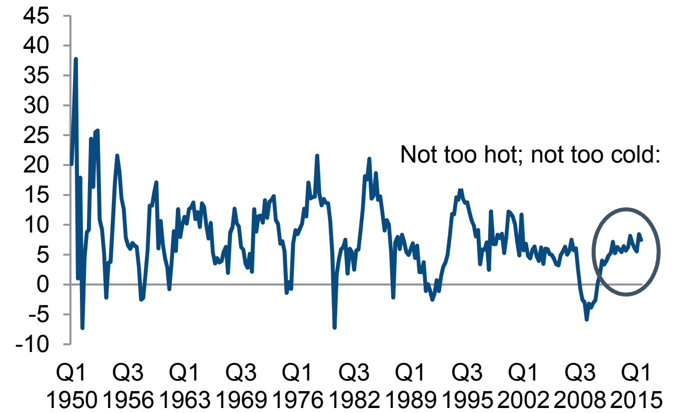
The same study notes caveats about the immediate negative effects of rising rates on longer-term bank assets, and how rate rises lower the discounted present value of future profits. But careful balance sheet analysis can allow active investors to identify those institutions that stand to benefit from rising net interest margins – after years of compression (Chart 3, next page) – that could result from increases in rates.

Chart 3. Banks' net interest margin is at multi-decade lows



Source: Federal Reserve Bank of St. Louis, July 2015

Chart 4. Growth (%) in total US consumer credit



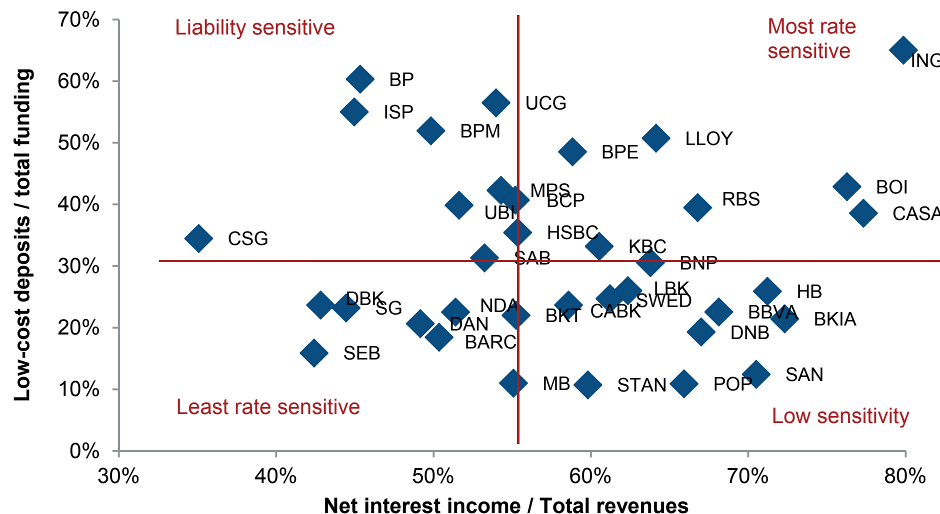
Source: Federal Reserve Board of Governors, September 2015, seasonally adjusted

ECONOMIC NORMALISATION

It's important to distinguish between rate rises in response to improving growth expectations, versus rate rises as a result of credit shocks. Central bank rate rises in the US and UK will be a response to an improving economy, and economic recovery will be supportive for financials, as it will encourage continuing loan growth (Chart 4 above) and transaction income, while better corporate profitability is benefitting credit quality. This, in combination with the fact that banks have been largely prudent in their underwriting of new credit since the 2007-2009 crisis, means that credit costs should remain at low levels for longer than generally expected.

The situation is different in the eurozone, where Greece and other peripheral nations have been vulnerable to credit shock rate rises. But the European Central Bank's decision earlier this year to commence full QE has lifted confidence, with financials benefitting from the more relaxed credit environment. Ongoing ECB balance sheet expansion should keep eurozone rates lower for longer. As in America, stock analysis will be important in order to identify how different institutions' business models and balance sheets are affected by changes in interest rates (Chart 5).

Chart 5. European banks' interest rate sensitivity



Source: Fidelity International, July 2015

MEETING REGULATORY DEMANDS

Despite some uncertainty surrounding what evolving Basel IV regulations on capital will entail, banks have for the most part adapted to post-financial crisis regulatory demands. They have been raising core 'Tier 1' capital, adapting to tighter funding/liquidity rules, more stringent recovery and resolution plans, and improved conduct requirements. This more settled regulatory environment should be conducive to good shareholder returns.

