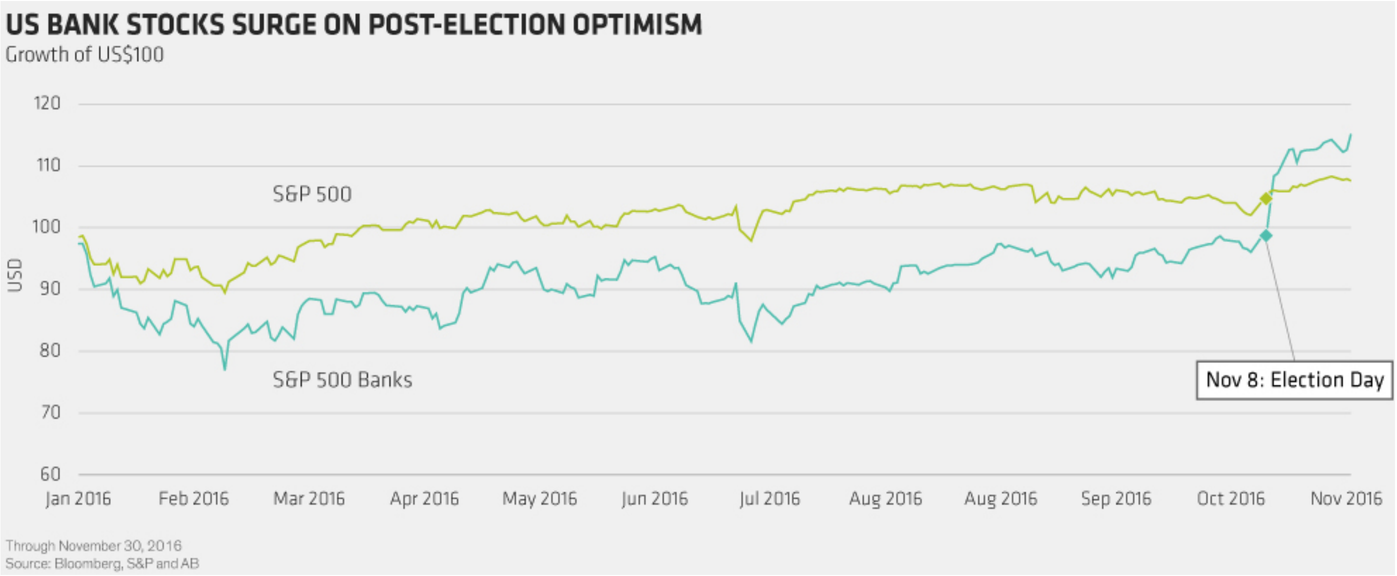
Buying into Banks as Trump Rally Unfolds

December 26, 2016
by Kurt Feuerman
of AllianceBernstein

It’s been a wild month for US banking stocks, which have rallied sharply since Donald Trump’s victory. So how can investors position themselves in the sector amid a potentially dramatic change in the business and regulatory environment?

After facing years of headwinds, US financials have been riding a wave of optimism. Since the election, the S&P 500 Banks Index has climbed by 17% through November 30.



Investors are beginning to believe that the new administration will usher in a new golden era for banking, which could foster robust earnings growth in the coming years. Several positive forces are likely to support the sector, including:

- **Faster economic growth**. The Republican sweep suggests that meaningful legislation is likely to be passed early in the Trump presidency. Lower corporate taxes and a fiscal spending boost are both on the agenda—and could fuel substantial economic growth. For investors, banks are pure plays on faster growth in America.
- **Higher interest rates**. Pivoting from monetary to fiscal stimulus could accelerate a rise in interest rates from historic lows. The Fed’s rate hike in December is likely to kick off a series of rate moves through 2017, in our view. Banks benefit most from rising rates, which increase their earnings from lending and investments.
- **Regulatory relief**. A Republican government is widely expected to reduce the regulatory burden that has evolved over the past eight years. The comprehensive Dodd-Frank rules probably won’t be quickly dissolved. But we expect Washington to gradually move toward pro-banking policies and away from the existing hostile environment. Over time, a friendlier regulatory environment can add to earnings leverage as legal and compliance costs fade. In addition, the extremely strict rules on capital allocation —which were already starting to ease—are likely to be eased further.
- **Lower corporate tax rates**. Trump has pledged to cut the corporate tax rate from 35% to about 20%–25%. This will buoy earnings per share (EPS) for US companies in general, with especially large benefits for companies that generate most of their profits domestically. Many multinationals, including technology, healthcare and consumer products companies, won’t be major beneficiaries because they generate a large proportion of profits abroad. Since most banks generate the bulk of their earnings at home, they should enjoy a big boost from lower tax rates.

