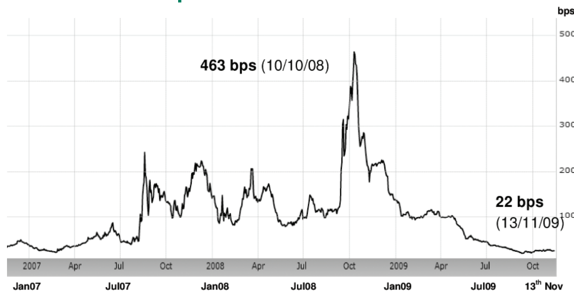
FINANCIAL SECTOR

Ronny Analyses The Prospect For The Sector

The subprime mortgage crisis in 2007 evolved into a global financial crisis in 2008. Over its course, giant financial institutions such as Bear Stearns and Lehman Brothers were brought to their knees. As a result, risk aversion heightened and capital markets became frozen. Exhibit 1 illustrates this point. The TED spread – an indicator of perceived credit risk in the general economy – spiked to a record high of 463 basis points (bps) in October 2008, about one month after Lehman failed. Banks stopped lending to each other and the global financial system was on the verge of collapsing. The crisis affected the real economy adversely. The global economy was sent into recession and the fear of revisiting the 1929 Great Depression appeared on everybody's mind.

Exhibit 1: TED Spread



Source: Bloomberg (as of 13th November 2009)

Fortunately, another Great Depression did not materialize. Co-ordinated efforts by governments around the world prevented that. The various governments moved to guarantee deposits, flush the economy with cash and recapitalize the banks. Now, the credit market has thawed. Recently, the TED spread has narrowed to the pre-crisis level of 22 bps.

The MSCI World Financials Index plunged by almost 80% from its peak in May 2007 to its trough in March 2009 (Exhibit 2). This has disheartened many investors. However, with the co-ordinated efforts by the various governments, the index has rallied by 138%, outperforming the 68% rise in the MSCI World Index. With the spectacular rally, questions have been raised as to whether we should stay invested in this sector and if this is a good time for those looking to invest.

Exhibit 2: Performance of MSCI World Financials index

In this article, we will discuss the outlook of the sector in the various regions: US, Europe, Japan and Asia Pacific ex-Japan (APEJ). We will then focus on valuations of the sector. As in our usual prudent demeanor, we will highlight the potential risks of the sector. Finally, we will make our conclusion based on the facts that have been discussed.

Outlook over the next 12 months

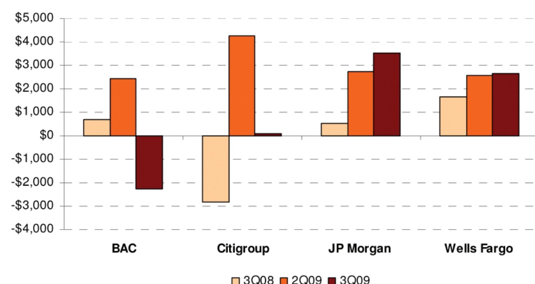
(1) US and Europe

(i) Net revenues of the banks are improving

The profitability outlook of the banks is improving. Many of the banks have registered year-on-year (yoy) growth in net revenues and net income. Banks such as Bank of America (BAC), JP Morgan, Wells Fargo, and BNP Paribas have chalked up higher revenue, in part due to their acquisitions last year. In the US, Wells Fargo and JP Morgan recorded growth of 116.5% yoy and 80.6% yoy respectively in their net revenue in the latest quarter. In Europe, as a result of its acquisition of Fortis Bank, BNP Paribas recorded 40% yoy increase in its net revenue in the same period.

