

## ***MONTHLY RESEARCH WEBINAR***

# **FINANCIAL SERVICES: INFLATION, INTEREST RATES, AND THE FED**

Moderator:

Jim Kelleher, CFA

Director of Research

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## ■ **Financial Services: Inflation, Interest Rates, and the Fed**

- Jim Kelleher, CFA, Director of Research
- Stephen Biggar, Director of Financial Services
- Kevin Heal, Senior Financial Services Analyst
- John Eade, Argus President

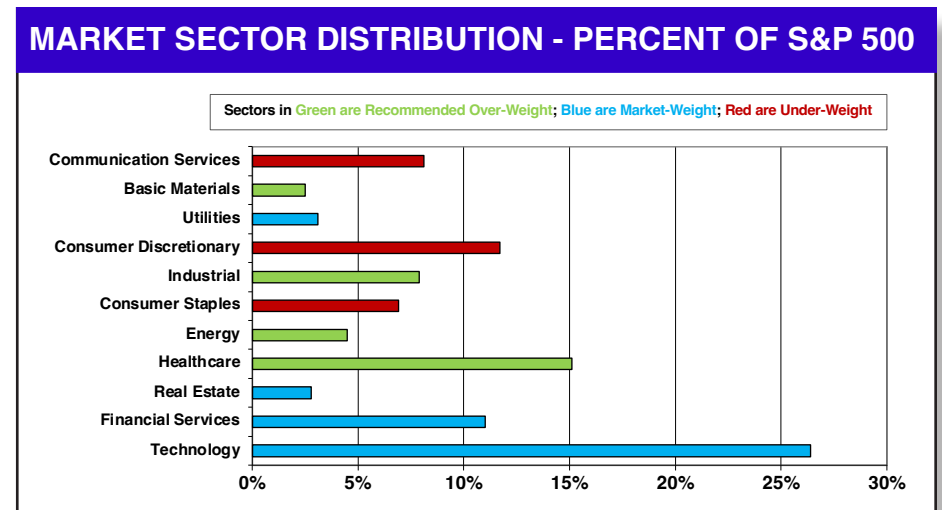
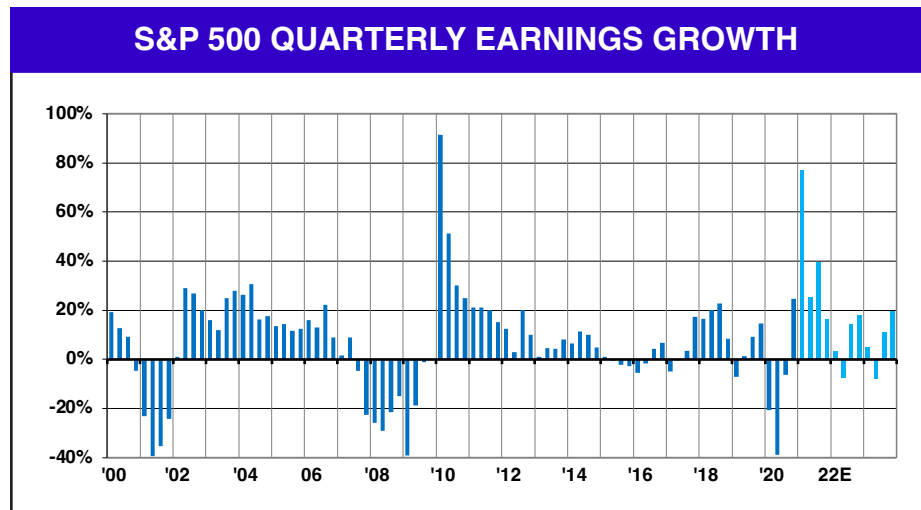
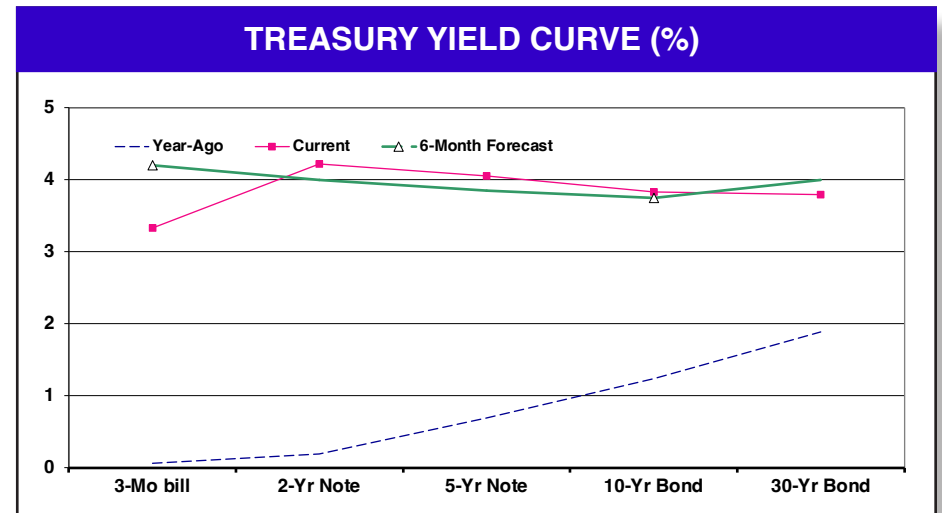
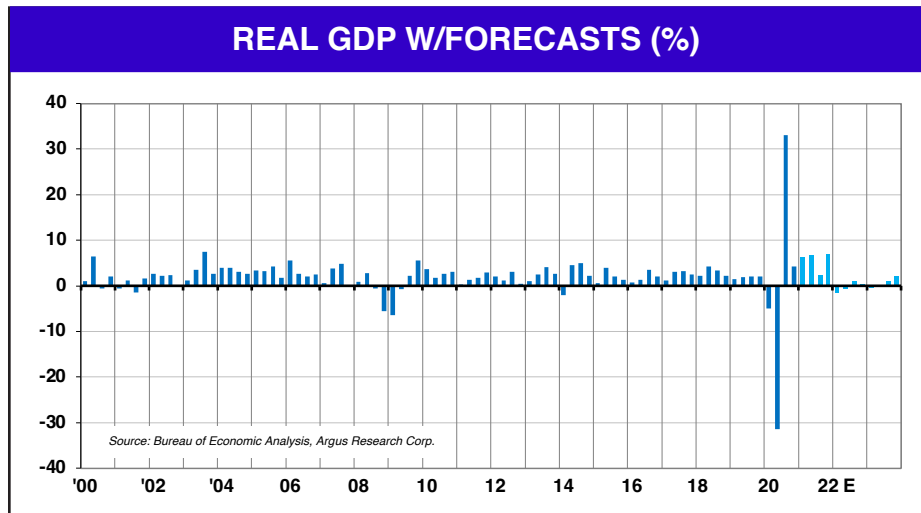
## ■ **Argus Quick Notes**

