Active Quantitative Equity

Where Equity Investors May Find Opportunity in Bank Stocks

- Rising interest rates are accelerating earnings growth among US banks, generating attractive valuations as investor sentiment improves.
- Valuations are even more favorable among Chinese banks, where fears of widespread instability in the banking system have so far failed to materialize.

Olivia Engel, CFA
Chief Investment Officer
Active Quantitative Equity

In our last commentary, we focused on health care as an important sector that we favor across global equity markets. This month, we're focusing on another segment that we rate highly in terms of expected return: banks.

In the low interest-rate environment that followed the global financial crisis, financial firms have experienced lackluster earnings. With all the buzz about high-growth stocks in technology and health care, and about the impact of trade tariffs on manufactured goods, it could be easy for investors to overlook financial stocks. But we believe that the financial sector offers attractive opportunities for equity investors. In this commentary, we'll concentrate our attention on the opportunities we see among US and Chinese banks.

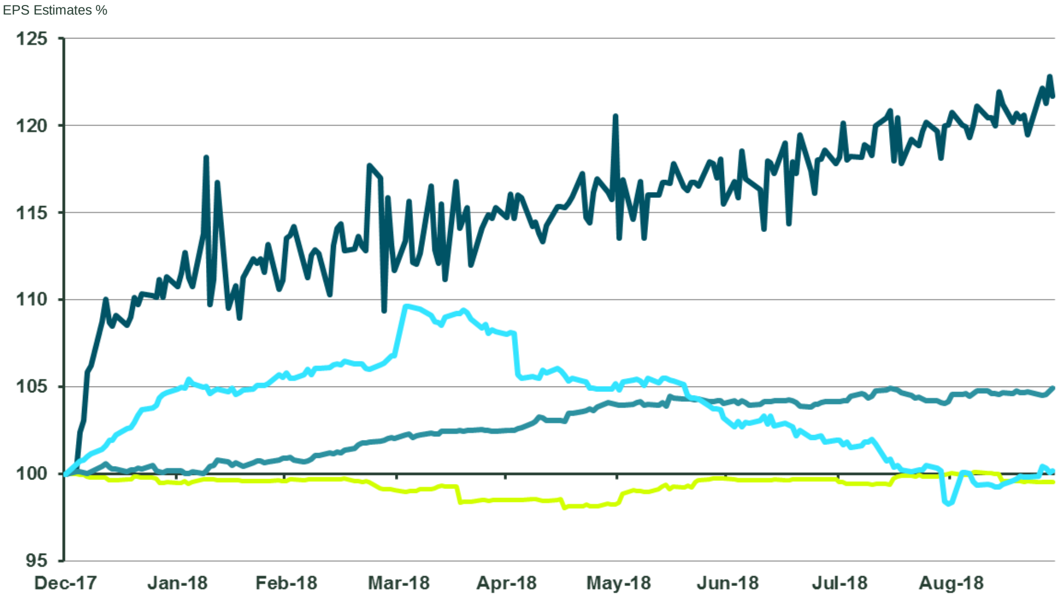
US Banks

So far in 2018, improving net interest margins – driven, in turn, by rising interest rates – are accelerating growth in forward earnings estimates and in trailing earnings among US banks. *(See Figure 1.)* The situation is quite different in Europe, Japan and emerging markets, where earnings growth is decelerating.[1]

CFA® is a trademark of the CFA Institute

[1] In Europe, earnings-per-share (EPS) has grown only 4% so far this year; Japanese and emerging market banks have experienced virtually no earnings growth in 2018.

Figure 1. **Forward earnings estimates are accelerating among US banks.**



Source: Bloomberg Finance L.P. As measured using MSCI Banks indices for US, Japan, Europe and emerging markets.

Figure 1.

12-month forward earnings-per-share (EPS) estimates for banks in each geographic area, as of 28 September 2018, indexed to base 100 from 29 December 2017 in local currency terms.

Legend

- US Banks
- Japan Banks
- Europe Banks
- Emerging Markets Banks

Because stock-price moves have not matched this earnings growth, price-to-earnings (P/E) multiples have contracted in US banks. This presents a buying opportunity. *(See Figure 2.)*

Figure 2. **Price-to-earnings multiples have contracted among US banks as earnings have grown, presenting a buying opportunity.**

	2017	2018 YTD
Trailing EPS Growth	12%	13%
Forward EPS Growth	17%	22%
Trailing P/E multiple end of period	16	13
Forward P/E multiple end of period	14	11

Source: Bloomberg Finance L.P. As measured by MSCI US Banks Index.

