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## REMEMBERING THE FUTURE

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### Down, Not Out: An Overview of Financials

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#### Introduction

As we restart our series of monthly newsletters highlighting a specific economic or financial them it seems most appropriate to target in on U.S. Financials and the sector's current position. An image we frequently invoke when discussing finance is to imagine the credit system in an economy as a factor similar to blood flow within a body: without healthy circulation organs throughout the body tighten and become distressed. The general economy will always be influenced by the level of credit and the level of credit will also be guided by the economy. Simply put, financials will always have a central place in economic shifts and movements.

Attention devoted to banks and financial institutions has not been scarce, both on our own website as well as the larger financial media, over the past several years. Corruption scandals, fines, stress tests, capital levels and other key words have made their way into the normal stream of news concerning the Financial sector while markets have boomed after the downturn of the Global Financial Crisis (GFC). It is against this backdrop we want to use this newsletter as an overview of where this sector stands in the general landscape of the economy and markets.

#### A Rocky Start

It is not surprising that Financials have lagged behind the rest of the market coming out of the recession. The sector has been hampered with

legal, regulatory and economic hurdles. Investigations into knowingly selling shoddy financial products, corruption allegations, and rate fixing were commonplace. New rules from Dodd-Frank, the Federal Reserve, and Basel have forced the banking industry to adjust their structures and operations. Asset managers, while taking greater market share, have also caught the eye of regulators amid debate on whether they are "Systemically Important Financial Institutions." Most of all, a weak and deleveraging economy stifled growth and the demand for credit while inspiring the Federal Reserve to lower the Federal Funds Rate to the zero lower bound and undergo extraordinary accommodation in setting monetary policy. The former hit the bottom line of firms in all sectors. The latter squeezed trading revenue and margins in the banking sector specifically. It follows that Financials, and banks especially, would not be able to keep pace with the market (Figure 1).

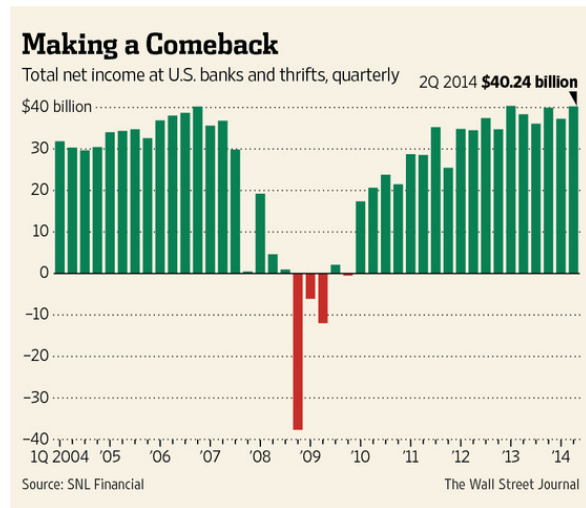
Figure 1: S&P 500 Financials (Red) vs. Index (Blue) since 2011

#### Fundamentals Taking Shape



Headline risks are still alive and well in the sector. Recent front-page material include the Fed rejecting living will arrangements of the eleven largest banks, Citigroup's spurned capital plan, and suits from the Department of Justice regarding shoddy mortgages and other financial products. However despite the infamous reputation banks in the U.S. have maintained their profitability and done so at high levels (Figure 2). While profits have been resilient Financials are valued lower than other sectors based on data from FactSet (Figure 3).

Figure 2: U.S. Bank Profits Strong (Wall Street Journal)



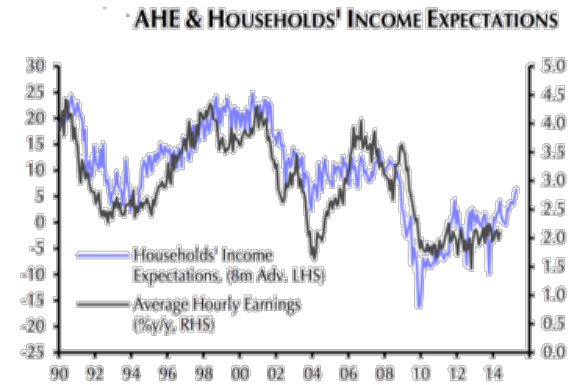
While Financials have been navigating their way through a foggy 2014 the general economy has consolidated to continue a solid rise into the future. Unemployment, though still stubbornly high, has come down from 7.2% this time last year to 6.2% currently.