Case study: Lloyds Banking Group

Since being bailed out by the UK government during the financial crisis, Lloyds has been reducing non-core parts of its business in order to improve Tier 1 Capital – which is projected to be 14% by year end. Core return on tangible equity has been rising and is now around 14% with a prospective 2016 dividend of 4.7%. The UK government has started selling its share in the bank, and the future of the restructured business is looking more promising.

"On a sector basis, financials are a bright spot as they continue to build capital and shore up their balance sheets."
David Simner
Portfolio Manager

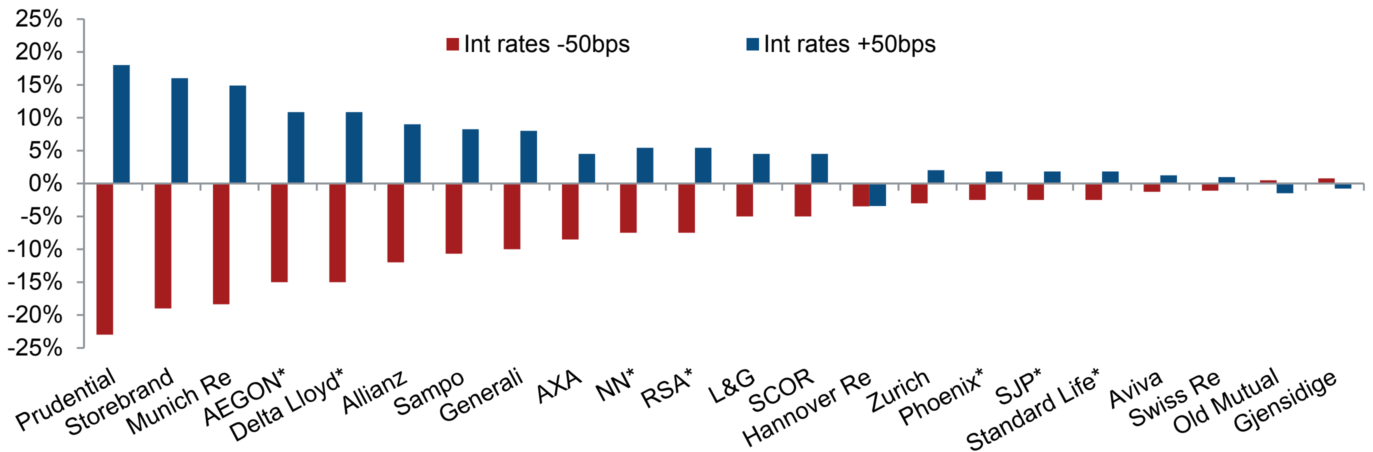
RELIEVING PRESSURE ON INSURERS AND PENSION FUNDS

Businesses in both of these sectors traditionally hold a large proportion of their assets in investment grade and government bonds, and rely on coupon income to pay liabilities over time. The prolonged low interest rate environment since 2008 has posed serious challenges for them, as new money and maturing assets are reinvested at yields that are lower than those promised to their policyholders.

Rising rates should have a particularly beneficial effect on the balance sheets of most life insurers (Chart 6). The present value of their future liabilities is discounted by rising rates, and although rate rises will lower the market value of their existing bond holdings, given that they tend to hold these to maturity, this matters less than the opportunity to reinvest at lower prices and higher yields. In 2013, close to 75% of US life insurers' total assets were in bonds, with a spread in the 60-70% range seen in most other developed countries (Italian life insurers holding closer to 90% in bonds).[2]

"Growth and rate rises in the US will support financial earnings and share prices, while monetary stimulus and some growth in the rest of the world will support share prices through higher asset prices and valuations."
Sotiris Boutsis
Portfolio Manager

Chart 6. Balance sheet sensitivity of life insurers, ranked by impact of 50bps move in rates



Source: Fidelity International, July 2015. *Numbers based on estimates, given lack of disclosure.