- Shooting Stars and Falling Angels 3Q22
- Small-Cap and Mid-Cap Favorites
- Best in Class for Safety
- High-Yield Stocks
- Find these on the homepage of our website

## ■ **Portfolio Update: the Argus Mid-Cap Model Portfolio**

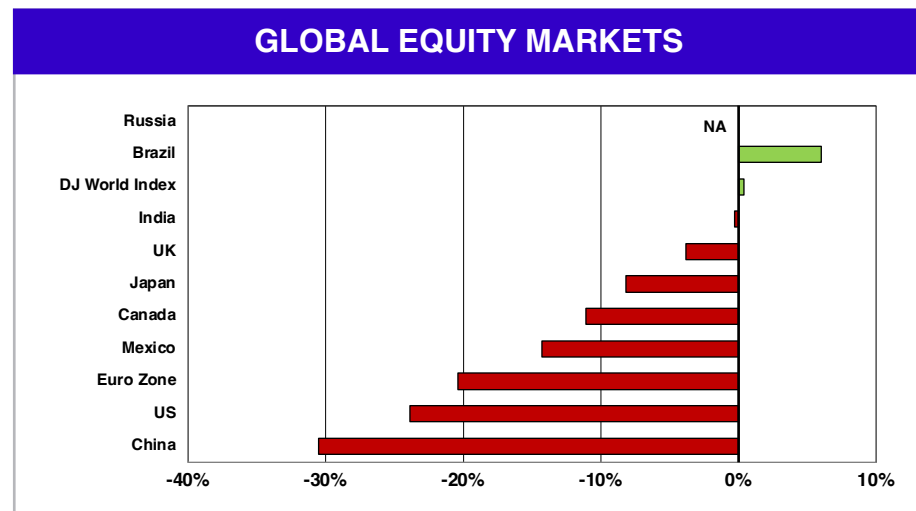
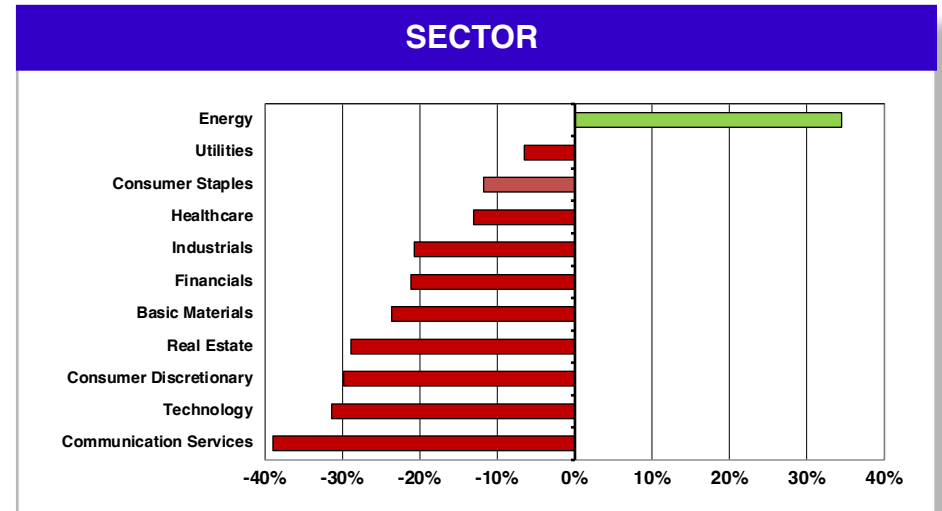
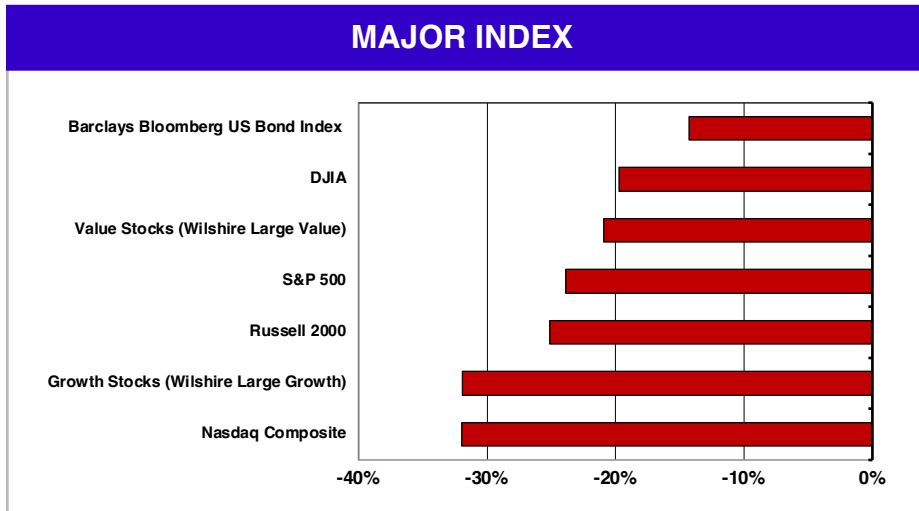
- Mid-Cap stocks have lagged YTD, but appear well-positioned
- Mid-cap companies are U.S.-focused (geopolitics, currency, etc.)
- After years of large-cap performance, SMID valuations are attractive
- Find the Argus Mid-Cap Portfolio on the homepage of our website

# MACRO FORECASTS



# MARKET PERFORMANCE

DATA AS SEPTEMBER 30, 2022



- **Expect 75 bps rate hike in Nov. & 50 bps in Dec. Believe Fed will take a faster approach and remain inflation data dependent vs. an uptick in unemployment. Potential pause at year-end to measure where economy stands.**
- **Headline inflation expected to ease. Energy \$\$ down. Core to remain high due to Shelter component.**
- **Fed began program to lower the \$8.96 trillion balance sheet in a measured approach starting June 2022. Passive QT- Let UST & MBS mature and not reinvest the proceeds. Balance sheet stands at \$8.79 trillion down \$170 billion (\$150 billion UST & \$20 billion MBS).**
- **Active QT - on the back burner for now. MBS holdings currently at \$2.7 trillion due to lower mortgage prepayments and remain below the monthly cap of \$35 billion.**
- **Seen a continued inversion of the curve as 2-10 spread is around negative 40-50 bps. 3-month t-bill – 10 yr remains positive at 40 bps. Inversion has preceded all recessions since 1950's.**

