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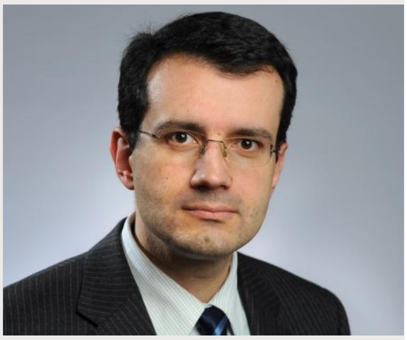
A Continuing Reflationary Tailwind

The financial sector has benefited from a tide of optimism about expectations of higher inflation and interest rates, a better economic backdrop, reduced margin pressures, less onerous regulation and lower US taxes. Following a sharp rally, Portfolio Manager Sotiris Boutsis, believes we are now entering a period when stock selection becomes more important. Over his seven year tenure, Sotiris has delivered cumulative returns of 105.3% (on a net of fees basis) outperforming the comparative index which returned 95.8%.[1] The FF Global Financial Services Fund is one of the largest in the peer group.



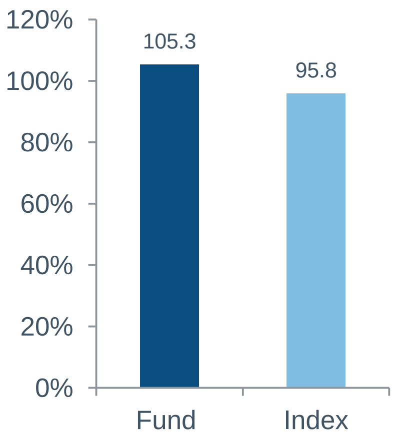
SOTIRIS BOUTSIS is the Portfolio Manager of the FF Global Financial Services Fund. He joined Fidelity in 2001 as an intern, and went on to become an equity analyst, covering various sectors before being promoted to Portfolio Manager in January 2010. Sotiris holds an Engineering Diploma and a PhD in Computer Science from Athens National Technical University, as well as an MBA from the London Business School.

A TALE OF TWO HALVES

2016 was a tale of two halves for financials. While the sector as a whole delivered 13.1% in US dollar terms, outperforming the broader market, the bulk of the re-rating took place in the second half – when financial stocks rallied 20.7%.[2]

The uptrend started in the middle of 2016, around the time bond yields bottomed soon after the moves caused by Brexit, but the process was accelerated after the election of President Trump. His stated intention of de-emphasisng globalisation, boosting infrastructure spending, lowering taxes and reducing regulation, caused a shift in investor focus from deflation to reflation, despite the fact that these forces had been at play for a while. We saw a sharp shift in investor positioning towards previously unloved financials, as investors re-evaluated the sector's prospects and took some of the most pessimistic scenarios off the table. A combination of increased inflation and interest rate expectations, a supportive fundamental backdrop and improved financial health of underlying businesses helped.

Chart 1. Cumulative returns over tenure, at 31 January 2017



Source: Fidelity International, 31 January 2017. nav-nav, gross income reinvested, A-Euro share class (net of fees). Index: MSCI AC World Financials + Real Estate blended index. Sotiris Boutsis' tenure starts from 1 January 2010

REFLATIONARY FORCES AT PLAY

Despite a lot of rhetoric around secular deflation, reflationary forces have been building recently, following an extended period of loose monetary policy. Economic growth has been modest but healthy, with the US, in particular, steadily moving towards full employment. Commodity prices have also strengthened recently as the supply/demand dynamic for oil has improved and other commodities have done better due to a combination of market and real economy factors.

To add to this, an upsurge in populism has forced a shift among politicians away from strict insistence on fiscal austerity towards tolerating a looser fiscal stance. Policymakers have also begun to question policies such as negative interest rates and ever-tightening regulatory standards, which some perceive as damaging to the economy. At the same time, the prospects of increased protectionism and trade barriers have meant expectations for inflation have increased. Following many years of worries around deflation, we appear to be finally reaching a point of seeing some inflation and moving away from the prospect of negative rates, at least for a while.

IMPROVING FUNDAMENTAL BACKDROP

At the same time, an improving fundamental backdrop is providing a positive tailwind to the financial sector, which is closely linked with the state of the broader economy.

In the US, we are seeing strong consumer spending and business investment as well as growing wages. Activity levels could be further supported if the new administration follows up on its promises for a fiscal stimulus, a drop in the corporate and personal tax rates and a reduction in regulatory overheads. With respect to Europe, following years of easy monetary policy it is in a cyclical recovery phase, with broad-based expansion in manufacturing and services PMIs as well as an upturn in hiring activity.