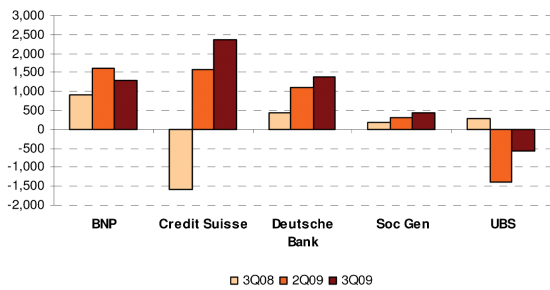
Exhibit 3 and 4 showed the earnings of the major banks in the US and Europe respectively. Majority of the banks have recorded improved profitability since last year. While Citigroup returned to profitability in the third quarter, its net income declined from the previous quarter due to the one-time US$11.1 billion pre-tax gain on the sale of Smith Barney in the previous quarter. Similarly, Bank of America's earlier quarterly net income was also boosted by the US$5.7 billion pre-tax gain on the sale of its stake in China Construction Bank. UBS continued to report losses due to significant accounting charge of CHF2.2 billion on tightening credit spread of its own debts, loss on UBS Pactual sale, and conversion of mandatory convertible notes issued to the Swiss Confederation.

Exhibit 3: Earnings attributable to shareholders (in USD)



Source: Companies' third quarter earnings releases

Exhibit 4: Earnings attributable to shareholders (in respective currencies)



Source: Companies' third quarter earnings releases
Note: Figures for BNP Paribas, Soc Gen, and Deutsche Bank are in €mil, while for CS and UBS are in Swiss francs.

In the US, net interest income of the major banks spiked yoy in the third quarter, reflecting the effect of the acquisitions. The effects on the net interest margin (NIM) are mixed. JP Morgan benefited from the wider loan and deposit spreads of Washington Mutual while Wells Fargo posted decline in NIM on its acquisition of Wachovia. However, the NIM of the two banks have begun to pick up in the latest quarter, after declining last year since the Federal Reserve cut its policy rate aggressively. NIM of JP Morgan and Wells Fargo rose by 4bps and 6bps to 3% and 4.36% respectively. However, across the board, the banks have experienced reduction in loans on quarter-on-quarter (qoq) basis the latest quarter. Total deposits at the banks except that of Wells Fargo increased slightly. As a result of the reduced loans and increased deposits, loan-to-deposit ratios (LDR) of the banks have declined. Including the effect of the acquisition of Fortis Bank, BNP Paribas's loans increased yoy while deposits fell yoy. On the other hand, Soc Gen saw its deposits base growing slightly faster than its loans on yoy terms. Net interest income for Deutsche Bank has also picked up. It improved by 13.4% qoq and 2.3% yoy.

We are also seeing similar trends in the investment banking industry. Goldman Sachs saw its total revenue double over the year. Net revenue of Morgan Stanley fell by half yoy due mainly to a gain of US$9.7 billion on its sales and trading revenue on debt-related credit spreads recorded in the third quarter last year versus a US$0.9 billion loss this year. Excluding this, it posted a 15.2% yoy growth in net revenue. Other banks such as Credit Suisse, JP Morgan and Deutsche Bank have also reported strong yoy growth in their investment banking revenues.

The improvement in the investment banking industry was primarily due to stellar performance in the trading of Fixed Income, Currency and Commodities (FICC). It is worth noting that other segments such as equity & debt underwriting, advisory and asset management did not perform as well. In the third quarter, FICC revenue at Goldman Sachs, JP Morgan and Deutsche Bank all rose signficantly by 270% yoy, 515% yoy, and 138% yoy respectvely. Credit Suisse reversed its CHF1.1 billion loss in the third quarter last year to CHF2.5 billion gain. These exceptional results reflected the strong performances from credit products and mortgages as credit spreads narrowed after widening to an unprecendented level last year. However, on a qoq basis, with the exception of JP Morgan, FICC revenue for the above mentioned banks declined due to lower market activity and a seasonal slowdown in the interest rate business.

