EQUITY

Will 2018 be a Banner Year for US Bank Stocks?

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Franklin Equity Group Vice President and Portfolio Manager Matt Quinlan explains why he thinks US banks could benefit from a more favorable economic and regulatory environment. Given this healthy backdrop, he believes select large-cap bank stocks may increase dividends and stock buybacks in the next two years.

Although valuations appear stretched in certain pockets of the US equity market, we see value in specific sectors. In particular, we like the prospects for US banks.

In our view, select large-capitalization US banks are likely to benefit from a growing US economy, higher interest rates and a less-restrictive regulatory environment. As a result, we think they have room to increase dividends and stock buybacks as earnings improve and capital is freed up.

Favorable Economic Backdrop

At this time, US economic growth appears to be on solid footing, with tailwinds from tax reform as well as some near-term fiscal stimulus. As the US economy continues to grow, we think select banks are likely to see increased loan and capital markets activity.

In addition, we think the upward momentum in US interest rates is likely to lead to higher bank net-interest income growth, and as a result, greater profitability potential. The US Federal Reserve (Fed) has said it plans to continue to raise interest rates as the economy improves. At its March monetary policy meeting, the Fed reaffirmed its projection of three interest-rate hikes in 2018, which would put the federal funds rate at 2.1% by the end of the year. Also, the Fed projected the fed funds rate will rise to 2.9% by the end of 2019.

Improving Regulatory Environment

In the past year, the regulatory backdrop for the US financial sector has improved for the first time since the global financial crisis (GFC) a decade ago. President Donald Trump's administration has proposed rule changes that would allow banks to hold less capital, based on how much leverage they hold.

US banks have worked to build up their capital ratios since the financial crisis. Now, we think regulators seem generally confident that bank capital ratios are sound. These institutions performed well in government-mandated stress tests last year, which allowed them to return capital to shareholders. We believe they are likely to continue to perform well.

As a result, select banks seem prepared to return an increasing amount of profits to shareholders as they generate higher levels of after-tax cash flows. Based on our analysis, these banks are likely to be able to boost buybacks and raise dividend payouts over the next couple of years. And because of the more favorable stress-test results, it appears more likely that the Fed will allow them to do so.

Investment Implications

We think valuations of select US banks appear attractive relative to the broader market. In our view, these banks have made great strides in becoming more efficient, and they have generated higher levels of capital than required to meet their regulatory requirements. We believe they stand to benefit from a growing economy and a more favorable regulatory environment going forward.

That said, if US economic activity slows and the outlook for interest-rate hikes decreases, our view could change. Although we don't see a cause for a slowdown at this time, it is possible a trade war could develop and lead to downward revisions in economic growth. So far, trade tensions have led to bouts of market volatility, but have not signaled that the economy won't be able to continue growing at its current pace.

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Investors should carefully consider a fund's investment goals, risks, sales charges and expenses before investing. Download a prospectus, which contains this and other information. Please carefully read a prospectus before you invest or send money.