Figure 3: Sector Forward P/E (FactSet) As of August 15, 2014

Basic Materials	16.8
Consumer Cyclical	17.8
Energy	13.9
Financials	12.9
Healthcare	16.2
Industrials	15.7
Consumer Defensive	17.5
Technology	15.3
Telecommunications	13.4
Utilities	15.5

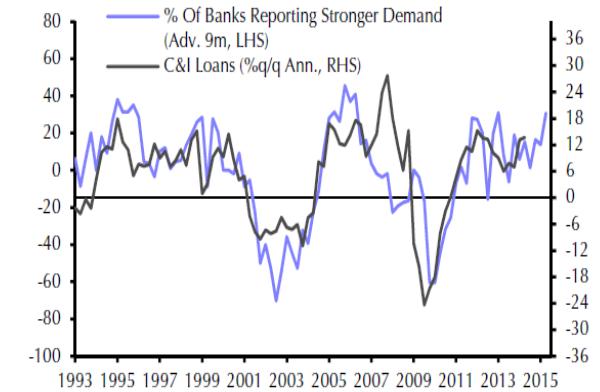
Capacity utilization continues to move upward. Demand for labor has grown. The housing market, while vacillating, has improved and corporate earnings continue to impress. On the whole the economy still possesses various weaknesses but the current positive momentum should translate into growing demand for loans and credit, supporting Financials (Figures 4 and 5).

Figure 4: Wage Pressures Building



Source - Thomson Datastream

Figure 5: Loan Demand on the Rise



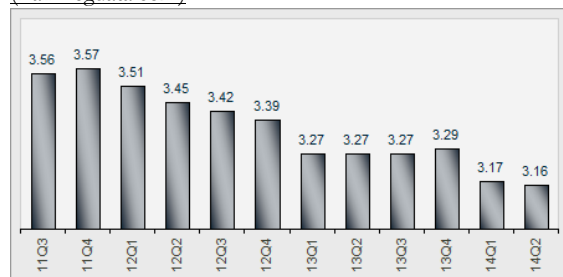
Sources - Thomson Datastream, Federal Reserve

Sustained growth in the economy over the next six to nine months will support corporate bottom lines and hopefully revitalize money velocity to some degree, the latter supported by the Fed's reverse repo program. As the economy solidifies and the path to a more normal monetary policy develops there are multiple, crucial consequences on the vitality of the Financials sector.

Commentary from the Fed has built in an understanding in the market that rate increases and an unwinding of stimulus are associated with a healthy general economy and should be welcomed.

First, as the Fed raises rates yield curves should steepen to a degree, though demand will demand given differentials with European bonds. Cheap credit from the Federal Reserve has lowered yields and flattened term premiums. In addition poor Q1 growth and geopolitical turmoil added downward pressure on interest rates. Banks' net interest margins have suffered as a result for multiple years (Figure 6).

Figure 6: Net Interest Margin, Top 100 Banks (Bankregdata.com)



When rate rises do commence the yield curve should steepen, widening spreads and improving margins. While interest normalization projects to be gradual any improvement would be welcome for banks and other industries that have seen their margins whittle.

Second, Mergers and Acquisitions (M&A) should remain alive and well in 2015. M&A activity has boosted markets so far this year and the transactions mean fees for management and advisory work for Financials while also supporting credit growth. The current low rate environment has prompted corporations to tap debt markets for buybacks and dividend increases until the economy solidifies. According to FactSet, the first quarter of 2014 saw the third most company buybacks since 2005. A combination of steady economic nurturing and less accommodative monetary policy in the near future will quell the

use of these techniques for raising share prices. Instead as the Federal Reserve raises rates corporations are likely to put their record cash reserves, which reached over \$2 trillion by the end of Q1 according to Bloomberg, to work through M&A or capital expenditures for growth. Higher rates will increase the cost of capital and corporations will have to grow from expansion. According to a survey conducted by Deloitte, a consultancy, 84% of corporate and private equity executives expect M&A activity to maintain or increase its 2014 pace for the next 24 months. Private equity firms reported they also expect deal size to increase. Related, nearly three quarters of surveyed investment bankers believe the IPO market will sustain its current momentum or accelerate per BDO USA, an accounting and capital markets advisory. New listings will support demand for banking and financial services for the rest of 2014 and into 2015.

An additional factor supporting U.S. Financials and banks specifically is the turmoil across the Atlantic. Recessions, austerity, the lack of reforms and deflationary pressure in Europe have choked growth on the Continent. Further, European banks are in far worse shape with respect to capital levels. European banks will continue to sell off assets to comply with mandated capital ratios creating a void in the market that U.S. banks are primed to fill. As firms such as BNP Paribas and Deutsche Bank reduce their presence in the States their American competitors stand to pick up market share and expand their base of assets.

In other industries asset management and private equity firms have been consistently buoyant coming out of the Financial Crisis. Firms such as The Blackstone Group, KKR, and Evercore Partners have seen their shares far outperform the Dow Jones Financial Index over the past 5 years and currently are holding record amounts of cash as reported by the Wall Street Journal. While taking vast amounts of market share away from their traditional investment bank rivals these firms have also shrunk the proportion of their business

models that rely on traditional private equity structures and turned to lending money or making long term investments in infrastructure according to The Economist. However, for those deals that are heavily financed with debt their size has steadily increased and taken a large jump in 2014; nearly 40% of leveraged buy-outs this year have been done with debt in amounts six times EBITDA per S&P Capital IQ. With the current low rate environment and enhanced scrutiny over the banking sector seeing such trends is not surprising. Commentary in the financial industry has voiced growing concern that with record levels of cash and high valuations present in the marketplace private equity firms may spark a bubble in acquisitions and asset prices in their quest to deliver returns, supporting our positive view of equities for the medium term.