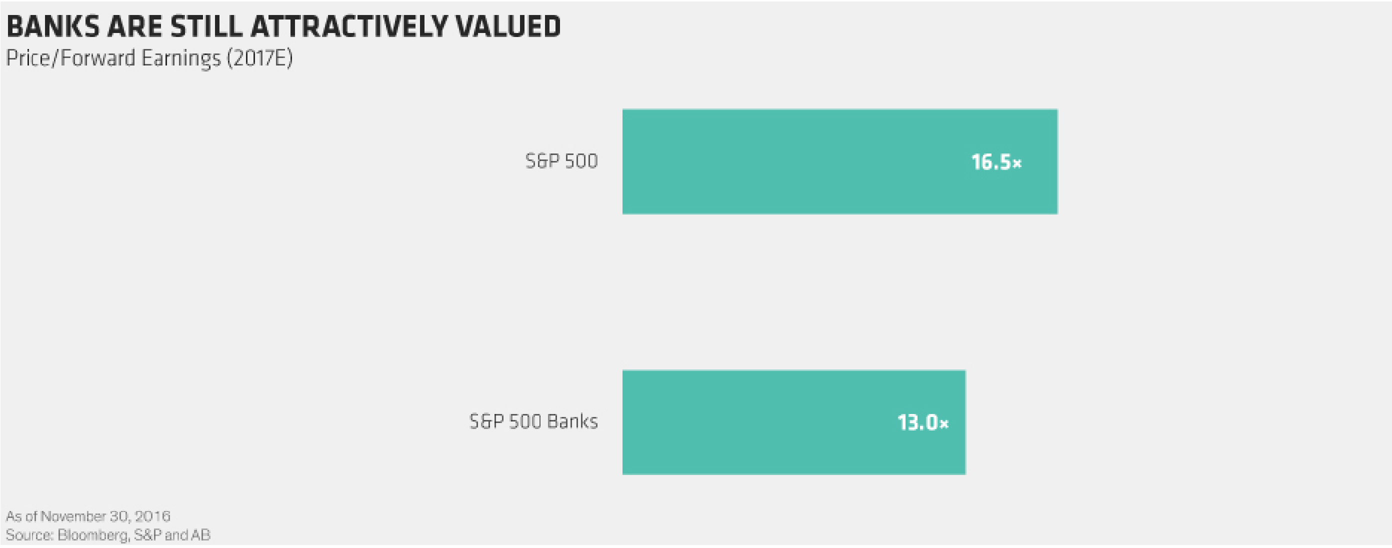
Of course, there are risks on the horizon. Economic growth might not accelerate as expected and interest rates could decline again. Both scenarios would undermine the bullish outlook for banks.

New Paradigm?

Despite the risks, we believe that a new paradigm has emerged since the election. In this new paradigm, the economic cycle starts to look like traditional cycles: growth accelerates, inflation increases and interest rates rise to normal levels. While it’s too soon to say just what “normal” will look like, if rates return to the 10-year Treasury yield average since 1962, they could reach 6.4%. In a rising-rate environment, we expect the banking sector to generate faster EPS growth than almost every other sector over the next four years.

Valuations vs. Quality

Based on estimated 2017 earnings, US bank stocks look attractively valued. Even after the recent rally, the S&P 500 Banks Index trades at a price/earnings multiple of 13×—a 21% discount to the S&P 500 (*Display*).



To benefit from the changing environment while hedging potential risk, we think it’s important to have exposure to different types of banks. Holding some banks with more volatile businesses and very attractive valuations offers the potential for outsize returns in a pro-bank environment. The risks of owning banks like these can be balanced by holding other lenders with strong, proven franchises and higher-quality fundamentals that, while slightly more expensive, still trade at reasonable valuations.

Bank quality can be assessed by looking at a firm’s underlying business drivers. Trading-oriented businesses or those with more emerging-market exposure may be more volatile in difficult market environments. Other banks with solid retail businesses and a loyal customer base may be more resilient in tough times.

The outlook for US banks is better than it’s been in years, in our view. Yet even with strong structural drivers, it’s important to look before you leap into the sector. Not all banks are created equal. But by choosing carefully and focusing on fundamentals, we believe investors can position themselves to benefit as a powerful shift in favor of financials unfolds over the coming years.

https://blog.abglobal.com