Financials Sector – 2019 Outlook

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With the global financials sector struggling over the last 12 months, what's in store for the industry in 2019?

Signature remains positive about the outlook. The financial sector's poor performance was driven primarily by increasingly negative sentiment; however, the sector may recover quickly as fundamentals generally remain healthy.

Global financials produced a negative return (-15.2% in U.S. currency) in 2018, measured by the MSCI ACWI Index, as earnings growth and fundamental value creation was overwhelmed by multiple compression. This potentially creates a strong set up for 2019 returns as risk premiums appear excessive relative to Signature's base case expectations.

U.S. banks

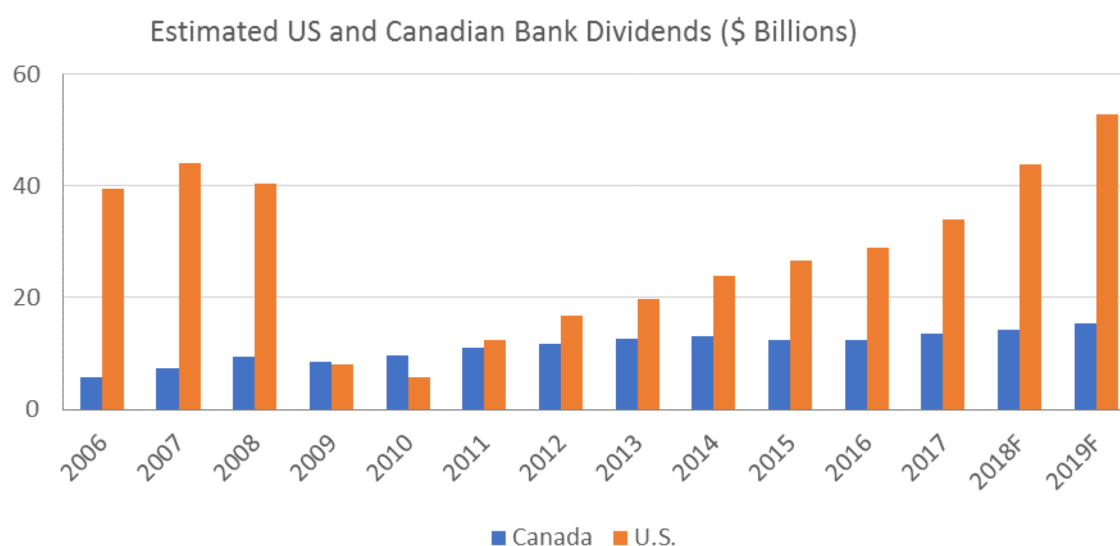
The MSCI US Banks Index generated a 2018 return of -17.2% despite strong earnings growth in 2018. Recently, 2019 earnings estimates have been trimmed slightly as analysts react to bond market rate expectations and build in additional conservatism given the current risk-off environment. The recent multiple compression, generally well over 20%, is in Signature's view excessive, perhaps even ridiculous. Fundamentals remain healthy and the billions of dollars being put to work via share repurchases are incrementally more rewarding.

In our view, 2018 was a terrific year for U.S. bank profitability – the return on assets was strong as credit costs were unusually low. Moreover, we expect recent strong profitability to continue as slightly higher credit costs can be partially offset with efficiency improvements. Bloomberg data suggests that the financial sector's aggregate earnings in 2019 will be only 3-4% above 2018 levels which seems reasonable. Capital management via share repurchases should, of course, support earnings per share growth above that 3-4% level.

As illustrated in Chart 1 below, U.S. banks have offered strong steady dividend growth from the 2010 trough. Notably, U.S. banks' dividend payout ratio has fallen significantly from pre-crisis levels. We estimate the average dividend payout ratio was above 70% in 2007 and is currently running closer to 29% in aggregate. U.S. banks are generally returning more capital to shareholders today via share repurchases than dividends. According to Signature's research, combined sector dividends and buybacks may approach $170 billion in 2019! When considering relative dividend

yield as a value consideration, it is crucial that investors consider the tremendous buyback yield in U.S. banks as well.