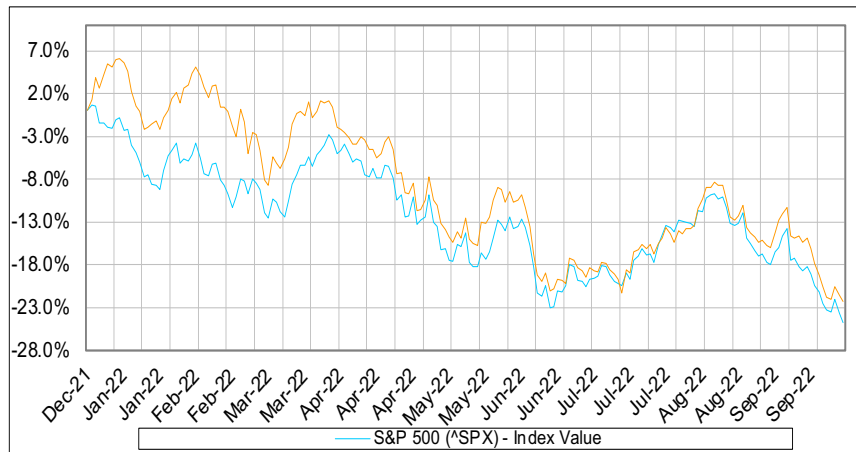
- **Headline CPI expected to abate in 4Q22 and into 1H23. Lower energy prices and “some” supply chain bottlenecks easing. Food prices remain elevated on higher prices for basic commodities (wheat, corn, etc.)**
- **Core CPI (ex Food and energy) may remain elevated due to higher rent component. Makes up approximately 33% of the total figure. Calculated on what a house/apt. would rent for, not the value of the house.**
- **FED would like a decline in housing prices and rents to ease inflation and lower the core rate, however it will take some time to see declines in the Shelter component.**

- **CPI is a survey of households prepared by Bureau of Labor Statistics.**
- **PCE is a survey of businesses prepared by the Bureau of Economic Analysis.**
- **They each have their own index formulas, weights and scopes.**
- **EX. Shelter is approximately 33% of CPI and 23% of PCE. Medical is approximately 8% of CPI and 22% of PCE.**
- **We expect the FED to use the PCE ex. Food & Energy to attain their ultimate goal of 2% inflation.**

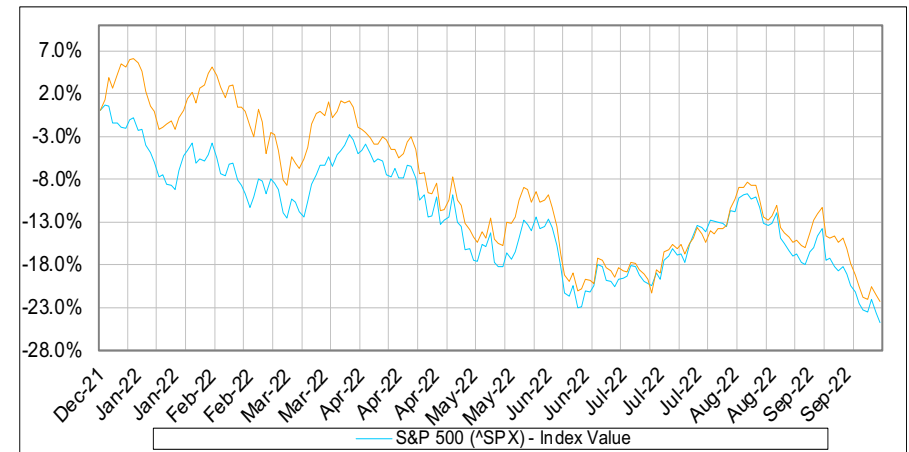
## ■ Performance

- Sector down 20.5% YTD through September 23 vs. 22.5% drop for broad market
- Diversified and Regional Banks both faring worse, down 27% and 25%, respectively, which we believe reflects concerns that aggressive interest rate hikes will result in a U.S. recession.