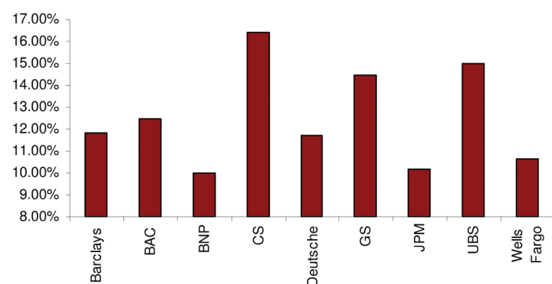
Revenue from equity underwriting improved substantially for the investment banks, reflecting an increase in industry-wide initial public offerings (IPO). In contrast, revenue from advisory was a major drag. It plunged yoy on reduced Mergers & Acquisitions (M&A) activities.

(ii) Financial institutions leveraging on buoyant capital markets to raise capital

Major banks have also raised capital to strengthen their balance sheets. In the US, the major banks were required to increase their capital to the desired levels as indicated by the stress tests done by the US Treasury and Federal Reserve. In Europe, the banks have also raised capital with the aim to repay the governments' aids offered during the crisis. Some of the latest capital raisings include those by BNP Paribas and Soc Gen which raised €4.2 billion and €4.8 billion respectively. Lloyds Banking Group is also raising £13.5 billion after the rights issue proposal was approved by the shareholders.

After a series of capital raising exercises by the banks, their balance sheets are now stronger than before. Exhibit 5 shows the Tier 1 capital ratio for the banks. Tier 1 ratios for most of the banks are now above 6%, a minimum requirement set by the US Federal Deposit Insurance Corporation (FDIC).

Exhibit 5: Tier 1 ratio as of September 09



Source: Companies' earnings releases

In the Insurance sector, the companies are also raising capital. AXA has recently announced plan to raise €2 billion in a rights issue to finance its acquisitions in high growth markets like those in Central and Eastern Europe.

(iii) More consolidation from divestment of non-core assets

Many financial institutions are returning to their main core businesses as opposed to diversifying across many businesses. This was also partly due to the need to beef up their capital bases after having been weakened by the huge write-downs they have taken. For instance, Citigroup has been gradually divesting its non-core businesses, with Nikko Asset Management and Nikko Cordial Securities being sold to Sumitomo Trust and Sumitomo Mitsui Banking Corporation (SMBC) – a subsidiary of Sumitomo Mitsui Financial Group (SMFG) – respectively. In Europe, ING is restructuring its business. It sold its US reinsurance business to RGA, its Asian Private Banking business to OCBC and Swiss Private Banking business to Julius Baer. RBS, in a bid to raise capital, sold part of its Asian banking operations to ANZ in August.

(iv) Strong operating profits for the European insurance companies

Insurance companies are turning profitable again on the improving

conditions in the capital markets. In addition, gross premiums earned by the companies have also improved. For instance, in the latest quarterly results release, Allianz reported a 3.9% yoy increase in gross premium earned. Life/Health insurance segment recovered strongly and was a major contributor to the improvement of the overall result. As a result of strong rebound in the Life / Health insurance segment, net income reached €1.3 billion compared to €2 billion loss in the same quarter last year.

The insurance division of ING became profitable again with net income of €311 million in the latest quarter as compared to a loss of €350 million in the third quarter last year. Its strong performance was attributed to the write-back in its investments amounting to €240 million as compared to €942 million of write-downs last year. In spite of a strong premiums earned in Europe, gross premium declined by 16% yoy attributed to lower sales recorded in the US and Asia Pacific.

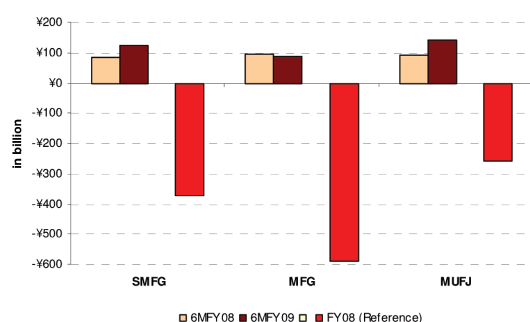
In the latest quarter, AXA posted a 2.3% yoy decline in its total revenue. Revenue from the Insurance segment recorded growth of 0.9% yoy.

