Schwab Sector Views: Financials: Value ... or Value Trap?

By BRAD SORENSEN | APRIL 11, 2019

Key Points

- The flattening—and recent inversion—of the yield curve has helped pressure the financial sector, leading to underperformance over the past year.
- The result is that the sector's valuations appear to be relatively attractive, but perceived value isn't necessarily a reason to invest.
- The financial sector is historically resilient, and many of the surrounding fundamentals look good to us. This provides potential opportunity, but it likely will require patience.

Schwab Sector Views is our three- to six-month outlook for 11 stock sectors, which represent broad sectors of the economy. It is designed for investors looking for tactical ideas. We typically update our views every two weeks.

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Justified weakness … or investor opportunity?

The financial sector has underperformed over the past year. Within that time period there have been periods of better performance, but none have translated into sustainable gains, at least to this point. We remain at marketperform for the sector and believe that the weakness is providing a potential opportunity for investors.

The financial sector is largely made up of asset gatherers (such as banks) and asset protectors (such as insurance companies). The asset protector portion of the group has actually performed relatively better, just modestly underperforming over the past month. However, the bigger portion of the sector has struggled as the yield curve has narrowed and recently inverted—meaning longer-term yields fell briefly below shorter-term yields.

That's not all that surprising, as asset gatherers historically have made money by paying interest on the assets they gather at short-term rates and lending it out at longer-term rates, pocketing the spread between the two. When that spread narrows, or disappears, that source of revenue is pressured. That pressure has historically had an impact on the financial sector.

Ned Davis Research (NDR) studied the last seven inversions of the six-month and 10-year parts of the curve, and found that the financial sector underperformed in the year leading up to the inversion in five of them. Additionally, NDR noted that the banking industry had its worst-performing periods when the spread between the two was less than 100 basis points (a basis point is one hundredth of one percent, or 0.01%). The recent underperformance has pushed the forward price-to-earnings ratio of the sector down to 11.5, below the 15-year average of 12.5, according to Strategas Research. Meanwhile, the PEG (price-to-earnings-to-growth) ratio of 0.8 is close to the lowest level seen since 1996.

Not all is gloomy

But just as the yield curve inversion doesn't mean that a recession is necessarily imminent for the overall U.S. economy (see Liz Ann Sonders' article "Blue, Red and Grey: Yield Curve Inversions" for more), the yield curve doesn't tell the whole story for the financial sector.

According to Yardeni Research, as a result of recent weakness, the financial sector is now at its lowest share of the S&P 500® since at least 1970—yet I don't believe that the sector's importance to the American and global economies has weakened to the point of justifying that degradation. It also appears to me that the financial sector continues to be haunted by the last recession and implosion of the housing market around 2008, with investors hesitant to get back into a group that was so damaged during that period.

However, the sector appears to be a much different one at this point, with much less risk. For one thing, the tier-1 capital ratio for U.S. banks is now close to 14%, up from below 5% in the lead-up to the 2008 crisis, according to the Federal Reserve Bank of New York and as reported by BCA Research. Additionally, bank loans now make up about 18% of nonfinancial corporate debt—down from 40% in 1980—while the share of leveraged loans held by banks has declined to less than 10% from about 25% a decade ago.

Both of these indicate to me that the amount of risk in the system is greatly reduced. In fact, the Federal Reserve appears to agree, as it recently loosened its so-called “stress tests” by getting rid of the “qualitative objection” (relating to management of operational failures), according to Reuters. Additionally, the financial sector appears to be much less reliant on “spread income” now than in the past, with fee revenue moving from just above 10% of total revenue in 1985 to between 35% to 40% the last 10 years (Cornerstone Macro).

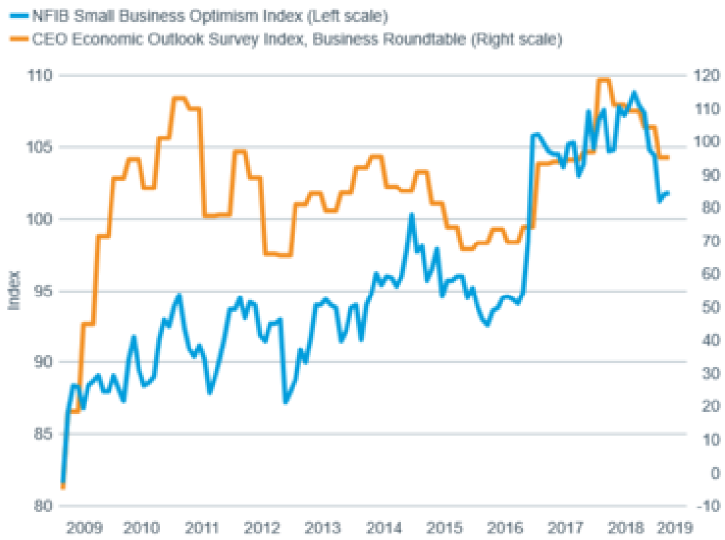
Another major factor that I believe is important to consider is where economic growth is headed. NDR has a study that shows that a rising Citigroup Economic Surprise Index has historically been positive for the financial sector, and we’ve seen signs that the index may be bottoming and could be about to rebound.