EMERGING MARKET OPPORTUNITIES

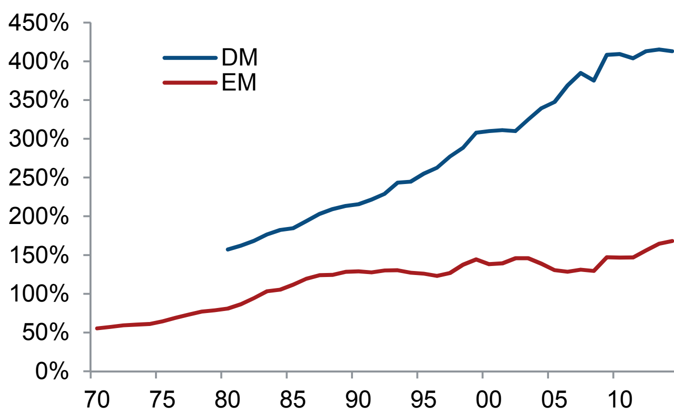
Emerging markets (EMs) are facing challenges at the moment. Weak commodity prices are hurting raw material-exporting nations, while the growth slowdown in China continues. Hopes for political reform in large markets like Brazil, Russia and South Africa are dwindling, while instability in the Middle East and Ukraine is not helping sentiment. But taking a longer-term view, it is likely that financial penetration in EMs will increase, as wealth grows and burgeoning middle class populations demand the sorts of financial services that people in the developed world take for granted: bank accounts, insurance products, broker accounts, and pensions.

Growth in total debt as a percentage of GDP in EMs over the last 30 years has been modest in comparison with DMs (Chart 7); with what little increase there has been entirely accounted for by growth in Chinese debt (Chart 8). There is plenty of room for credit growth in these markets, with all the opportunities for well-managed financial firms that this implies.

Case study: Nigerian banks

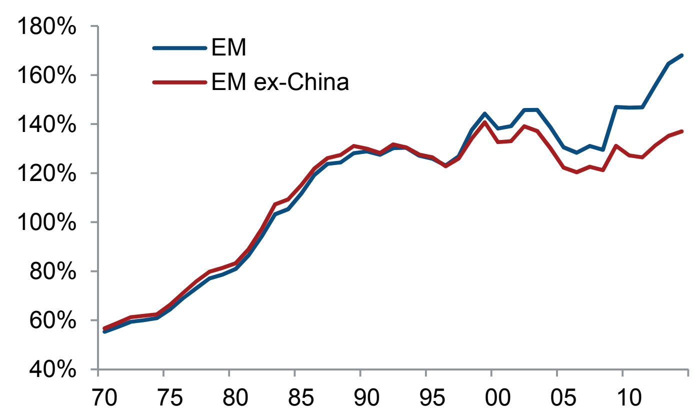
Sub-Saharan Africa's population is expected to grow from just under 1 billion today to around 2 billion by 2050.[3] Nigerian banks like Zenith Bank and Guaranty Trust could be major beneficiaries of this demographic dividend and the scope for financial development in the country. Their balance sheets are solid, they pay attractive dividends, and the new government's business reform plans are boosting their prospects.

Chart 7. Total debt (% of GDP)



Source: Emerging Advisors Group, March 2015

Chart 8. Total EM debt (% of GDP) excluding China



Source: Emerging Advisors Group, March 2015

M-PESA

A good example of an EM financial opportunity is M-Pesa, an SMS-based money transfer service. It was first launched in 2007 by African telecom firms Safaricom and Vodacom ('M' stands for mobile, and 'pesa' is Swahili for money), and enables millions who have mobile phones but no bank account to send and receive money and make bill payments. A third of Kenyan GDP now runs through M-Pesa payments, and it still has significant growth potential given the demographics in its key African and Indian markets. Alternate payment systems and the broader development of 'FinTech' could be one of the great global innovation stories of the coming years.

DIVERSITY IN GLOBAL FINANCIALS

M-Pesa highlights the diversity of opportunities in global financials. Transaction processing companies like Moody's are another such example. They benefit from pricing power, the repeating nature of their business – as issued debt needs to be regularly refinanced and rated – and growth in capital market penetration in a number of economies. These companies are also developing new lines of business focused on monitoring, compliance and risk solutions. Similarly, asset managers benefit when economic conditions are favourable as growth in company earnings generate inflows.

The larger capital requirements banks face are pushing them in the direction of increasing income from non-lending activities, and wealth management's fee-based income is attractive. A 2014 study from Fidelity Investments of 140 executives at US regional, national and community banks found that 42% had increased their involvement in wealth management activities in the previous five years.[4] Reorienting their businesses away from capital-intensive activities towards wealth management generates higher return on equity, higher valuation multiples and means excess capital can be returned to shareholders.