(2) Japan

(i) Improving profitability on the back of falling provision for credit losses

Exhibit 6 shows that Japanese banks returned to profitability in the first half of FY09 (the fiscal year ends in March) after chalking up huge losses in the second half of FY08. Net interest income of the banks rose while NIM continued its decline since last year. We do not expect the margin to expand given that Japan is still in deflationary phase. Major banks with the exception of SMFG have set aside higher provision for credit losses in the first half of FY09.

Exhibit 6: Net income attributable to shareholders (in JPY)



Source: Companies' third quarter earnings releases

SMFG recorded net income of ¥123.5 billion in the first half of FY09, an increase of 48.4% yoy. It reversed a ¥373.5 billion loss recorded for the FY08 ended 31st March 09. Net interest income rose slightly by 0.7% yoy to ¥683 billion. NIM fell by 13 bps to 1.62% and it has been on decline since Bank of Japan cut its policy rate by 40 bps at the end of last year. Provision for credit losses declined to ¥268.5 billion on a consolidated basis from ¥302.2 billion last year. This was mainly attributed to the improvement in the quality of loan books at SMBC.

Even though SMFG has posted improved results for the first half of FY09, it revised down its projections made earlier this year. SMFG cited the increase in provision for credit losses of certain subsidiaries and equity method affiliates as the reason behind the downgrades. Net income was projected to be the same while operating profit was projected to be ¥20 billion lower, estimated at ¥490 billion.

Mizuho Financial Group (MFG), on the other hand, posted a decline in its net income. Net income fell by 7.1% yoy to ¥87.8 billion in the first half of FY09. On a positive note, this was a reverse of the ¥588.8 billion loss recorded for its FY08. Core profits improved to ¥1 trillion, helped by increase in trading income and drop in interest expenses as the deposit rates fell. NIM fell slightly by 3 bps yoy to 1.41%. Total provision for credit losses rose to ¥161.7 billion, an increase of ¥18.9 billion from the same period last year.

Mitsubishi UFJ Financial Group (MUFJ) registered a 53.2% yoy increase in net income to ¥141 billion for the first half of FY09. This strong performance was attributed to its increase in revenue and gains on their equity securities. Net interest income rose by 14.9% yoy despite a 14 bps yoy drop in NIM to 1.45% in the quarter. MUFJ set higher provision for credit losses to ¥444.2 billion, a 32.6% yoy rise. The sharp rise was primarily attributed to their overseas subsidiaries and the consolidation of its new subsidiary, ACOM, whereas their domestic subsidiaries reported decrease in credit costs.

(ii) Write-backs on their corporate shareholdings are likely

Japanese banks are likely to write back the value of their corporate shareholdings in view of the stock market recovery in Japan. The corporate shareholdings mainly reflect the cross-shareholdings with key borrowers and related investors. Daiwa, in its latest report on the sector, analyzed the relationship between the TOPIX level and unrealized gains/losses on corporate shareholdings of the major banks. According to Daiwa, if TOPIX were to reach 1,100 by 2010, the banks stand to post an unrealized gain of ¥3.7 trillion from end FY08 level.

(iii) Major Banks have raised capital

As a result of the falling stock market early this year, the Japanese banks had to face significant write-downs on their corporate shareholdings. Thus, similar to their peers in the US and Europe, they have also raised further capital to strengthen their balance sheets. SMFG and MFG have each raised ¥848 billion and ¥526.4 billion respectively this year. MUFJ has also recently announced plan to raise another ¥1 trillion in addition to the ¥398.6 billion raised late last year.

(3) Asia Pacific ex-Japan (APEJ)

(i) Banks remain profitable

Banks in the region remain fundamentally strong. In Singapore, the third quarter results of the three banks (DBS, UOB, and OCBC) are showing signs of optimism. With the exception of OCBC, earnings of the other two local banks rose qoq on loan growth and stabilizing NIM. For instance, net income of DBS rose by 2% qoq to S$563 million due to housing loan growth.

