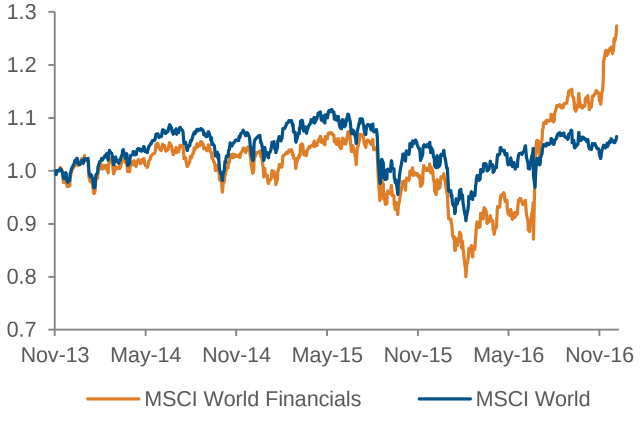
Polar Capital Global Financials Team

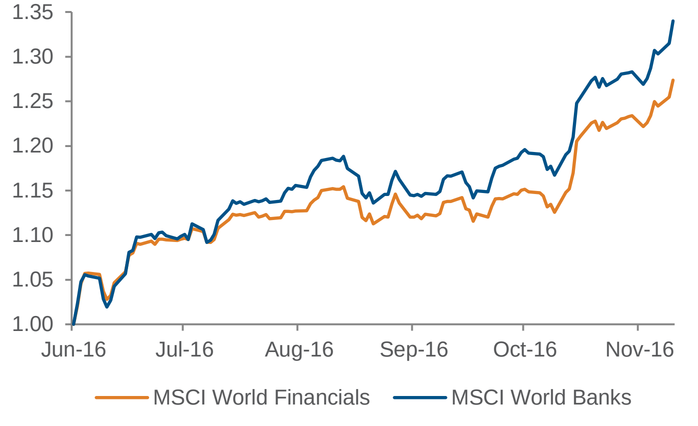
Bank rally strong positive signal for financials

The past few months have seen global financials (MXWO0FN) significantly out-perform global markets (MXW0), with banks being the core drivers of that re-rating. Over the past six months global financials have outperformed global markets by 7.4% and global banks (MXWO0BK) have outperformed global financials by 1.5% after many years of lagging. It might surprise investors to know that financials have materially outperformed markets over the past five years, although the vast majority of this has come from more periphery sub sectors such as non-life insurance and real estate rather than the core banking sector. The beginning of outperformance from the higher beta bank component of the financial benchmarks implies a broader positive reassessment of the outlook for the financial sector and plays in favour of our global financial Funds, which are more skewed to the banking sector.

MSCI World Financials vs MSCI World (3 years)



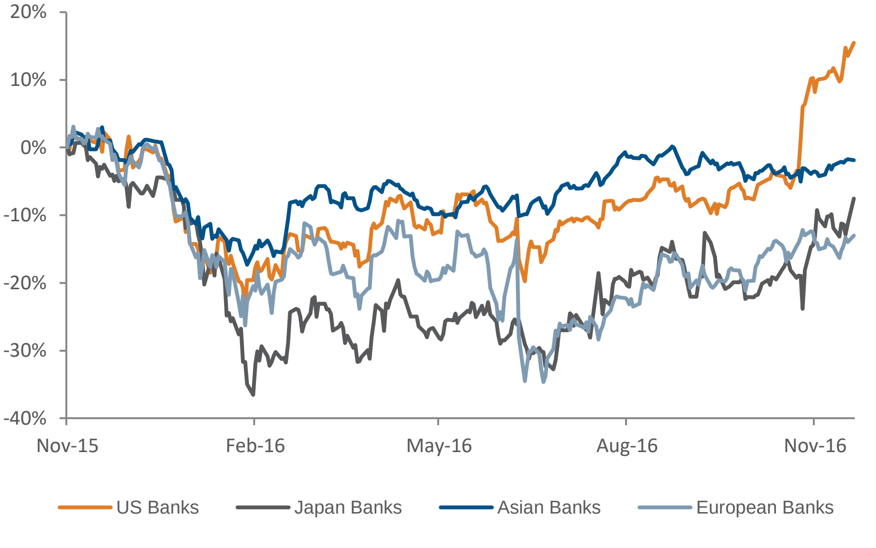
MSCI World Banks vs MSCI World Financials (2H16)



Source: Bloomberg, 7 December 2016. Past performance is not indicative or a guarantee of future results.