Figure 2.

Earnings-per-share (EPS) growth and price-to-earnings (P/E) multiples for US banks, as of 31 December 2017 and 28 September 2018

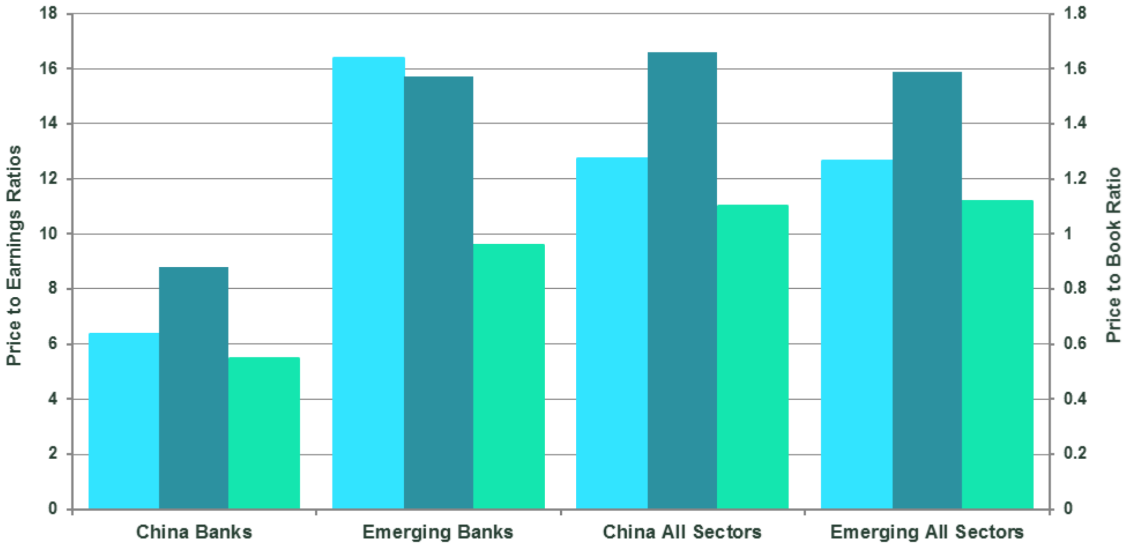
Attractive valuations are just one dimension of the current opportunity in US banks; investor sentiment is another. Our sentiment metrics – which measure, for example, how hedge funds are positioning, how analysts are revising their top- and bottom-line earnings estimates and how price trends have been moving – show that investors are beginning to reward and pay attention to US banks. We also view management's opportunism in managing capital positively for US banks. From a quality perspective, banks in the United States do not score quite as highly in our analysis compared to banks in other regions, because Tier 1 capital ratios[2] in US banks are less strong than ratios elsewhere. The valuation opportunity in the United States, however, outweighs their slightly lower capital ratios.

Chinese banks

Another area where we see opportunity is Chinese banks. Unlike US banks, our measures of investor sentiment are not currently favorable to Chinese banks; however, banks in China present an even more attractive valuation opportunity than US banks. Chinese banks are currently trading on a P/E ratio of around 6 on average, compared with around 13 for Chinese stocks more broadly and for emerging markets.[3] Most Chinese bank stocks are trading at a discount to their book value.

[2] "Tier 1 capital" – the ratio of core equity capital to total risk-weighted assets – is a measure of a bank's capital adequacy and, therefore, its overall financial strength. The tier 1 capital ratio is a cornerstone of the Basel III framework of capital and liquidity standards, which was developed in the aftermath of the financial crisis to improve banks' resilience and reduce systemic risk.
[3] As at September 26 2018, as measured by MSCI Emerging Markets Index, MSCI China Index, and MSCI China Banks Index, sourced from Bloomberg Finance L.P.

Figure 3. **Valuation metrics for banks in China are compelling.**



Source: Bloomberg Finance L.P. as at 28 September 2018, as measured by MSCI Indices in US dollar terms.

Figure 3.