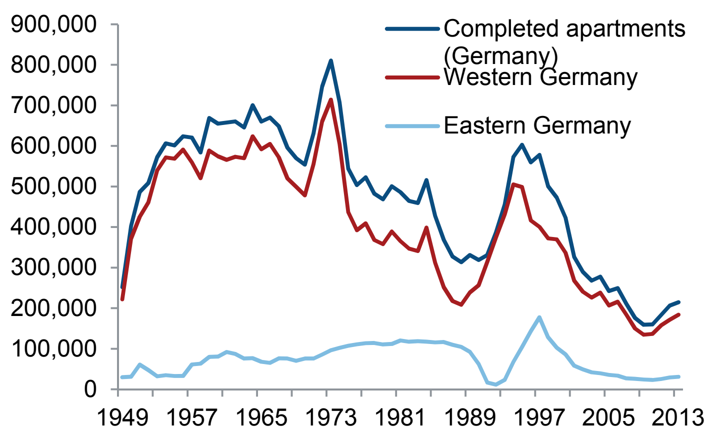
Real estate investments are another option. Certain property stocks in EMs are attractive, based on favourable demographic and consumption prospects, and low mortgage and personal debt penetration (case study, right). Within developed markets, surging urban populations as a result of internal and external migration combined with low supply (Chart 9) and a healthy economy are making German residential real estate look attractive, with rental prices picking up over the last two years (Chart 10).

"A rise in US interest rates could have a significant effect, but I think tightening is likely to be slow and shallow, with there being potential benefits here too – such as a stronger outlook for the US financial sector. Furthermore, while the Fed looks to tighten in the near future, both the ECB and BoJ have shown willingness to be more accommodative."
Nick Peters
Portfolio Manager

Case study: Ayala Land

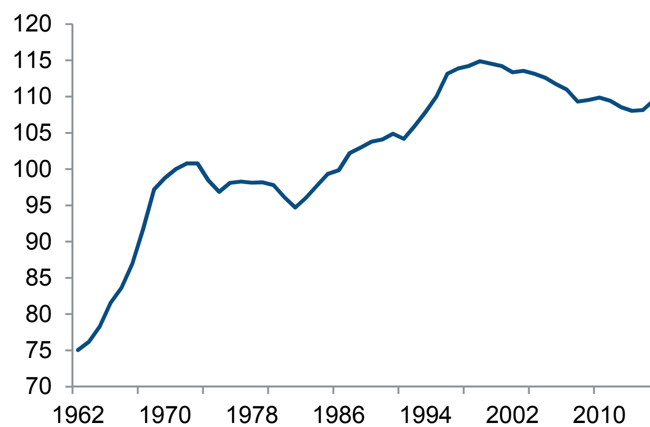
This company is the strongest player in the Philippines' residential property market. Earnings have been rising consistently, with EPS expected to increase by 15-20% over the next two years and a gradual increase in the dividend yield.

Chart 9. The tightening supply of German residential units



Source: Fidelity International, July 2015

Chart 10. Rising real rental costs in Germany (1971 = 100)



Source: Fidelity International, July 2015

CONCLUSION

After the financial crisis and subsequent fallout, investors could be forgiven for wariness towards financial stocks. But a generally positive macroeconomic backdrop bodes well for the sector, as does monetary normalisation in the US and UK, after years of extremely loose policy brought about by the 2007-09 crisis. In the short term, EM financials may face challenges from slowing growth; but in the longer term, finance is likely to be a standout growth area in developing economies.

Though insurers still face work in adapting to new regulations, banks have largely been successfully in adapting to post-crisis regulation and conduct requirements. This means that the outlook for the sector is now more promising, while rate rises in the US

and UK should be a positive for insurers, and a plus point for banks that are able to raise their net interest margin as a result.

Continual attention to political and macroeconomic developments as well as potential regulatory changes will remain essential for investors – particularly relating to evolving Basel IV capital regulations for banks and new solvency requirements for insurers. But discerning active investors should be able to find plenty of exciting prospects across a range of subsectors in the global financial universe.

FOOTNOTES

1. 'Interest Rate Risk and Bank Equity Valuations' Federal Reserve Board, 2012-26
2. OECD Business and Finance Outlook 2015
3. UN DB research, Fidelity International, July 2015
4. http://www.fidelity.com/inside-fidelity/using-an-advisor/banks-expect-wealth-management

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