The key driver of that strong performance has been the US banking sector which now accounts for 22% of the global financials benchmark (MXWO0FN) and has materially out-performed both European and Asian banking sectors (although Japanese banks have also performed well during this time). Added to which, smaller regional US banks have performed particularly well, an area where we tend to focus on through the Polar Capital Financial Opportunities Fund.

US, Japan, Asian, European bank performance ($), 12 months



Source: Bloomberg, 7 December 2016. (MXU0BK, MXEU0BK, BPRBANK, TPNBNK).

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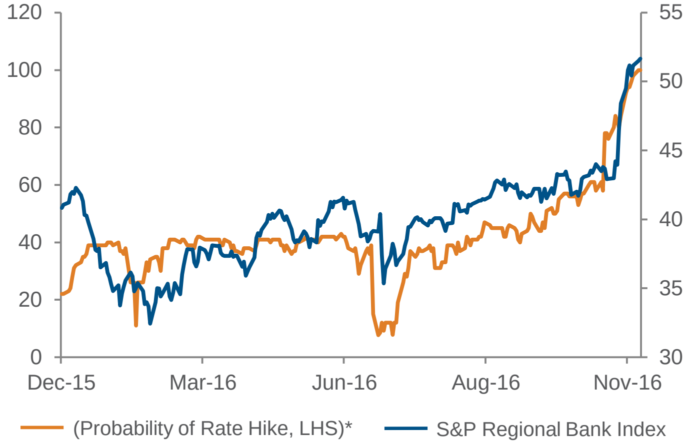
The banking sector is cheap but it has been cheap for a long time, so why is the market reassessing the outlook for the sector? We suggest the following issues are driving it and expectations have materially improved following the election of Donald Trump and the continued control of Congress by the Republicans.

1. US interest rate rises are imminent

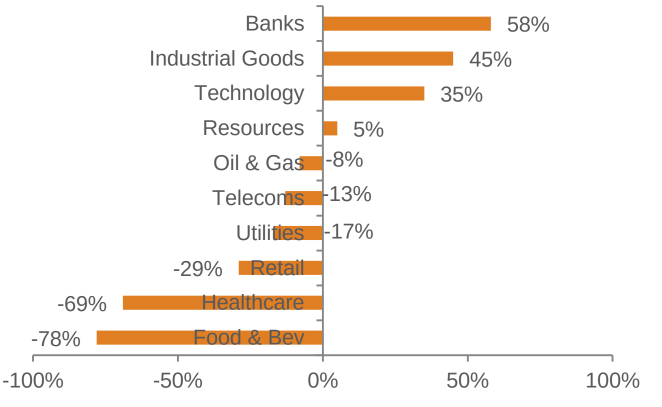
Expectations for a rate rise have increased materially in recent months and this implies a bottoming out of the constant downward trend in bank net interest margins. It should also be noted that long rates have already risen materially and this is particularly positive for the banking sector since it tends to take short-term deposits and price loans off long-term rates. Added to which the balance sheets of banks are more positively sensitive to a rise in rates since there is a high proportion of non-interest bearing deposits. For example, JPMorgan would see a US$2.8bn rise in earnings if interest rates rose 100bp, whilst HSBC has suggested a US$1.4bn boost to Net Interest Income if interest rates rose 25bps[1]. Overall, investors have to ask themselves which sector will be beneficiaries of rate rises and clearly the banking sector (and life insurance) is high up on that list.

Source: 1. HSBC 2016 Interim Report; JPM 3Q16 10-Q Filing.

Rate hike % (Dec '16) vs S&P bank index



Correlation to US 10Y bond yields - last 5 years



***** Implied probability of Fed rate increase in December 2016.
Source: Bloomberg, 7 December 2016.

2. Shift to fiscal rather than monetary drivers

There is a growing acceptance that loose monetary policy has not helped boost economies and a greater focus on government spending and tax cuts are needed (although it remains to be seen how these will be funded). Overall, any further boosts to the economy can only be helpful for banks since it is expected this will improve the prospects for loan demand.