Trailing and forward earnings and book-value price multiples, as of 28 September 2018

Legend

- Price to Earnings
- Price to Book
- Price to Forward Earnings

Why are banks in China apparently undervalued? Chinese banks have been out of favor for many years, with investor concern centering on the potential for non-performing loans, reportedly bad lending practices, and the high overall leverage in China's financial system. Despite these fears, the Chinese government seems to have sufficient liquidity and a big-enough regulatory toolbox to bail out any pockets of instability. Annual GDP growth in China is currently expected to continue to hover around 6%, which also tends to support the banking sector. Chinese banks are generating a return on equity (ROE) as high as any other segment in the emerging markets (around 13% on average).4 ROE among Chinese banks has remained steady, in contrast with other emerging market segments, where banks' ROE has been dropping since July. While investor sentiment is poor vis-à-vis Chinese banks, earnings forecasts are starting to turn upward as of Q3 2018. We believe that the resulting valuation gap among Chinese banks – especially when viewed together with favorable quality attributes in this segment – presents a margin of safety for investors. Nonetheless, we are keeping an eye on our risk factors for any emerging signs of weakness in the sector.

The bottom line

We believe that banks in both the United States and in China present opportunities for investors. A diversified exposure to highly ranked stocks in these segments is worth investigating.

Glossary

Earnings per Share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Earnings Growth is the annual rate of EPS growth

Price to Earnings is the ratio of a company's stock price to the company's earnings per share.

Price to Book is the ratio used to compare a company's current market price to its book value

Return on Equity (ROE) is a ratio that measures profitability of a business in relation to the book value of shareholder equity

Growth stock A company that in anticipated to grow at a rate above the average for the market, rather than yield high income.

Value stock A company with solid fundamentals (e.g., dividends, earnings and sales) that tends to trade at a lower price than its peers.

[4] As of 26 September 2018, as measured by MSCI Emerging Markets Index, MSCI China Index, and MSCI China Banks Index, sourced from Bloomberg Finance L.P.

Marketing communication

State Street Global Advisors Worldwide Entities

Australia: State Street Global Advisors, Australia, Limited (ABN 42 003 914 225) is the holder of an Australian Financial Services Licence (AFSL Number 238276). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240-7600. F: +612 9240-7611. **Belgium**: State Street Global Advisors Belgium, Chaussée de La Hulpe 120, 1000 Brussels, Belgium. T: 32 2 663 2036. F: 32 2 672 2077. SSGA Belgium is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Canada**: State Street Global Advisors, Ltd., 770 Sherbrooke Street West, Suite 1200 Montreal, Quebec, H3A 1G1, T: +514 282 2400 and 30 Adelaide Street East Suite 500, Toronto, Ontario M5C 3G6. T: +647 775 5900. **Dubai**: State Street Bank and Trust Company (Representative Office), Boulevard Plaza 1, 17th Floor, Office 1703 Near Dubai Mall & Burj Khalifa, P.O Box 26838, Dubai, United Arab Emirates. T: +971 (0)4-4372800. F: +971 (0)4-4372818. **France**: State Street Global Advisors Ireland Limited, Paris branch is a branch of State Street Global Advisors Ireland Limited, registered in Ireland with company number 145221, authorised and regulated by the Central Bank of Ireland, and whose registered office is at 78 Sir John Rogerson's Quay, Dublin 2. State Street Global Advisors Ireland Limited, Paris Branch, is registered in France with company number RCS Nanterre 832 734 602 and whose office is at Immeuble Défense Plaza, 23-25 rue Delarivière-Lefoullon, 92064 Paris La Défense Cedex, France. T: (+33) 1 44 45 40 00. F: (+33) 1 44 45 41 92. **Germany**: State Street Global Advisors GmbH, Brienner Strasse 59, D-80333 Munich. Authorised and regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). Registered with the Register of Commerce Munich HRB 121381. T: +49 (0)89-55878-400. F: +49 (0)89-55878-440. **Hong Kong**: State Street Global Advisors Asia Limited, 68/F, Two International Finance Centre, 8 Finance Street, Central, Hong Kong. T: +852 2103-0288. F: +852 2103-0200. **Ireland**: State Street Global Advisors Ireland Limited is regulated by the Central Bank of Ireland. Registered office address 78 Sir John Rogerson's Quay, Dublin 2. Registered Number: 145221. T: +353 (0)1 776 3000. F: +353 (0)1 776 3300. **Italy**: State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano) is a branch of State Street Global Advisors Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), with a capital of GBP 62'350'000.00, and whose registered office is at 20 Churchill Place, London E14 5HJ. State Street Global Advisors Limited, Milan Branch (Sede Secondaria di Milano), is registered in Italy with company number 06353340968 - R.E.A. 1887090 and VAT number 06353340968 and whose office is at Via dei Bossi, 4 - 20121 Milano, Italy. T: 39 02 32066 100. F: 39 02 32066 155. **Japan**: State Street Global Advisors (Japan) Co., Ltd., Toranomon Hills Mori Tower 25F 1-23-1 Toranomon, Minato-ku, Tokyo 105-6325 Japan. T: +81-3-4530-7380. Financial Instruments Business Operator, Kanto Local Financial Bureau (Kinsho #345), Membership: Japan Investment Advisers Association, The Investment Trust Association, Japan, Japan Securities Dealers' Association. **Netherlands**: State Street Global Advisors Netherlands, Apollo Building, 7th floor Herikerbergweg 29 1101 CN Amsterdam, Netherlands. T: +31 20 7181701. SSGA Netherlands is a branch office of State Street Global Advisors Limited. State Street Global Advisors Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Singapore**: State Street Global Advisors Singapore Limited, 168, Robinson Road, #33-01 Capital Tower, Singapore 068912 (Company Reg. No: 200002719D, regulated by the Monetary Authority of Singapore). T: +65 6826-7555. F: +65 6826-7501. **Switzerland**: State Street Global Advisors AG, Beethovenstr. 19, CH-8027 Zurich. Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-105.078.458. T: +41 (0)44 245 70 00. F: +41 (0)44 245 70 16. **United Kingdom**: State Street Global Advisors Limited. Authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 2509928. VAT No. 5776591 81. Registered office: 20 Churchill Place, Canary Wharf, London, E14 5HJ. T: 020 3395 6000. F: 020 3395 6350. **United States**: State Street Global Advisors, 1 Iron Street, Boston, MA 02210-1641.

