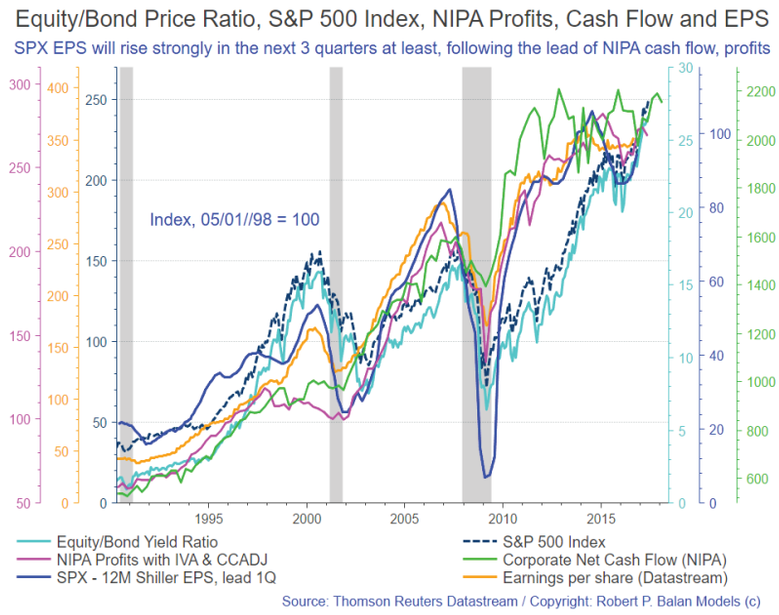
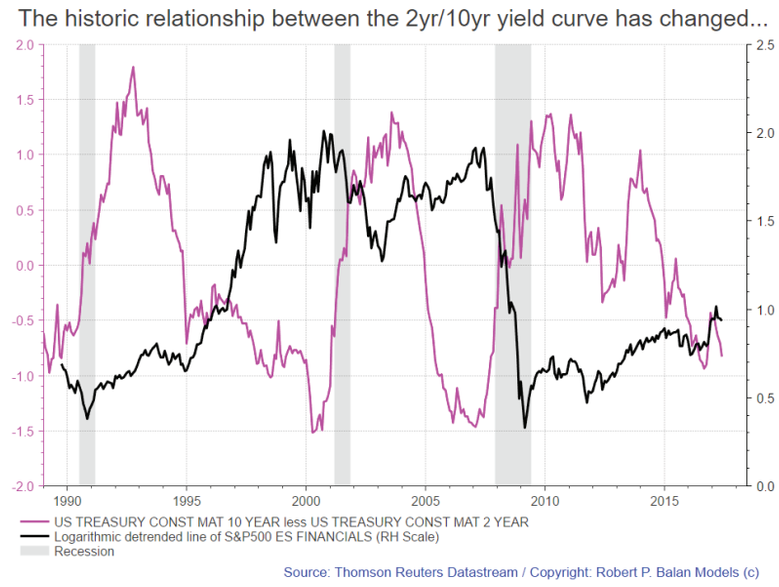
35 / The US financial sector is set to outperform during H2 2017, and may now provide opportunities to investors

The US Financial Sector has come under scrutiny again as it resumes underperforming the broad market S&P 500 Index after a promising uptrend during Q1 2017. One of the reasons which encouraged us to write this article is that we believe that the financials will catch up to the broad S&P 500 index, for the economist's famous reason - «if a trend cannot continue forever, it will stop.» **And we think the banks have been undervalued for too long, and the day for that undervaluation to stop is nigh.**

By Q1 this year, the financials were on track to finally reach parity with the broad S&P index. And the motive force for that uptrend was the election of Mr. Donald Trump as president of the United States. **The markets were buoyed by the promise of less regulatory overload for the banks, lower corporate taxes, and a reflationary environment which should be positive for financial intermediaries.** But by early March, GDP growth surprised to the downside, then Mr. Trump`s agenda by tripped up by the Republican Congress` failure to pass an alternative to the ObamaCare, and subsequent scandals along with unfortunate backlash from the Trump`s dismissal of James Comey as FBI director.





There is no benefit going into the merits (or lack thereof) of the latest allegations of malfeasance against President Trump. It is widely covered by old-fashioned media and the internet news outlets, and it is up to the talking heads on the TV news to debate. We will only discuss the effect of Mr. Trump`s predicament on the markets. And, for now, we are not too concerned about the perceived, growing risk that President Trump will be impeached, which will undercut his agenda, which the banks find positive for the financial sector in general. **The US has experienced only three impeachment episodes over the past 100 years:** the Teapot Dome Scandal (April 1922 to October 1927), Watergate (February 1973 to August 1974), and President Clinton's Lewinsky Affair (January 1998 to February 1999).