Surprise Index may be about to turn higher

Source: Charles Schwab, Macrobond, Citigroup as of 4/11/2019

And while business confidence has fallen a bit recently, U.S. bank loan issuance has increased as of late—rising 5.8% year-over-year (y/y) in the week ended March 29th (ISI Evercore).

Business confidence has weakened…



Source: Charles Schwab, Macrobond, National Federation of Independent Business, Business Roundtable as of 4/11/2019

...but bank loans have increased.

Source: Charles Schwab, Macrobond, Federal Reserve as of 4/11/2019

And despite the yield curve issues, and perhaps a sign that the financial sector isn't a one-trick pony, First Call earnings estimates for the financial sector are for 3% y/y growth in the first quarter, one of only four sectors that are currently projected to post y/y gains.

Finally, the regulatory environment, which we've talked about before, appears to us to be firmly in the tailwind camp at this point. In fact, despite the rancor and division in Washington, our own Washington insider Michael Townsend is reporting that a key House committee recently passed a bill that should expand the availability and flexibility of 401(k) accounts, and has a fairly good chance of becoming law (although nothing is assured). This stands to expand access and the attractiveness of 401(k) accounts—which we believe would be a benefit to at least portions of the financial sector.

So what does it mean?

The financial sector has been volatile and vulnerable to shifts in the yield curve. That isn't likely to change in the near term, in my view, and we remain at marketperform. For those investors who are underinvested in the sector, I suggest this is a decent time to add to positions. Meanwhile, those investors with patience and a strong stomach could benefit in the longer term, as this appears to be a fairly attractive entry point to the group.

Schwab Sector Views: Our current outlook

Sector	Schwab Sector View	Date of last change to Schwab Sector View	Share of the S&P 500 Index	Year-to-date total return as of 4/10/19
Communications	Underperform	09/28/2018	10%	17.88%
Consumer discretionary	Marketperform	07/17/2014	10%	19.43%
Consumer staples	Marketperform	05/07/2015	7%	11.55%
Energy	Marketperform	11/20/2014	6%	18.58%
Financials	Marketperform	08/16/2018	13%	11.85%
Health care	Outperform	01/26/2017	15%	6.61%
Industrials	Marketperform	01/29/2015	10%	18.10%
Information technology	Marketperform	08/16/2018	20%	23.71%
Materials	Marketperform	01/31/2013	3%	14.10%
Real estate	Marketperform	08/16/2018	3%	18.63%
Utilities	Marketperform	08/16/2018	3%	9.74%
S&P 500® Index (Large Cap)				15.89%

Source: Schwab Center for Financial Research and Standard and Poor's as of 3/31/19.

Clients can use the Portfolio Checkup tool to help ascertain and manage sector allocations.

What is Schwab Sector Views?

Schwab Sector Views is our three- to six-month outlook for 11 stock market sectors, which are based on the 11 broad sectors of the economy.

The sectors we analyze are from the widely recognized Global Industry Classification Standard (GICS) groupings. After a review of risks and opportunities, we give each stock sector one of the following ratings:

- Outperform: Likely to perform better than the rest of the market.
- Underperform: Likely to perform worse than the rest of the market.
- Marketperform: Likely to track the broad market.

How should I use Schwab Sector Views?

Investors should generally be well-diversified across all stock market sectors. You can use the Standard & Poor's 500 allocations to each sector, listed in the chart above, as a guideline.

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The S&P 500 Index is a market-capitalization-weighted index comprising 500 widely traded stocks chosen for market size, liquidity and industry group representation.

The S&P 500 Financials Index comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

The Citibank Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means that the data releases have been stronger than expected and a negative reading means that the data releases have been worse than expected.

The NFIB (National Federation of Independent Business) Small Business Optimism Survey which is based on the responses of 740 randomly sampled small businesses in NFIB’s membership, surveyed monthly.

The Business Roundtable CEO Economic Outlook Index is based on a survey conducted quarterly of member CEOs’ plans for hiring and capital spending, and their expectations for sales, over the next six months.

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