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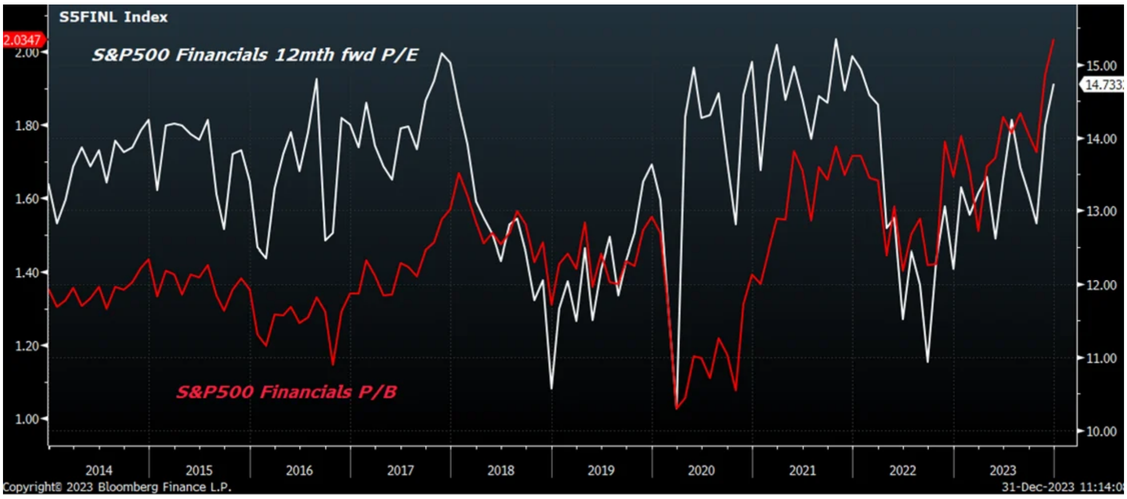
Qi Sector Spotlight - US Financials
The Great Escape?

A core tenet of the proverbial soft landing thesis – where inflation converges back to target without breaking the labour market – is a broadening of the bull market outside of the Technology sector.

Indeed, the rapid easing in financial conditions has coincided with the equal-weighted S&P500 outperforming the market-cap weighted index into year-end.

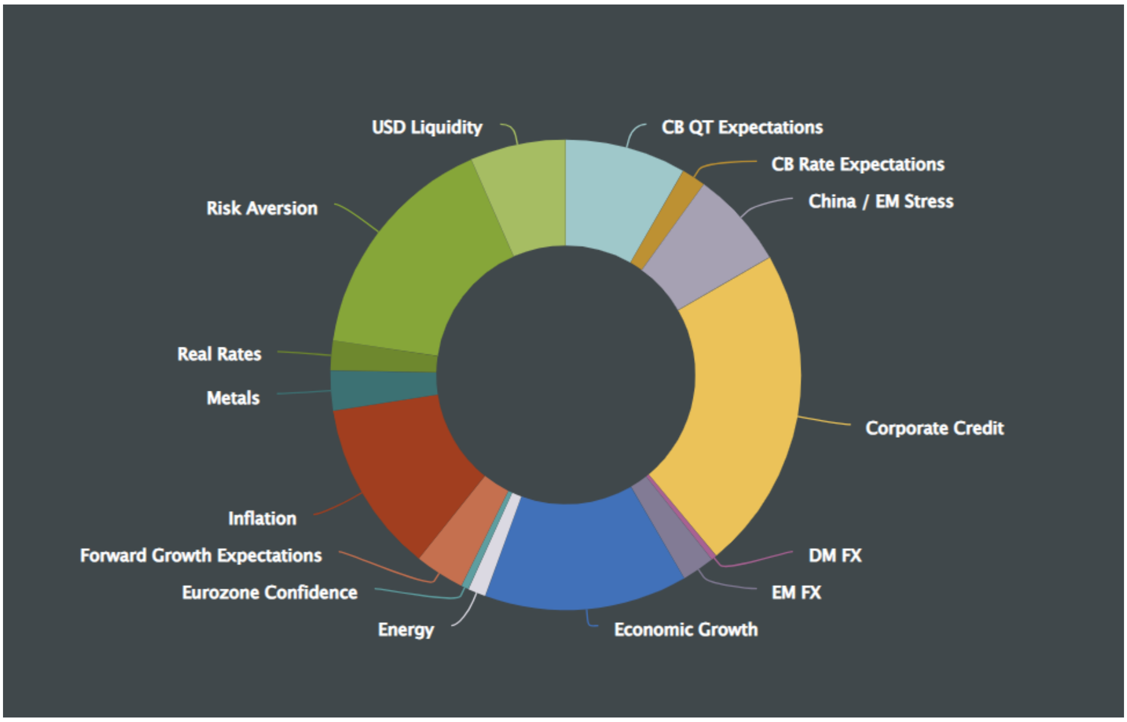
The biggest contributor to that equal-weighted index outperformance is the Financials sector – rallying ~20% from close to 1yr lows at the end of October to 1yr highs in just 2mths.

