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KEEFE, BRUYETTE & WOODS ISSUES 2015 U.S. BANKING SECTOR OUTLOOK

Analysts Paying Close Attention to Interest Rates, Regulatory Risks, and Improving Lending Conditions

New York – December 11, 2014 – Keefe, Bruyette & Woods (KBW), a full-service, boutique investment bank and broker-dealer that specializes in the financial services sector, and a wholly owned subsidiary of Stifel Financial Corp. (NYSE: SF), has released its 2015 U.S. banking sector outlook. KBW analysts expect a variety of factors to impact bank stock performance in the coming year, including an expected rise in interest rates, continued regulatory and legal risks, and improvements in market and lending conditions.

Universal Banks: Sector in Transition

For 2015, Universal Banks will benefit from improved market and lending conditions including increased market volatility, which should boost trading activity and higher short-term rates, which should result in improved margins. However, these banks will face increased risks outside the United States along with regulatory and legal headwinds. KBW expects the ultimate end point for bank regulatory ratios to finally be determined in the coming year, but it expects those ratios will be meaningfully higher than what is currently required. As a result, upward performance will be limited as returns compress. KBW does not view price-to-earnings valuations as attractive and regulatory and litigation risks also remain a potential overhang on stock performance.

"We are recommending that investors maintain a market weight position in Universal Bank stocks," noted Frederick Cannon, KBW Global Director of Research. "Universal Banks should benefit from higher short-term rates, but we believe the benefits are already reflected in earnings and valuations. It is our view that upward estimate revisions will be the main driver of stock performance in 2015 for Universals. However, most banks lack tangible catalysts to drive earnings per share above our current estimates."

Within Universal Bank stocks, KBW rates The Goldman Sachs Group (GS) and State Street Corporation (STT) at "Outperform" and all the remaining stocks at "Market Perform". KBW continues to like the fundamental outlook for STT and believes the stock is at an attractive valuation relative to peers based on return expectations and growth outlook. The firm also believes that Goldman Sachs will continue to outperform since its valuation is still reasonable and the company will benefit from improving capital markets activity along with market volatility and economic growth.

KBW is “Market Perform” on the remaining Universal Bank stocks (BAC, BK, C, JPM, MS, and WFC) as earnings-based valuations are not cheap and catalysts for earnings growth above current estimates appear remote given the current macro conditions and regulatory environment. KBW would look to own the group when valuations improve relative to the broader market or if differentiated outlooks arise relative to other banks groups. KBW expects Universal Banks will continue dealing with litigation and regulatory risks throughout 2015 and this will limit the upside in share appreciation.

Large Regional Banks: It’s All About the Fed

The fight between lackluster growth today and the promise of better growth when the Federal Reserve raises rates is likely to be on display in 2015. With the sector trading at a lower relative price-to-earnings multiple than last year and expectations that the Fed will finally raise interest rates, KBW can envision the stocks doing reasonably well in the early stages of the year, as hope springs eternal. However, KBW believes the perceived leverage that is already embedded in earnings estimates must come to fruition or the stocks are at risk later in the year. As a result, KBW maintains a market weight position on the group for 2015.

Heading into 2015, KBW thinks the large-cap banks are still at risk for downward earnings estimate revisions, as its 2015 and 2016 estimates remain 2-3% below consensus. The analysts’ view is that the Fed will keep interest rates lower for longer and will move in a very slow manner once it tightens, and that the yield curve flattens as low global rates anchor long-term U.S. rates. This will result in a less optimistic earnings outlook than consensus.

Even if KBW’s fundamental view proves accurate, it may not matter for a period of time. The analysts believe investors are willing to look through the lack of revenue growth and tepid earnings growth in the sector today for the promise of better growth when interest rates rise. In addition, the value investor is discovering that it is hard to find areas of interest given the surge in valuations of many other non-bank sectors. Analysts see a 21% discount to the broader market and a sector’s fundamentals that are positively levered to an increase in interest rates while other industries could be negatively impacted.

“The true test will come after the Fed raises interest rates,” said Christopher Mutascio, Head of Large-Cap Bank Research at KBW. “Our concern is that a fair amount of net interest margin expansion is already embedded in estimates and investor expectations,” he added. “If the net interest margins don’t expand to the degree that is expected a quarter or two after the Fed starts to raise interest rates, then the bank stocks could be vulnerable, especially as the loan loss provision expense inflects and provides an offset to modest margin expansion.”

KBW likes names that can grow net interest income regardless of what the Fed does or does not do (HBAN) and the isolated names in which the analysts believe the consensus estimates are too low (STI). KBW is more cautious on names that have massively outperformed in 2014 on lackluster earnings quality (WFC) and names with expensive valuations despite slowing growth engines (USB).

SMID-Cap Banks: Estimate Revisions Key to the Stocks

Earnings revisions, not price-to-earnings expansion, drove this year’s performance in the small- and mid-cap bank (SMID) stocks. In order to get the stocks right in 2015, KBW believes it will once again come down to the direction of estimates. In-line valuations with historicals and the risk of lower rates for a longer time period keep KBW neutral on the group—although it remains selectively constructive on differentiated business models and select asset sensitivity.

On the positive side, KBW remains generally encouraged by the loan growth recently produced by the SMID-cap banks and believes the group remains poised to continue to take market share from its larger brethren and grow at a multiple of GDP. In addition, credit quality still remains very strong and while reserve releases aren't providing the earnings kicker that they did a couple of years back, KBW believes losses are likely to remain well below historical levels for the foreseeable future. Finally, building M&A momentum—primarily (but not exclusively) on the smaller side—is an additional consideration for the group as it relates to driving incremental earnings growth, as well as improved sentiment altogether.

"The SMID bank group isn't without its challenges, most notably the impact on bank profitability from the persistently low interest rate environment both domestically and abroad," noted Jefferson Harralson, Head of Small-Cap and Mid-Cap Bank Research at KBW. "The resulting impact on bank net interest margins (NIM)—the most meaningful input to forward estimates—remains significant. In addition, expense headwinds from increased financial regulation remain a consideration for underlying bank profitability entering 2015, though regulatory headline risk appears to be showing some signs of abating."

Investors can contact their KBW representatives to obtain copies of the KBW bank outlooks. Members of the press interested in obtaining copies of the full reports or who wish to schedule an interview with a KBW analyst should email kbwpr@intermarket.com.

About KBW

KBW LLC, a Stifel company, operates in the U.S. and Europe through its broker dealer subsidiaries, Keefe, Bruyette & Woods, Inc. and Stifel Nicolaus Europe Limited ("SNEL"), also trading as Keefe, Bruyette & Woods Europe ("KBW Europe"). Over the years, KBW has established itself as a leading independent authority in the banking, insurance, brokerage, asset management, mortgage banking and specialty finance sectors. Founded in 1962, the firm maintains industry-leading positions in the areas of research, corporate finance, mergers and acquisitions as well as sales and trading in equities securities of financial services companies.

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