3. Easing of the regulatory environment

After many years of constantly more onerous regulations, the debate (certainly in the US) has now shifted as to whether regulations are too onerous. Key regulations such as the Dodd Frank Act (and more specifically the Volcker Rule which limits proprietary trading) are being reassessed, although, again it remains to be seen as to how successful the new US government will be in amending these regulations. Other regulations under review include a rise in the threshold of the CCAR process (from US$50bn to $250bn+) which would be very positive for some of our smaller bank holdings. Also the DOL Fiduciary Rule (looking at costs of savings/retirement products) might be relaxed. The outcome of the Basel Committee's new capital framework is expected to be released in January and comments from the Basel Committee suggest the focus will be on harmonisation of standards rather than further driving up capital requirements.

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4. Corporate Tax cuts

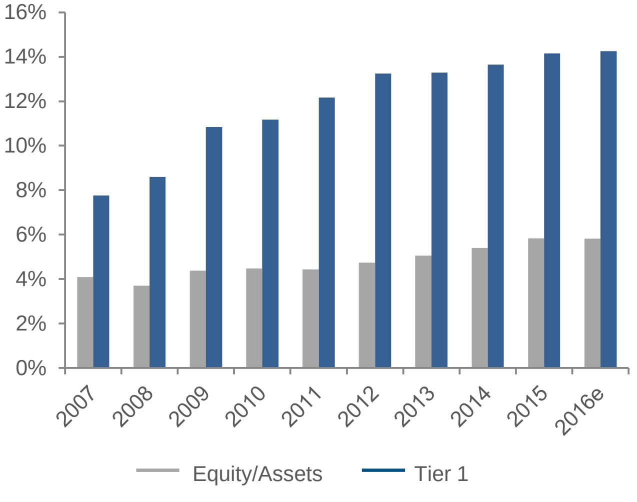
All banks are beneficiaries of corporate tax cuts but regional banks are expected to benefit the most since they are primarily domestic businesses and have limited deferred tax assets which could be impacted (the likes of Citigroup and Bank of America would be negatively impacted in the short-term because of their high DTAs and the write-downs which would be needed).

One note of caution is that much of the recent re-rating of the banking sector in the US has been based on speculation as to what Donald Trump might actually change and the expectation of interest rate rises rather than the reality of what has actually happened. However, investors should not ignore that balance sheet fundamentals have improved materially and so should some of these changes actually be enacted it will be a material benefit to the sector. We would highlight the following supports for the sector:

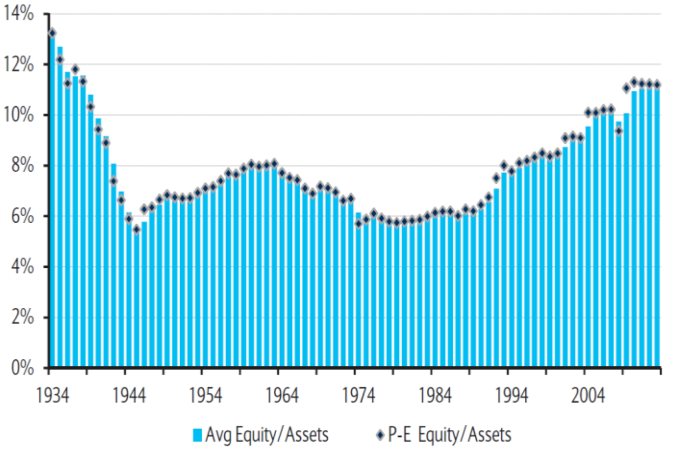
i) Capital positions are much stronger

Banks have been increasing their capital positions consistently for many years and though new regulations might be more onerous, their ability to meet them is increasingly a given (with a few notable exceptions in Europe) particularly in the context that we don't believe there is dramatic loan demand ahead.

European bank tier 1 & equity/assets ratios[1]



US banks equity/assets ratio[2]



Source: 1. Polar Capital, 30 September 2016. **Source: 2.** Barclays (US Large-Cap & Mid-Cap Banks report, 18 March 2014). It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this document. A list of all recommendations made within the immediately preceding 12 months is available up on request. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital.