NIM remained stable and fee income rose to the highest level in seven quarters. Furthermore, non-performing loans (NPL) remained stable. Similarly, UOB has also posted a 2% qoq rise in its net income. In contrast, OCBC posted a 3.3% qoq decrease in its earnings. We expect the three banks to benefit from improving economic environment in the region over the next 12 months.

In China, the earnings of the banks were supported by lower provision for credit losses. The year-to-date loan growth in China has been exceptional as the government flushed the economy with liquidity to prop up the economy. NIM has also declined substantially on lower benchmark interest rate. In the latest quarter, Bank of China (BOC) posted an 18.8% yoy increase in net income. Net interest income was relatively unchanged as strong loan growth offset decline in NIM. NIM fell to 2.03%, a decrease of 65 bps compared with the same period last year. To further illustrate the exceptional loan growth in China, BOC has recorded 44% increase in its loan year-to-date to the third quarter this year. Provision for credit losses fell by 82% yoy. Similarly, in its latest quarterly report, Industrial and Commercial Bank of China (ICBC) posted a 19.1% yoy growth in net income on the back of strong loan growth. Provision for credit losses was also much lower than last year. Net interest income for ICBC fell by 4.3% yoy.

(ii) Expansion of NIM

NIM of the banks is expected to expand as policy rates in the region are forecasted to rise over the next 12 months on the back of economic recovery in the region. According to a study done by Credit Suisse, NIM of the banks in APEJ typically widen on rising policy rates environment as loans generally get repriced faster than deposits. The expansion of the margins is expected to be the greatest in South Korea (+32 bps), followed by China (+24 bps), Thailand (+24 bps) and Taiwan (+24 bps).

Stock Market Outlook

Valuations of the financial sector are still attractive (Exhibit 7). The price-to-earnings ratio (P/E) and dividend yield (DY) are in-line with those of the MSCI World Index. In terms of price-to-book (P/B), it is trading at 33% discount to that of the MSCI World. Although the trailing P/E of the sector is slightly higher relative to that of MSCI World, this is due to depressed earnings as financial institutions incurred huge losses on writedowns over the past year. Looking at the components of the MSCI World Financial Index (Exhibit 8), we note that insurance companies are relatively cheaper in terms of P/E and D/Y.

Exhibit 7: Valuations of world financial sector

As of 30th Oct	P/E			P/B	DY (%)
	08	09E	10E	09E	09E
MSCI World	14.4	17.0	13.4	1.8	2.6
MSCI World Financials	22.1	17.8	13.0	1.2	2.6

Source: Citigroup, MSCI

Exhibit 8: Components of MSCI World Financial Index

As of 30th Oct	P/E			P/B	DY (%)
	08	09E	10E	09E	09E
Banks	15.7	18.8	14.1	1.3	2.8
Diversified Fin	-77.9	23.7	13.1	1.1	1.4
Insurance	14.8	11.5	9.5	1.2	3

Source: Citigroup, MSCI

At the regional level, European financial sector is still cheap. Its dividend yield ranges from 3.22% for the banking sector to 4.91% for the insurance sector. Furthermore, the insurance sector is also trading at single-digit P/Es for 2010 and 2011. In contrast, the valuations of the APEJ financial sector look comparatively more expensive than that of Europe.

As the global economy recovers, analysts have also begun to revise upwards their expected earnings in the next 12 months. According to a study done by Citigroup, there is a strong correlation between sectors' performances and their respective 12-month forward earnings. Among the sectors, it recommends buying into Financials given that the sector is still trading at a cheap forward PE multiple of 13x despite having rallied significantly from its March low. Moreover, historically, financials sector tend to outperform when the economy starts to exit out of recession.

Risks

Despite the improving outlook, there are still negative headwinds facing the sector. Some of the potential risks that may affect the outlook of the sector include i) potential worsening commercial real estate (CRE) outlook, ii) further write-downs, iii) potential rise in NPL of Chinese banks, iv) tighter regulation and higher capital requirements, and v) unexpected events.