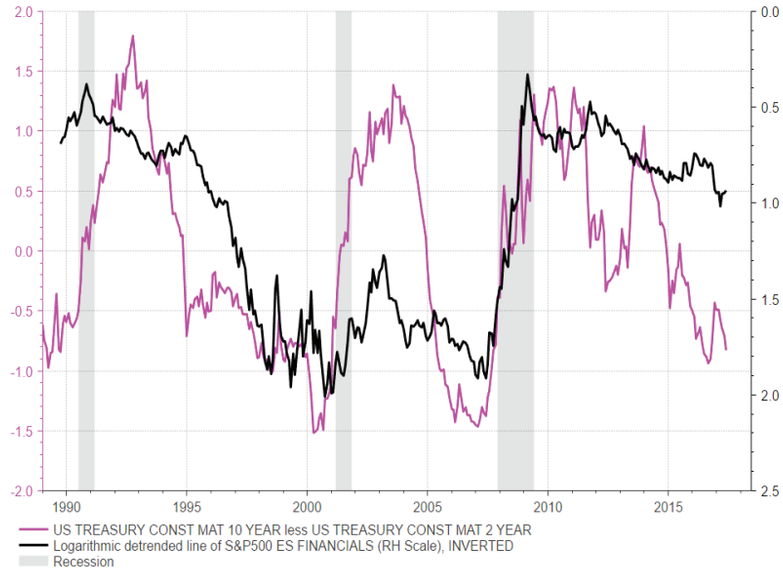
There was not much negative impact on the markets, or specifically on the financials, except for the Watergate crisis which happened while the US economy was, at that time, undergoing one of the deepest recessions in the post-war era. The present economic situation is not dire at all. **After a weak Q1 growth, activity is rebounding during the second quarter. The Atlanta Fed's GDPNow model is predicting growth of 3.2% while the NY Fed's Nowcast is calling for 2.3%.**

The Q1 2017 earnings season was a strong one. Moreover, our leading indicators predict continued healthy profit growth for the remainder of the year in the U.S. and into Q1 2018 at least (see graph above). **As long as corporate earnings are rising, investors will largely shrug off the reality show in Washington DC.**

Moreover, the litany of scandals afflicting the Trump administration will unlikely derail large parts of Trump's market and bank friendly policy agenda. Tax reform and deregulation are two key areas where the president and congressional Republicans agree with, and so progress looks certain by year end. The prospect of deals on those subjects should buoy investor sentiment during H2 2017. **Thus, while equities may indeed remain under pressure near term, the outlook for the next 3 quarters (at least) look reasonably good.**

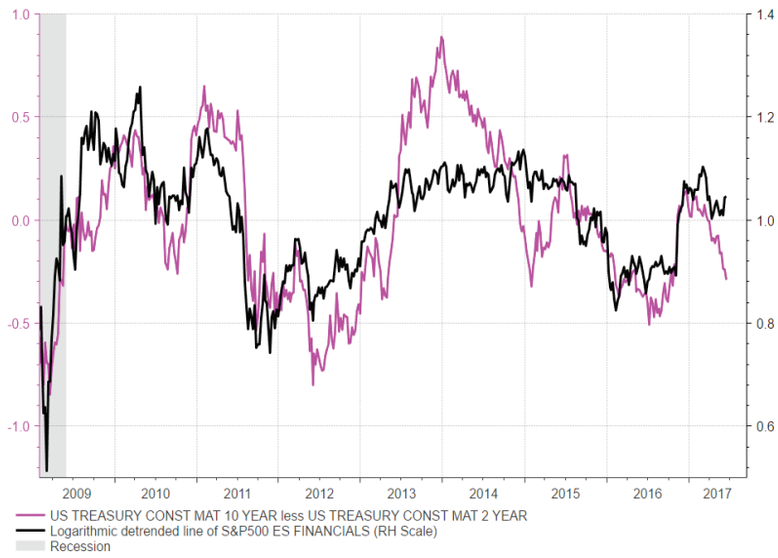
The June FOMC meeting provided some support and clarity to our long-standing call that there could be just one rate hike in H2 2017, probably by September. **The easier policy trajectory that the FOMC recently unveiled could provide a strong tailwind for the financial sector, as ratcheting monetary policy higher has always flattened the yield curve.** A static curve, or better – a steepening curve – is exceedingly crucial to the recovery in the financial sector`s future valuation. This requires some explanations as the historic relationship between the yield curve and the financial sector has radically shifted. It used to be that there was a negative correlation between the financial sector`s valuation and the slope of the yield curve – a flatter slope of the curve has been beneficial to the sector *(see 2nd graph previous page)*. **But that changed during Q1 2009, when the QE-fuelled recovery from the Great Financial Crisis started.**

Correlation between yield curve vs Financials was negative until Q1 2009



Source: Thomson Reuters Datastream / DCC & Robert P. Balan Models (c)

Since the GFC recovery, curve vs Financials relationship turned positive



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Since the recovery from the GFC started in Q1 2009, the relationship between the yield curve and the financial sector has turned positive – a steeper yield curve boosts the sector valuation. While a flattening curve pushes down the stocks in the sector. That is one reason why tightening monetary policy, the dynamics of which always flattens the yield curve, is devastating to financial stocks

(see 1 st and 2nd graph above).

With the Fed slowing down the pace of policy tightening during H2 2017, we look forward to a much more improved outlook for financials for the rest of the year, and possibly into Q1 2018. In fact, the sector`s recovery has started with the friendlier June FOMC statement, and the ratio between the financial sector and the broad S&P 500 index has begun to rise *(see last graph previous page).* We also expect the 10yr yield to rise over the next few weeks, and **if the Fed indeed does slow its tightening rhetoric (which will keep short term rates steady), then we could see a start of a steeper yield curve. That would be positive for the financial sectors stocks. The currently depressed sector valuation is therefore an opportunity for investors to take another look at this sector, which we believe will do well for the rest of the year.**