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## Why Financial Stocks Could Begin a Turnaround in 2012

*T. Rowe Price Portfolio Manager Eric Veiel's 2012 Outlook for the Financials Sector*

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2011 proved to be another disappointing year for the financials sector, as a lack of confidence in the stability of global sovereign bond markets eroded expectations for economic growth and heightened the pressure on banks around the world, especially in Europe. In fact, 2011 was the fifth straight year that the sector underperformed the broad market.

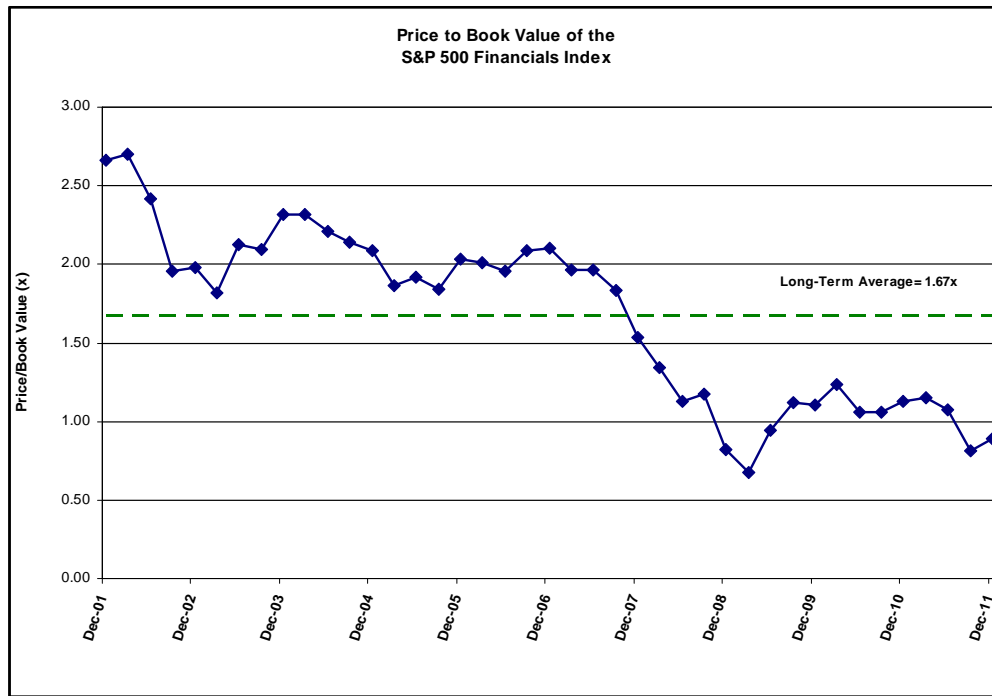
However, years of underperformance, negative sentiment toward the sector, attractive valuations versus historic levels, and improving economic data have the potential to create a positive outcome for financial stocks in 2012. The following reflects the views of Eric Veiel, lead portfolio manager of the T. Rowe Price Financial Services Fund.

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### **Low Valuations, Poor Sentiment, and Possible Regulatory Clarity Are Positives...**

We begin the new year with some tangible evidence that 2012 may turn out to be strong for financial stocks, specifically U.S.-based companies.

- **Valuations are low and sentiment is poor.** Valuations as measured by price-to-book value ratios are as low as they've been in the past decade—except for the very worst points of the 2008-2009 financial crisis—especially in subsectors like diversified money center banks and life insurance (see chart). With valuations and sentiment at or near trough levels, a lot of bad news may be already baked into stock prices. Any material improvement in the landscape for financials could lead to stronger stock performance.



**This chart is shown for illustrative purposes only and does not represent the performance of any specific security. *Past performance cannot guarantee future results.* It is not possible to invest directly in an index.**

**Source: FactSet**

- **Several key economic metrics, including U.S. nonfarm payrolls and—most importantly—U.S. housing starts, have been very resilient over the past several months.** Housing and jobs are two of the key variables needed to lift bank earnings. Housing directly affects credit losses, and an increase in jobs should boost demand for loans and consumer credit and lead to greater corporate borrowing.

- **Greater clarity on the U.S. regulatory changes affecting commercial and investment banks is increasingly likely.** Specifically, the final rules that will dictate what “proprietary” trading is (i.e., the Volcker Rule) and how the derivatives markets will be regulated should emerge by the middle of this year. Clarity on these two issues should provide significant relief to these industries. Additionally, the Federal Reserve will make this year’s bank “stress test” results public, which we believe will increase transparency and benefit the strongest U.S. banks.

### **...But the Skies Are Not All Clear for Financials**

- **There’s no sign of improvement in the interest rate environment, which is crucial for bank and insurance company profits.** Banks tend to have better profits when interest rates on the

long-term loans they extend to borrowers are notably higher than the interest rates they pay to short-term depositors. The 10-year U.S. Treasury bond yield remains at an uncomfortably low level of around 2.00%. This, along with the low rates of shorter-maturity bonds, creates a flat Treasury yield curve that will continue to pressure profits. Unfortunately, there is little reason to believe that interest rates will rise materially this year, as the Fed will likely engage in continued manipulation of the yield curve through purchases of Treasury securities in an effort to keep borrowing costs low in hopes of spurring growth.

- **The situation in Europe remains unresolved.** The European Central Bank managed to remove the immediate risk of a major bank failure thanks to its three-year longer-term refinancing operation, which pumped nearly 500 billion euros of liquidity into the European banking system. However, the larger issue of reducing the debt burdens of several large eurozone members, notably Italy and Spain, remains a threat to European gross domestic product (GDP) growth and potentially the stability of the euro. Any negative shocks in Europe would be felt by the major U.S. banks due to the interconnectivity of global financial institutions and the likely negative revisions to U.S. GDP prospects from turmoil in Europe.

- **China's potential housing/real estate bubble adds risk.** As we saw in the U.S., the collapse of a real estate bubble can have significant negative ramifications for an economy and its banking system over several years. The Chinese government is well aware of this risk and has ample tools to use to orchestrate a so-called "soft landing" for its real estate market. But a misstep leading to weak economic results in China, combined with austerity-driven weakness in Europe, would almost certainly prove to be too much for the U.S. economy to overcome. This would likely negate the signs of improvement we are seeing in key U.S. economic data.

### **A Balanced Approach to Investing in the Financials Sector Seems Prudent**

- We believe that the combination of five years of financial stock underperformance and the resulting negative sentiment toward the sector, plus attractive valuations versus historic levels and improving economic data, has the potential to create a positive outcome for financial stocks in 2012.

- However, because we are not confident in a sustained improvement in the interest rate environment, we have positioned the Financial Services Fund to have a balance between stocks that

have the potential to do well in an improving interest rate environment and a mix of more defensive names that rely less on the interest rate environment for their earnings growth.

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Price-to-book value ratio: A valuation measure that compares a stock's market price with its book value; i.e., the company's net worth divided by the number of outstanding shares  
S&P 500 Financials Index: A sub-index of the S&P 500 Stock Index that includes all of the financials sector components of the S&P 500

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