(i) Commercial Real Estate (CRE)

The performance of the CRE sector may be a concern. Loose monetary policy in the pre-crisis years has propped up real estate prices to record levels. Refinancing the loans has become an issue as real estate prices tumbled. Some of the owners have defaulted on their loans and banks had to write down on their loans. In the US, 115 regional banks have failed year-to-date mainly due to their high CRE exposures. If the outlook of CRE were to deteriorate further, the large banks would have to take further write-downs on their loan books. The Federal Reserve and IMF have also voiced their concerns on the CRE sector lately. IMF highlighted that European countries such as UK, Ireland and Spain that have seen their real estate prices decline substantially are of particular concern.

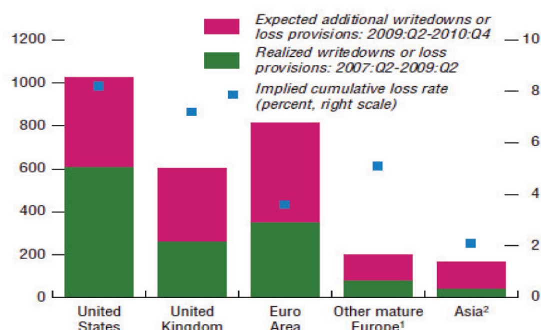
The latest Senior Loan Officer Opinion survey on Bank Lending practices in the US showed that almost 75% of the respondents indicated that they had extended the maturities of more than one-fourth of their CRE loans that were scheduled to mature from the beginning of the year. Given that real estate prices have declined significantly since these loans were first made, extending the maturities may only be delaying the eventual defaults from poorer quality loans. This poses a huge risk as the bad quality loans may default.

(ii) Further write-downs to continue

Write-downs on illiquid assets and provisions for credit losses have significantly reduced the profitability of the banks. We have seen stabilization in the provisions of credit losses by the major banks in the world though they remained elevated as compared to last year.

The IMF, in its latest Global Financial Stability Report, estimated that total global write-downs by banks and other financial institutions from the second quarter of 2007 to the end of 2010 to be US$3.4 trillion, a US$600 billion decrease from their earlier projection. This was owing to improvement in credit markets due to the policy actions by governments around the world. Specifically, for banks, total write-downs are estimated to be US$2.8 trillion, of which US$1.3 trillion has been written off through the first half of 2009. Exhibit 9 shows the regional breakdown of total write-downs by banks.

Exhibit 9: Realized and expected write-downs or loss provisions for banks by region
(in billions of U.S. dollars unless otherwise shown)



Source: IMF staff estimates.
[1]Includes Denmark, Iceland, Norway, Sweden, and Switzerland.
[2]Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

We expect the rate of the write-downs by the banks to continue in the next 12 months. There has also been concern that European banks will face more write-downs than the US banks as the former has not been very aggressive in making the write-downs.

(iii) Potential rise in NPL of Chinese banks

We are concerned over the Chinese banks given that so far their earnings have been supported by a temporary huge increase in loan growth. There have been reports that new loans are being channeled into the real estate and stock markets. Prices of both sectors have risen substantially since the beginning of the year. Should the rallies in both areas fade out, loans used to fuel the rallies may become NPLs and the banks will have to write down on those loans.

(iv) Tighter regulation and higher capital requirements

Governments around the world are also planning to impose tighter regulations. Banks will be subjected to closer supervision by the respective authorities in the various countries. In their latest Communiqué, Finance Ministers and Central Bank Governors of the G-20 countries agreed to ensure full, timely and consistent implementation of the proposed reforms. Some of them include 1) the need for the Basel Committee to develop stronger standards by end-2010 and full implementation by end -2012, 2) the urgency for all financial firms to adopt sound compensation policies that are aligned with long-term value creation, and 3) move to minimize the impacts of default by systematically important institutions. As of now, some of these reforms have already been implemented or are undergoing discussion. The pending reforms could potentially create an uncertain and hostile environment for the banks to operate.

The Basel Committee is now drafting new measures to strengthen the regulatory capital framework. It aims to introduce new standards to promote the build-up of capital buffers that can be drawn down during periods of stress, and strengthen the quality of bank capital. The details of the proposed plan will be available soon.