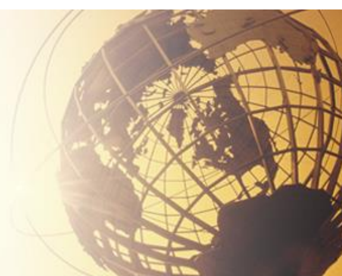
Chart 1



Source: Bloomberg L.P., Signature Global Asset Management, as at December 31, 2018.
The chart shows estimates for 2018F and 2019F; actual results may vary.

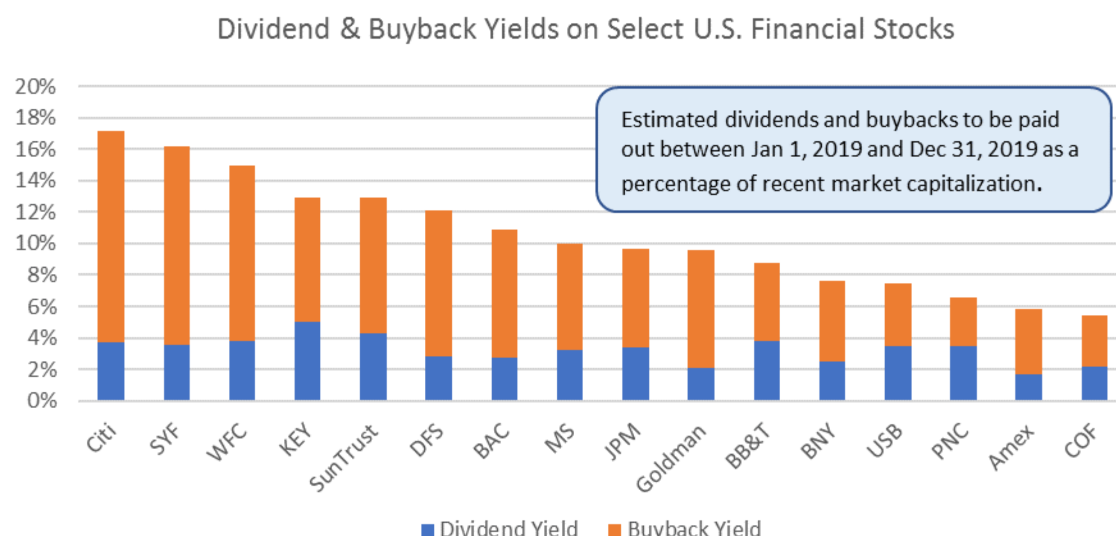
Looking forward, we expect dividend growth to remain relatively attractive but moderate from extremely strong levels. **Signature's research suggests that U.S. bank dividends in 2019 will be 20% higher than 2018 levels, which are 28.5% above 2017 levels**. This strong dividend growth has been supported by rising dividend payout ratios and strong earnings growth, which were aided by tax cuts and interest rate increases. With current aggregate sector dividend payout ratios below 30%, the sector retains room to support dividend growth with a rising payout ratio for a few more years to perhaps 40-45%.

In 2010 we took a long-term view that as profitability and dividends normalized over time, the U.S. banks would outperform the market in terms of dividend growth and price appreciation. While they have since outperformed on dividend growth, they have underperformed the broad market (S&P 500) in terms of price appreciation. This disconnect between superior dividend growth to the market and lagging relative performance seems unsustainable. We continue to believe relative valuation and attractive fundamentals should support U.S. bank outperformance, acknowledging



that the market has strongly disagreed with Signature's view recently. As illustrated in Chart 2 below, the combined dividend yields and buyback yields are extremely supportive of potential outperformance.

Chart 2



Sources: Company reports, Bloomberg L.P. as at December 31, 2018.
For Illustrative Purposes Only. The chart shows estimates only, actual results may vary.

European and U.K. banks

European and U.K. banks have largely been a value trap for many years. Since December 31, 2010 European and U.K. banks, as measured by the STOXX Europe 600 Banks Index (SX7P), have lost almost 10%, including reinvested dividends. Still, we took the view in mid 2018 that European bank valuations had become compelling relative to U.S. valuations.

Chart 3 below illustrates the valuation disconnect between European and U.S. banks as measured by the simple price to book ratio. Signature believes the bulk of this valuation differential is fundamentally supported; but having U.S. banks trading over 170% of the European bank price/book ratio is excessive and, from that level of discrepancy, European banks could start to outperform U.S. banks. Since the end of June 2018, U.S. and European bank stocks are each down 17% and Signature's view that European banks were positioned to outperform has been wrong thus far.