S&P 500 vs. Financial Sector Index – YTD 2022



S&P 500 vs. Financial Sector Index – 3 years



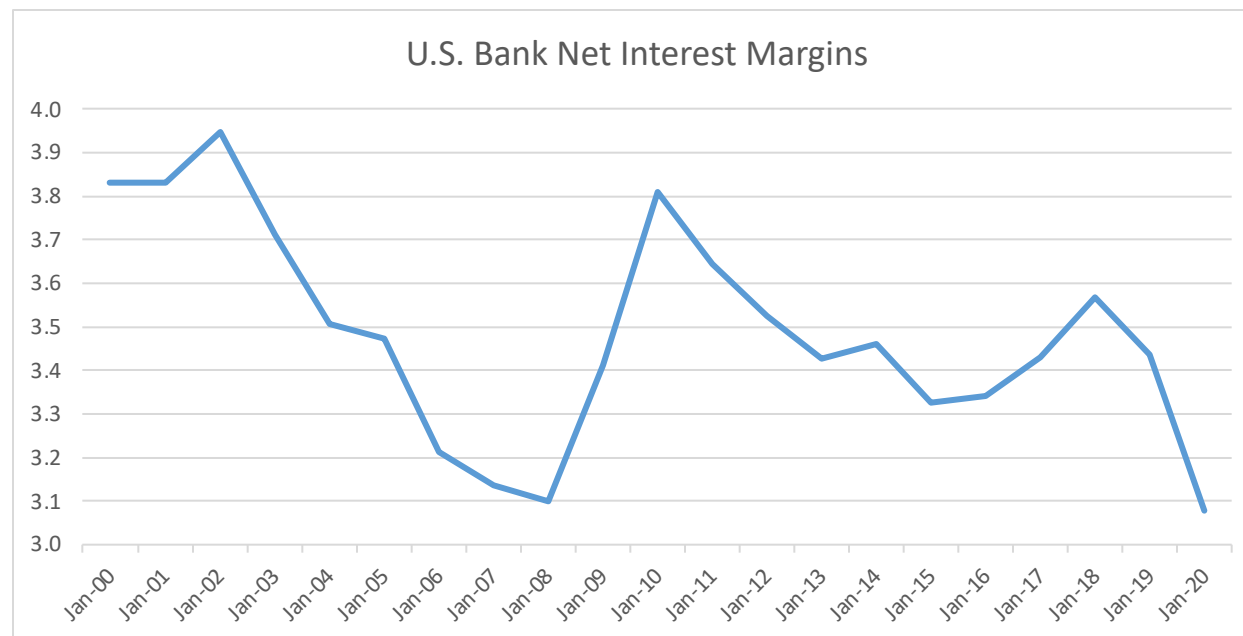
Source: S&P Capital IQ



## ■ Our Recommendation is Marketweight

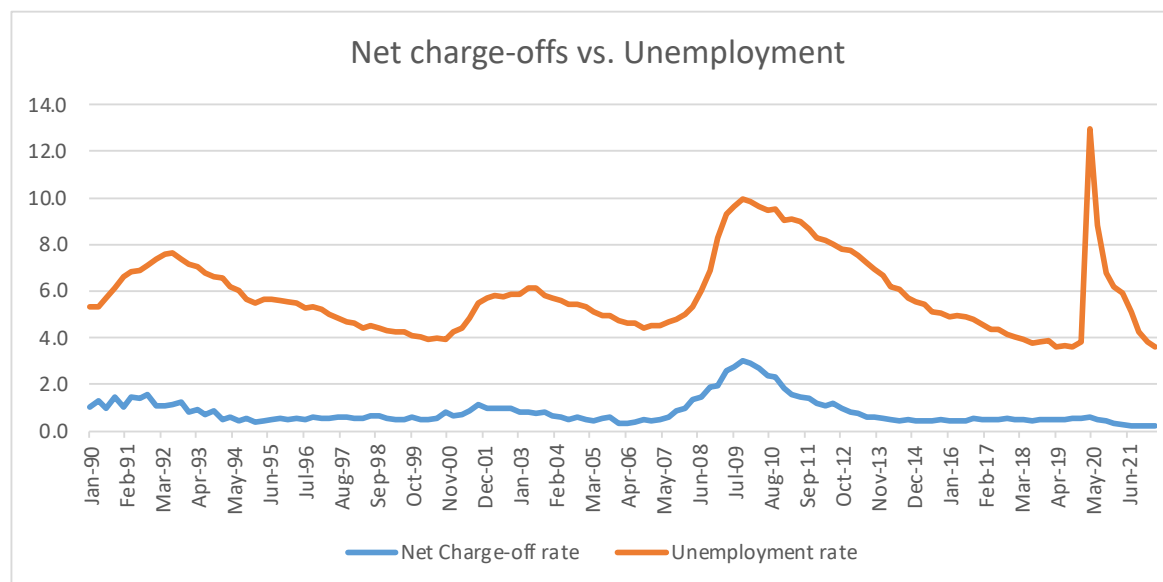
- Marketweight stance based on:

- » Rate rises will continue to benefit net interest margins. We see Fed funds topping at 4.5%-5% in 2023.



Source: World Bank

- **Loan growth had been improving, aided by roll-off of government stimulus measures, but we expect will come under pressure as rates rise.**
- **Major banks also contending with sharply lower capital markets revenues. Trading holding up well, but equity and debt underwriting, along with M&A activity, remains in a deep downturn.**
- **Loan loss provisioning expected to increase as bank management's factor in risk of recession. Higher unemployment and credit costs go hand-in-hand.**



Source: St. Louis Federal Reserve

## ■ **Truist Financial Corp. (TFC: BUY)**

- **BB&T Corp. and SunTrust Banks merger still providing benefits.**
- **Expect \$1.6 billion merger expense savings by 2022 year end.**
- **Medium-term goals of above-peer-average ROE (20%+) and efficiency measures (low 50s) following merger.**
- **Steady growth profile, strong revenue diversification, and an above-average dividend yield, which we believe merit a premium valuation.**
- **Target price \$67**

## ■ Prudential Financial (PRU: BUY)

- 2Q Return on Equity declined to 9.3%, still above many of its peers.
- Expanding into higher margin geographic areas (EMEA, Africa) and shedding assets in lower margin areas (Japan, Korea).
- Expect lower COVID-19 morbidity rates offset by lower equity and fixed income valuations.
- Recently raised quarterly dividend rate 4% to \$1.20 for a yield of 5.1%.
- Target price of \$112

## ■ **Citizens Financial Group. (CFG: BUY)**

- **Expanding presence on East Coast with acquisition of HSBC's branches and online deposits. Added approximately 800,000 new customers.**
- **Acquired Investors Bancorp expanding presence in NYC and Philadelphia markets. Top-10 bank in deposits in NYC Metro area.**
- **Closed the acquisition of JMP Group, a provider of investment banking services for the technology and healthcare sectors.**
- **Future potential acquisitions in wealth management.**
- **Has been hurt lately on lower loan demand and lower mortgage originations.**
- **Dividend yield of approximately 4.6%**
- **Target price of \$53**

## ■ CME Group Inc. (CME: BUY)

- Expect volumes in the rate markets to increase on uncertain timing of FED rate hikes.
- Volumes to increase in energy, agriculture, cryptocurrency and new ESG related contracts.
- Continue to introduce new micro contracts geared toward retail investors.
- Recently raised quarterly dividend 11% to \$1.00, for a yield of approximately 2.1%. Also historically pays a special dividend in January pushing the dividend yield to 3.5%-4.0%.
- Target price of \$230

## ■ US Bancorp (USB: BUY)

- USB well levered to rising interest rates. We look for sequential margin improvement in all quarters through 2023 year-end.
- See high-single digit net interest income growth in second half 2022.
- Agreed last September to acquire MUFG Union Bank's core regional banking franchise from Mitsubishi UFJ Financial, which has a focus in California, Washington and Oregon, including about \$58 billion in loans. Transaction expected to be 8% accretive to earnings when fully integrated.
- Target price of \$63

## ■ **American Express Co. (AXP: BUY)**

- **Worldwide credit card and travel-related services.**
- **Travel and entertainment categories, where AXP has large market share, continue to have strong potential for rebound.**
- **Higher income customers less impacted by inflation pressures.**
- **Management issued robust guidance for 18%-20% revenue growth for 2022.**
- **Making progress on expanding merchant acceptance.**
- **Target price of \$210**



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