



We See the Greatest Opportunities in Stocks That Have a Bright Long-Term Outlook but Face Elevated Near-Term Risks

The Morningstar U.S. Financial Services Index rose 1% quarter to date through Sept. 24, in line with the market as a whole (Exhibit 7a). Overall, the median U.S.-based financial-services stock trades at about a 2% discount to our fair value estimate, so we consider the U.S. financial sector slightly undervalued.

At the conclusion of its September meeting, the Federal Open Market Committee voted to decrease its target rate range to 1.75%-2% from 2%-2.25%. For the third consecutive time under Chairman Jerome Powell's tenure, the vote was not unanimous. The economic picture remains murky, but overall conditions haven't been deteriorating as fast as some may have expected, and two members voted for no change in the benchmark rate, while one voted for a 50-basis-point cut. According to the FOMC dot plot, many contributors expect the federal-funds rate to decrease another 25 basis points (Exhibit 7c).

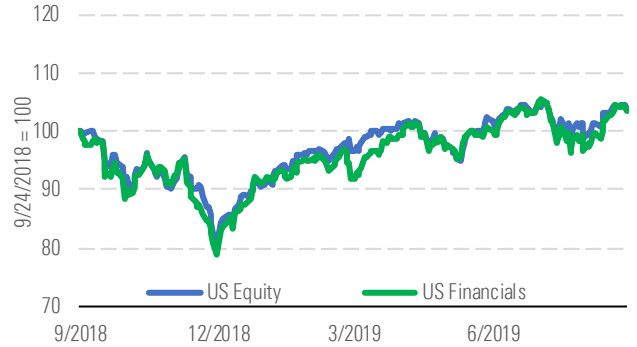
It's important to consider both short-term interest rates, such as the federal-funds rate, and long-term interest rates, such as the yield on the 10-year Treasury, when looking at stocks in the financial sector. The yield on the 10-year Treasury averaged 1.63% in August 2019 compared with 2.07% only several months ago in June 2019 and 2.89% a year ago in August 2019 (Exhibit 7d). With funding sources for financials, such as bank deposits, often linked to short-term interest rates and certain interest-earning assets, such as mortgage loans, tied to long-term rates, a flat or inverted yield curve can pressure net interest income.

Whereas over the previous year we've had times where whole financial industry groups were undervalued, we believe investors should now be much choosier. Most of the undervalued financial stocks in North America either have company-specific issues that we believe the market isn't appropriately pricing or are more economically sensitive names. While there are near-term risks to the companies we currently regard as undervalued, they also have the greatest probability of long-term outperformance.

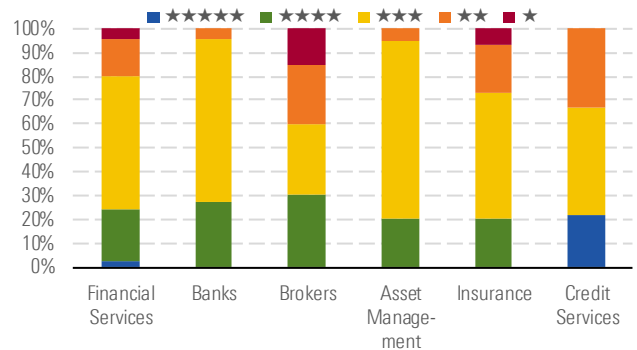
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Exhibit 7 Interest Rates Are Driving Higher Volatility in Financials

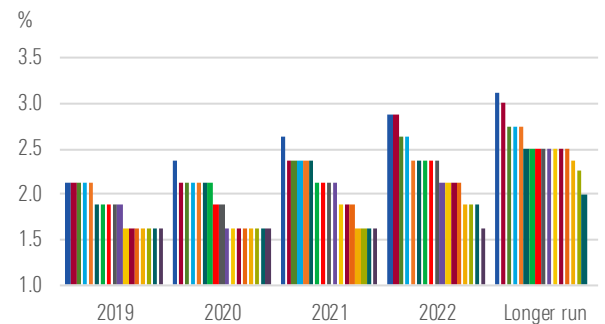
7a Financials have recovered from the beginning of the year.



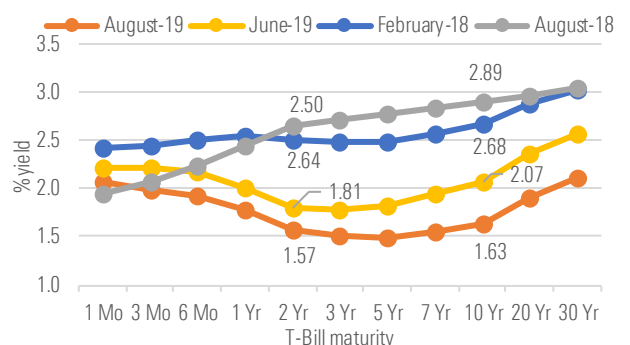
7b More undervalued names have higher economic sensitivity.



7c Fed expects to keep rates below 2% through 2020.



7d The yield curve has dramatically changed in a short period of time.



Source: Morningstar, US Treasury, FRED.
Data as of Sept. 24, 2019.

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