Chart 3

Source: Bloomberg L.P., Signature Global Asset Management as at December 31, 2018.

BKX: KBW Nasdaq Bank Index

SX7P: STOXX® Europe 600 Banks Index

European and U.K. bank dividend payout ratios have remained higher than in the U.S. and so their total dividends paid in U.S. dollars has consistently exceeded U.S. levels. Given the tougher economic environment, we believe European and U.K. bank dividends aren't likely to exceed 2007 levels until 2020. Share repurchases are much less significant outside the U.S. and are only relevant in a few individual cases. The current outlook for dividend growth is promising as capital adequacy has greatly improved for most institutions.

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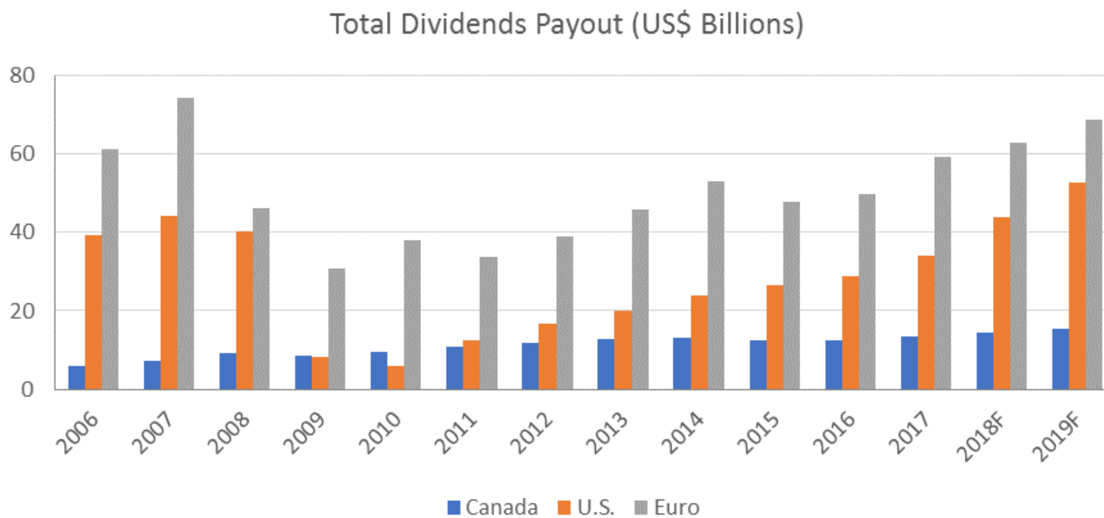
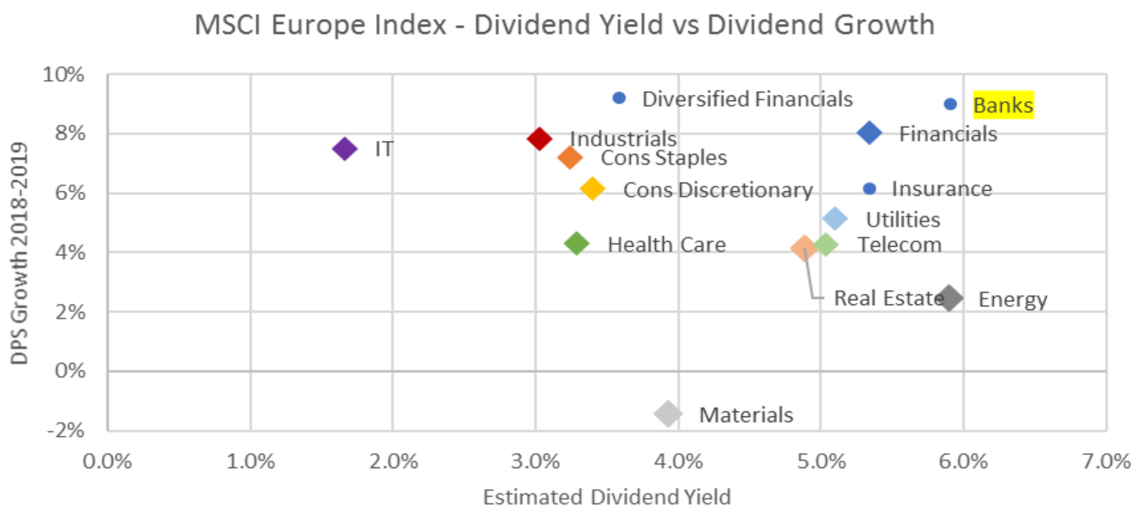
Chart 4



Source: Bloomberg L.P., Signature Global Asset Management as at December 31, 2018.
The chart shows estimates for 2018F and 2019F; actual results may vary.