For use in Australia. Issued by State Street Global Advisors, Australia, Limited (AFSL Number 238276, ABN 42 003 914 225) ("SSGA Australia"). Registered office: Level 17, 420 George Street, Sydney, NSW 2000, Australia T: +612 9240 7600 Web: ssga.com. This communication is directed at institutional and wholesale clients only. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) are not entitled to rely on this communication.

For use in EMEA. The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the European Communities (Markets in Financial Instruments) Regulations 2007. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information provided does not constitute investment advice as such term is defined under the Markets in Financial Instruments Directive (2004/39/EC) and it should not be relied on as such. This communication is directed at professional clients (this includes eligible counterparties) who are deemed both knowledgeable and experienced in matters relating to investments. The products and services to which this communication relates are only available to such persons and persons of any other description (including retail clients) should not rely on this communication.

For use in Switzerland. The information provided does not constitute investment advice as such term is defined under applicable Swiss regulation and it should not be relied on as such.

Disclosure

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information.

The views expressed are the views of Olivia Engel only through September 30, 2018 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

Investing involves risk including the risk of loss of principal.

Actively managed funds do not seek to replicate the performance of a specified index. Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

The MSCI World Index, MSCI World ex US and the MSCI US Index are trademarks of MSCI Inc. MSCI indices are the exclusive property of MSCI Inc. ("MSCI"). MSCI and the MSCI index names are service mark(s) of MSCI or its affiliates and have been licensed for use for certain purposes by State Street Global Advisors ("SSGA"). The financial securities referred to herein are not sponsored, endorsed, or promoted by MSCI, and MSCI bears no liability with respect to any such financial securities. No purchaser, seller or holder of this product, or any other person or entity, should use or refer to any MSCI trade name, trademark or service mark to sponsor, endorse, market or promote this product without first contacting MSCI to determine whether MSCI's permission is required. Under no circumstances may any person or entity claim any affiliation with MSCI without the prior written permission of MSCI.

All the index performance results referred to are provided exclusively for comparison purposes only. It should not be assumed that they represent the performance of any particular investment.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without SSGA's express written consent

www.ssga.com

©2018 State Street Corporation. All Rights Reserved.

2266082.1.1.GBL.RTL Exp. Date: 09/30/2019