Asset managers meanwhile utilize far less leverage in their operations. As pointed out in a recent issue of The Economist Blackrock's balance sheet is a fraction of HSBC's, which stands at \$2.5 trillion, even though the manager is responsible for \$4.4 trillion in assets. Building upon product platforms that are liquid and low cost has boosted the growing popularity of asset managers, such as Blackrock and Vanguard. As these institutions grow in size the more likely they are to garner attraction from regulators. The concentration of assets to such a degree is enough to get attention; the more wealth asset managers are responsible for the more sway they have on the market place and the rest of its players. No action has been taken so far but the risk of intervention by institutions such as the Financial Stability Oversight Council lingers.

Figure 7: Regionals Have Been Resilient in 2014 Compared to Bigger Names  
 Wells Fargo (White), PNC (Green), SunTrust (Orange), BBT (Purple), JP Morgan (Teal)  
 Bank of America (Yellow), Goldman Sachs (Blue)



### Eye on Regionals

Performance in Financials has not been equal across various industries. For much of 2014 regional bank stocks have had strong performances compared to banks that were further entrenched in the messy travails of securitization and financial engineering and thus exposed to more regulatory pressure (Figure 7).

For one, many of the most well known regional banks (Wells Fargo, PNC, SunTrust, etc.) are less leveraged than the larger investment banks (Figure 8) who have caught the eye of regulators more frequently as a result. Wells Fargo and PNC had no problems passing Federal Reserve stress tests. Regionals are more insulated from the esoteric products and practices and have seen a steady climb in their Earnings per Share (EPS). Simply put, regional banks have their fundamentals in line, are well positioned to benefit from any marginal signs of vigor among consumers and the economy as a whole, while also having superior capital positions to protect against downturns.

Figure 8: Debt Equity Ratios of Major Firms, Morningstar

Firm	Debt/Equity Ratios			
	2011	2012	2013	2014-Q1
Wells Fargo	0.97	0.88	0.99	1.04
SunTrust	0.55	0.46	0.52	0.61
PNC	0.99	0.75	0.87	0.93
BBT	1.25	1.0	1.07	1.03
Fifth Third	0.76	0.53	0.71	0.99
Goldman Sachs	2.58	2.41	2.26	2.31
JP Morgan	1.46	1.41	1.48	1.46
Bank of America	1.76	1.26	1.14	1.16
Morgan Stanley	3.3	3.1	2.84	2.66
Citi	1.82	1.28	1.12	1.12

Regional banks are more reliant on general deposit taking and lending services than some of their counterparts in the sector, services that are more stable and predictable. But these firms are also demonstrating growth and expansion trends. Wells Fargo for example recently announced plans

to double the size of their asset management portfolio to \$1 trillion over the next decade. Having a sturdy foundation is crucial as sensitivity to the welfare of banks is sharp but plans for growth are welcomed for building diversification and raising revenue growth.

What's been detrimental to regional banks over the past couple of months is the tightening of the yield curve as it has reduced income according to Bloomberg. Diminished spreads have cut into margins and flummoxed both traders and commentators as a whole. Investment banks have diversified their operations since 2009 and have been able to overcome narrow spreads better than regionals. While betting on spreads has been perilous in 2014 further tightening remains limited while rising consumer power and incremental improvements in the employment picture support a case for Regionals. Moreover, rate normalization should improve banks' balance sheet positioning by discounting their assets more favorably through accounting mechanisms.

### **Conclusion**

Financials stand to benefit from a continued economic recovery in the United States in the medium term from multiple sources. The sector has trailed thus far and for valid reasons: new

investigations into criminal practices, fines, and unsatisfactory regulatory compliance could reappear at any given moment, which would weigh down on Financials. Recent evidence suggests however that markets believe this risk is falling, evident in the rise the sector saw after Bank of America's record \$17 billion fine was announced. Improvements in housing, wage growth, consumer demand and long term unemployment point to the economy solidifying its gains while reaching for greater heights. The Financials sector is poised to profit from these trends while also being a direct benefactor to the normalization of monetary policy by the Federal Reserve. Regional banks specifically, due to their proximity to a variety of consumer and commercial sectors, remain particularly attractive while corporate growth and M&A activity offer promise to other parts of the sector.

Debate on whether bond and equities markets currently stand in bubble territory has been a dominating topic well in to 2014 for commentators and analysts. As valuations continue to be stretched investors and market participants are on a murky quest to find value. The lagged performance by Financials may provide just the opportunity.

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