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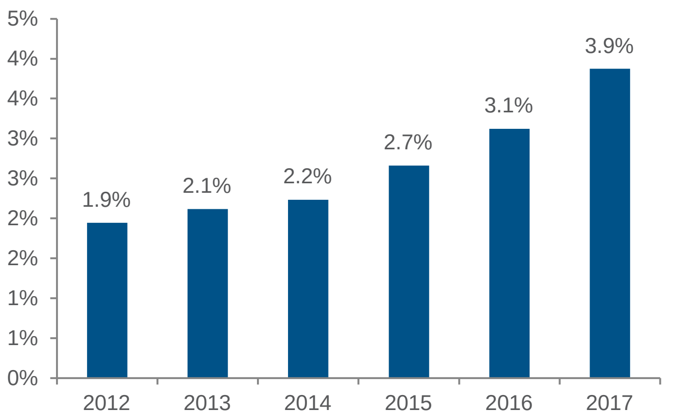
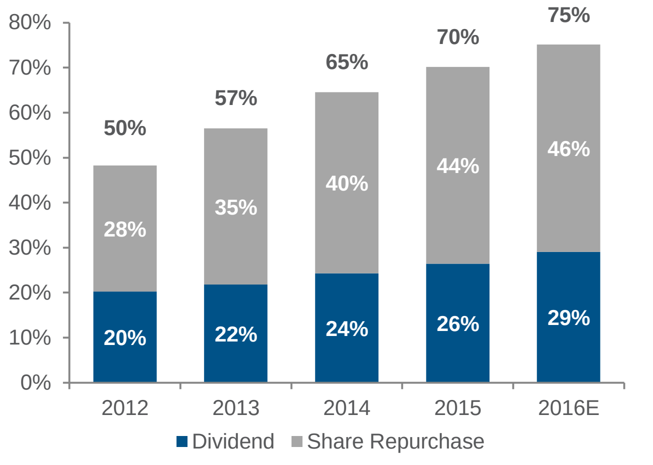
ii) Capital Return to remain strong

The combination of improved profitability and better capital adequacy will further boost the potential for buy-backs and dividend payments (the latter a particular attraction for investing in European banks). Financials are already one of the better yielding sectors but we expect them to be able to retain that position in the future.

European bank dividend yields[1]



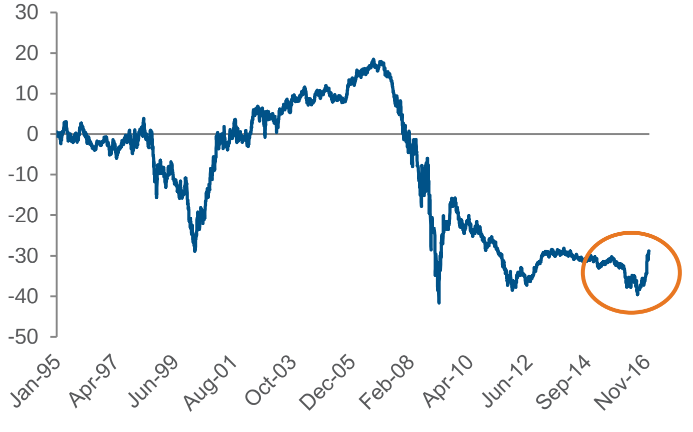
US banks total gross payout ratio[2]



Source: **1.** Polar Capital, 7 December 2016**. 2.** Sandler O'Neill, SNL Financial, April 2016. Past performance is not indicative or a guarantee of future results.

Looking at some of the price movements in recent weeks some investors might think that they have missed the opportunity, however, we would argue that a bank sector re-rating has only just started and has a long way to go for it to return to historic valuations relative to the market.

MSCI World Financials vs MSCI World



MSCI World Financials P/B

In terms of gaining exposure through Polar Capital Funds, the Polar Capital Financial Opportunities Fund is the most exposed to the banking sector with 67% of the Fund in banks compared to 52% for the benchmark (and 29% of the portfolio is in US banks compared to 22% for the benchmark, a proportion which has risen in recent months). The Polar Capital Global Financials Trust also has high exposure to banks (66%) and a greater bias to large-cap positions in particular in Europe.

Source: Bloomberg 7 December 2016. Past performance is not indicative or a guarantee of future results.

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