In light of this, IMF and Goldman Sachs analyzed how much additional capital the banks would need to raise in a stricter capital requirement environment. According to a study by IMF, US and European banks do not need to raise any new capital to reach Tier 1 ratio of 6% by 2010 after factoring in the expected write-downs and earnings over the period. However, European banks are projected to need to raise US$150 billion and US$380 billion to reach Tier 1 ratio of 8% and 10% respectively by 2010. Higher capital requirements will mean less capital will be available for loans and hence a reduced return on equity for the banks.

Daiwa Securities expected the capital adequacy and Tier 1 capital ratios for the major Japanese banks at end-September 2009 to improve and should average around 12.9% and 9% respectively. The improvement is on the back of an absence or narrowing of unrealized losses on securities. However, with financial regulators moving to tighten capital adequacy regulations globally, the emphasis could be on core Tier 1 ratio which consists of only equity and retained earnings. As a result, Japanese banks that are weak in their core Tier 1, might need to raise further capital in the form of share issuance which could cause meaningful share dilution and this could be a major negative to their shares performances in the short term. However, in the longer run, the improvement in the quality of their capital will help to strengthen their balance sheets and provide greater buffer in the event of further stress in the financial system.

(v) Unexpected events

The unexpected announcement by the Dubai World to postpone debt repayments of all of its debts including those owed by its property unit, Nakheel, highlighted the risk of investing in the sector. Based on a report by Credit Suisse, UK banks look vulnerable given their relatively high exposure in UAE as compared to their peers. Moreover, such event also showed that loans made to government-linked companies are not without risk as the Dubai government announced that it will not guarantee the debt of Dubai World.

Conclusion

To summarize, the banks have returned to profitability again. Their balance sheets are now much stronger owing to a series of capital raising exercises. In addition, insurance companies

are also in the black again, owing to increases in premium earned and write-back on their investments. Despite that, we have highlighted the potential risks faced by the sector such as I) potential worsening CRE outlook, II) further write-downs, III) potential rise in NPL of Chinese banks, IV) tighter regulation and higher capital requirements, and V) unexpected events. On relative valuation, the financial sector is cheap relative to the MSCI World Index. Within the sub-sector, Insurance sector looks attractive. At this point, financial sector in APEJ does not seem attractive.

In view of this, we remain positive on the sector given the improving outlook. Historically, the financial sector tends to outperform on economic recovery. Proposed reforms are beneficial to the sector in the long run. Reforms on the compensation packages help to discourage the management to take on excessive risk. Similarly, stricter capital requirements reduce the management's ability to take on huge risk. Although earnings growth will be slower in the future, this will be compensated by the lower downside risks.

Fund Selection

For exposure to the financial sector, we recommend Fidelity Global Financial Services for cash investment. Exhibit 10 illustrates the performance of the funds. The geographical breakdown and sectors breakdown can be seen in Exhibit 11.

Exhibit 10: Performance of Fidelity Global Financial Services Fund

	Annualized Bid-to-Bid price returns (SGD)				Ann.
	1-mth	6-mth	1-yr	3-yr	St. dev
Fidelity Glb Financial Services	0.7%	27.3%	31.4%	-13.3%	26.0%

Source: Fundsupermart (as of 13th November 2009)

Exhibit 11: Geographical and Sectors breakdown of Fidelity Global Financial Services Fund

Fidelity Global Financial Services Fund					
	Geographical breakdown			**Sector breakdown**	
1	US	37.40%	1	Financials	88.70%
2	UK	17.60%	2	Information Technology	3.00%
3	Brazil	7.00%	3	Industrials	2.20%
4	South Africa	5.10%	4	Consumer Discretionary	1.20%
5	Germany	4.70%	5	Cash	4.90%
6	Italy	3.90%			
7	Israel	3.30%			
8	China	2.40%			
9	Others	13.60%			
10	Cash	4.90%			
	Total	**100.00%**		**Total**	**100.0%**

Source: Latest factsheet of Fidelity Global Financial Services fund