We also note that compared with U.S. and Canadian financials, European banks offer attractive dividend yield with superior dividend growth as illustrated by Chart 5.

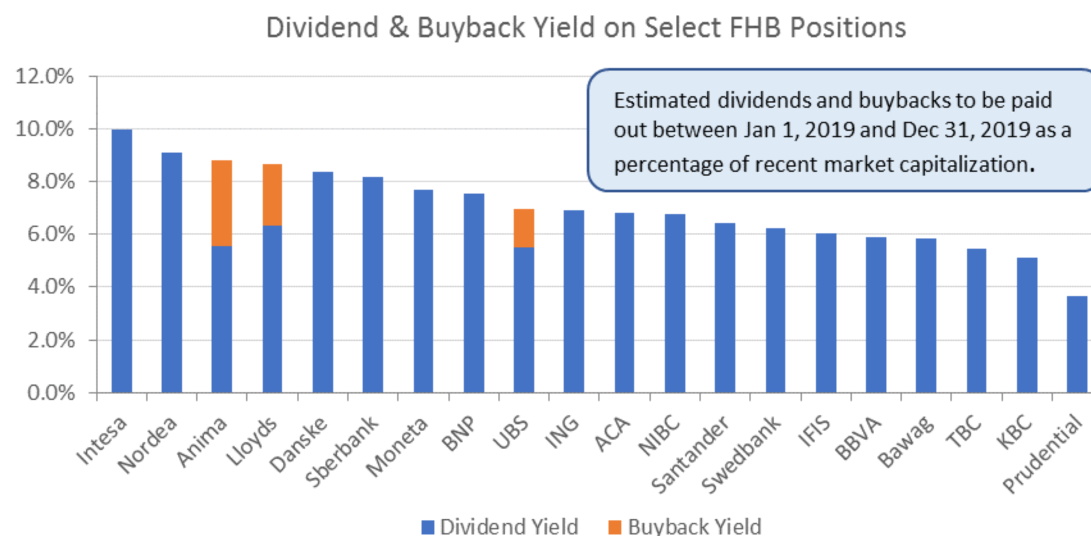
Chart 5



Source: Bloomberg L.P., MSCI, Signature Global Asset Management as at December 31, 2018.
For Illustrative Purposes Only. The chart shows estimates only, actual results may vary.

Signature has conviction that the European bank sector offers attractive and growing dividends. It is notable that the banks have very high leverage to a potential improvement in the operating environment because returns in many cases remain depressed by the low interest rate environment. Chart 6 below illustrates the supportive dividend and buyback yields available in various Signature positions owned in our funds and **active** ETF mandates.

Chart 6



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Canada's financials sector

The MSCI Canadian Financials index generated a negative 9.3% return during 2018, materially outperforming global financials. Domestic banks returned -7.9% (per S&P/TSX Banks Industry Index) while domestic life insurance companies performed much worse. Our domestic banks experienced materially less multiple compression than their global counterparts and, as a result, continue to look relatively expensive, especially given high domestic household debt. Signature's base case expectation is for mid-single digit earnings growth and positive equity returns although we would like to see greater growth concerns discounted in the valuations for us to become more

upbeat. Scotiabank remains our favourite domestic bank stock as valuation is arguably at trough levels and earnings from recent acquisitions will support relatively strong forward earnings momentum.

Valuations for domestic life insurance companies become increasingly compelling following their poor performance in 2018. Signature continues to see Manulife's risk premium as excessive and we currently find this stock compelling relative to its global peers. We also find Power Corp and Power Financial's dividend yield of more than 6% extremely attractive. In Canada, Signature's preference for life companies over banks clearly hurt results in 2018; however, we continue to view such positioning as most prudent.

IMPORTANT INFORMATION

John Hadwen is a portfolio manager to and an investor in some of the Signature funds and certain ETFs which may hold the securities discussed herein.

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