Financial Stocks Poised for Potential Growth

Over the past decade the financial sector of the stock market as measured by the S&P 500 index has been the worst performing sector. From 2007 through 2016 the financial sector had a negative annualized return of -.43%. Well below the average sector annualized return of 7% (SPDR, 2016). It is no wonder that this sector underperformed as it was at the epicenter of the financial crisis of 2007-2009. With the ensuing crisis and the market collapse during this time, the Federal Reserve Bank, led at the time by Ben Bernanke pursued an aggressive expansion of money supply through unprecedented programs in order to stabilize the markets and the banking system. It can be debated whether these programs were successful, but the effect on the financial sector, now history, is apparent.

With the beginning of the New Year and a new administration in the White House, the Federal Reserve (FED) has finally embarked on a reversal of sorts by now raising interest rates. Their objective had been to raise the benchmark interest rate earlier but did not have confidence in the growth of the overall economy though their employment mandate had been met. Beginning in December of 2015 with the first increase since 2006 (prior to the financial crisis), the FED raised rates .25% followed by a second increase of the same size in December of 2016 just after the elections and again on March 14, 2017. The anticipation is for two more increases of the same magnitude before year end.

Financial stocks are well positioned because of a number of factors: rising rates, deregulation, and valuation. As the broader markets have risen and valuations have become stretched, financial stocks are trading at lower price to earnings multiples PE Ratios (Gara, 2017) than the rest of the market. Some of this is the spillover from their lost decade of growth. But as interest rates rise, banks benefit as their profits increase as a direct result. For instance, Bank of America is estimated to earn $5.3 Billion over the next 12 months as rates are projected to rise to 1% (Maxfield, 2016).

One of the most striking philosophical changes of the new administration from its predecessor is the push for deregulation in many sectors and particularly in the financial sector. Clearly a beneficiary to this paradigm shift has been the banking and financial sector which as rallied as Executive Orders “aimed at rolling back financial regulations “ have been signed (Imbert, 2017). Perceived as having been overly regulated after the financial crisis, financial stocks have rallied since the elections with the expectation of reduced regulation and the realization as Executive orders have been enacted. An interesting study about the regulation/deregulation arguments can be viewed in the article written by Norbert Michel and published by the Heritage Foundation. He argues that the financial sectors have been heavily regulated for over 100 years without any “substantial reduction in financial regulations in the U.S.” (Michel, 2016)

Two factors that contribute to the growth of a publicly traded stock are both earnings per share as well as the price multiples or PE ratio. As has been sited the PE ratios of the banking stocks are well below that of the stocks in the broader indices. As projections for the financial stocks to earn more become reality and the perception that this sector will benefit from the market environment, financial stocks have the potential to increase from both an earnings and a multiple expansion standpoint.

Perhaps the financial sector finally has some wind at its back. Sectors as well as most investments tend to revert back to the mean or their average return. Will this be the decade for financials? Time will tell but they are poised for growth!

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