

COMMENTARY

Opportunities in the financial sector

MORE than three years have passed since the United States housing market imploded. Financial institutions deemed "too big to fail" fell one after another, triggering a crisis that threatened to extend to the rest of the world. How is the financial sector looking right now? What are current opportunities for investors in this sector?

JOHN DOYLE, deputy chief investment officer of UOB Asset Management and fund manager of the United Global Capital Fund, recounts the events that unfolded in the crisis and shares his investment views for the sector.

We can trace the first cracks in the global financial architecture to late 2006. Ameriquest announced it was shutting down its mortgage origination branches to focus on an online model. Then in November, HSBC warned that bad debts in the US were rising at an alarming rate.

In April 2007, New Century — one of the nation's largest sub-prime lenders — filed for bankruptcy. Just as economist Robert Schiller had warned back in 2005, the housing bubble had burst. By the fall of 2008, many of the market participants most directly exposed to the housing bubble, like Bear Stearns and Lehman Brothers, were wiped out or deeply impacted.

An asset bubble of unprecedented proportion had triggered a credit, capital and liquidity crisis that shook the global financial sector to its foundation, requiring public support to prevent outright collapse. While systemic collapse was averted, a global economic downturn ensued, broadening the problem well beyond the sub-prime lending market.



Bank of America was one of the US banks that posted lower profit and revenue last month, amid an economy that is 'muddling along', even as others like Citigroup and JP Morgan reported lower profits. BLOOMBERG

BACK FROM THE BRINK

Fortunately, US policy makers had learned from past crises and resisted calls to let the affected banks fail.

They ensured that the financial systems continued to function through a combination of interest rate reductions, capital injections and liquidity support. These moves were broadly mirrored around the world as other central banks stepped in and stabilised financial markets.

As a result, the financial sector slowly returned to profit, especially for financial institutions with strong underlying core profitability. The US banks' return on average assets, which is a gauge of profitability, turned sharply negative during the crisis before recovering to a positive 0.5 per cent to 0.6 per cent level early this year.

Recently, two key indicators of capital and liquidity give us more reasons to be optimistic on the financial sector's medium-term prospects.

Capital levels, as measured by tangible equity to tangible asset ratio, have recovered and are above pre-crisis levels. Similarly, the sector's liquidity is now strong, with the loan to deposit ratio at 86.8 per cent, having peaked at 97.4 per cent in June 2008, when many of the banks had to absorb off-balance sheet vehicles onto their balance sheets. Capacity to lend appears to be no longer a constraint now.

Recently, many market observers have voiced their concerns that the US banks are not lending and this potentially dampens US business and economic growth. However, we feel that pedestrian credit demand is more a function of the fact that the household sector is de-leveraging and the reality that economic growth is being driven by wage increases and not borrowing.

This is a necessary development that is positive for the broader economy, the financial sector and households in the long run.

Also, credit growth is more a function of income and investment, and this will come back in time.

But we believe it will be more sensible and aligned with broader economic growth in the future. In any event, credit quality — not credit growth — is relatively

more important for a positive medium-term outlook.

Already, we see credit quality improving. This suggests a gradual upward bias to profitability and valuations, which will be the key element to medium-term performance.

POTENTIAL GROWTH OPPORTUNITIES

The financial sector valuation is very supportive of a multi-year re-rating.

As at last month, the MSCI World Financial Index traded at a price/book value multiple of 1.1x. This is still a long way off from longer term averages of 1.7x, implying up to a 50-per-cent re-rating potential into recovery. Over the medium term, investors can look forward to a re-rating of the sector as credit conditions normalise.

In the short-run, investors in the financial sector can look forward to strong growth in traditional lending areas in some of the higher-growth and lower-risk emerging markets, where there is strong credit demand and robust earnings.

Concurrently, there are some opportunities in higher growth, higher value-added fiduciary segments in developed markets that today are very attractively priced in relation to longer term growth prospects.

These segments, such as payment services, custody and trust services and wealth management, are generating growth opportunities that are significantly greater than in the traditional credit and insurance segments. Furthermore, many of the leading franchises in this area are well positioned to continue to expand their services beyond their traditional borders into higher growth emerging markets.

By itself, the financial sector offers sufficient breadth that lends itself well as an investment opportunity across a wide range of economic and business conditions.

Today, key indicators suggest that opportunities are starting to avail themselves to the individual looking to invest in the sector. The sheer size of the financial sector in the global economy means that it will continue to offer a sector of opportunities too many to ignore for investors. ■