Elsewhere, Japan's decision to peg yields near zero in the context of globally rising yields has resulted in Yen weakness, which is serving to reflate the domestic economy. The Chinese economy too has re-accelerated following stimulus in 2016, and a number of economic indicators are at multi-year highs. Even though the monetary policy is likely to tighten from here, China is unlikely to go into its National Congress with an underperforming economy.

What does this imply for financials? A strong economic backdrop, higher inflation and interest rates could represent an important change in the operating fundamentals of banks and other financial companies. Following years of margin compression in a low interest rate environment, banking stocks may finally see margins improve. This has the potential to support an earnings upgrade cycle, especially since most bank management teams are managing costs tightly. Banks could also benefit from improved lending activity and better credit quality that will result from the improved health of corporates in general, as pricing power will benefit overall corporate fundamentals. Most notably, the improving outlook for inflation has reduced the probability of some extreme scenarios of negative rates persisting for protracted periods of time, with the potential to pose existential risk to certain business models in the financials space.

HEALTHIER BALANCE SHEETS AND POTENTIALLY LESS ONEROUS REGULATION

Financial businesses have also spent the better part of the last decade rebuilding balance sheets, raising new equity from the markets and using their admittedly modest profitability to deal with non-performing exposures.

An overall improvement in balance sheet quality has removed questions around the capital adequacy of a number of banking systems. In those cases where balance sheet quality has not been adequately addressed yet, mainly in Europe, the ECB has upped the pressure and business plans are being revised appropriately. Investors are finding it increasingly difficult to overlook the sector now that balance sheets are in better shape and there is some possibility of a historic reversal in interest rates, albeit over very many years.

To add to this, there are indications that the regulatory onslaught on the sector may be abating. President Trump has taken steps to revise Dodd Frank and the DOL rule and in Europe politicians have openly supported a re-evaluation of Basel IV. Progress on these fronts would allow banks to hoard less capital, and increase return on equity, which would lead to rerating. In addition, if regulatory restrictions were to be relaxed, that would be unlikely be restricted to financals. A reduction in regulation in general would support business sentiment for the overall economy, and improve the outlook for capital deployment in investment or acquisitions.

FOCUS ON STOCK SPECIFIC FUNDAMENTALS

My investment process is designed to find companies with a potential to improve return on assets and return on equity, as this typically leads to a rerating. I am also interested in companies whose earnings delivery is ignored by the market. I believe it is important to emphasise quality franchises and businesses that have strong assets, likely to withstand periods of volatility, and companies with good management that can create value and navigate periods of uncertainty to our benefit.

Within the portfolio, 2016 saw an increased exposure to banking and insurance businesses at the expense of real estate and financial technology holdings that had done well. A number of names introduced last year rallied strongly in the post-Trump surge and have in fact met price targets. I am now using those proceeds to finance a number of new purchases.

Given the above backdrop of opportunities, risks, policy uncertainty and sharp price moves, I am focusing on building exposure to the new top-down tailwinds on a bottom-up, stock-by-stock basis. New holdings include the likes of credit card issuer and electronic payment services business Discover Financial Services, whose differentiated strategy of targeting the younger borrower cohort is resulting in market share gains versus its peers who target high spenders. Not only should it benefit from a likely lower corporate tax rate, but less oversight could drive bigger buybacks. Investors have recently shunned consumer finance names, leaving the stock relatively inexpensive, and it is now one of the largest relative positions in the fund. Encouragingly, there is a multitude of opportunity on a global basis and I have added a number of names where there are stock-specific catalysts that the market is currently ignoring.

RISKS

After a long period of recovery and adjustment following the 2008 crisis, we are at a stage in the financial sector where new tailwinds are gathering while some of the headwinds are abating. Still, a number of risks remain, such as those related to policy implementation in the US, political uncertainty in Europe, and the possibility of a protectionist backlash – even though most of these are broad-based and not specifically linked to financials. We also need to monitor market variables such as currencies and yields, as sharp moves could dampen economic growth or raise questions about debt sustainability. However, at this stage, these risks are not centre stage.

FOOTNOTE

1. Fidelity International, 31 January 2017. Nav-nav, gross income reinvested, A-Euro share class (net of fees). Index: MSCI AC World Financials + Real Estate blended index. Sotiris Boutsis' tenure starts from 1 January 2010 to present. Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. Holdings will vary from the index quoted. For this reason, the comparative index is used for reference only. Numbers may not sum due to rounding.

2. Datastream, 31 December 2016. Based on relevant global total return indices.

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