This has been reflected in sharp multiple expansion – the 12mth fwd PE for the XLF ETF now sits closer to 10yr highs than 10yr lows before the rally. Earnings estimate now need to follow suit. See the charts below.



Is 2024 the year of the Great Escape for Financials? Positioning data shows that the sector has been under-owned over the last 2yrs – it has lagged the broader market over this period. We see the sector as barometer of soft landing sentiment – with lower rates helping deposit growth return and a help to capital ratios, at a time when credit concerns so far seems contained. Albeit, the backdrop remains of tightening lending standards and meagre loan growth.

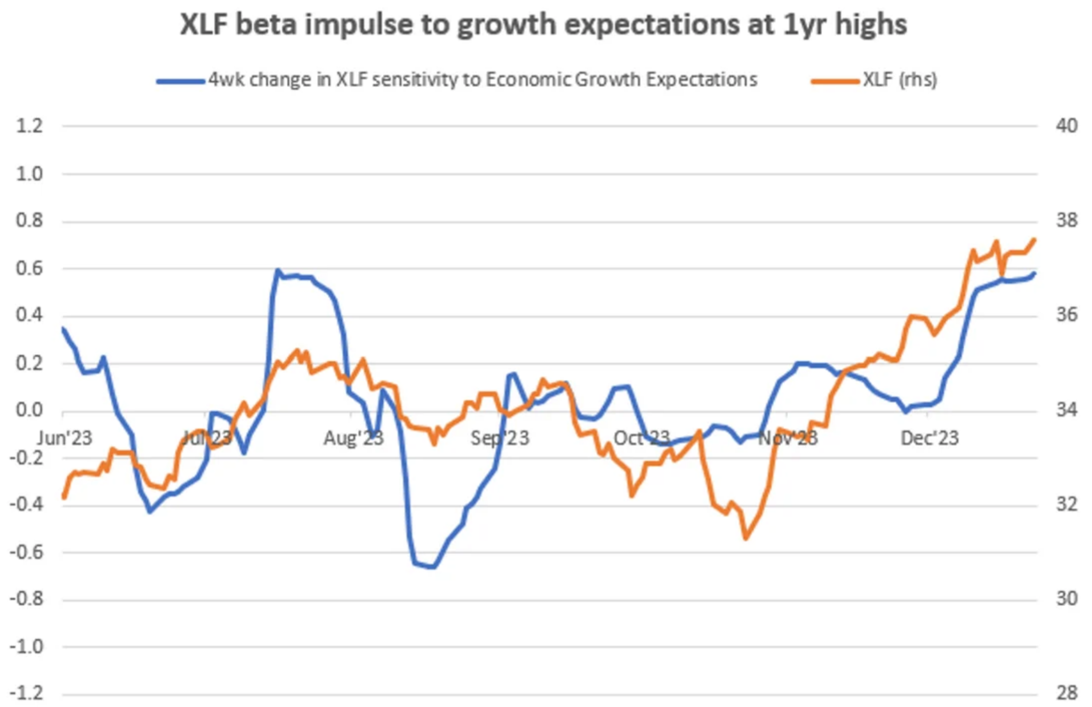
Qi shows the most important macro drivers of the sector are in order: credit spreads, risk aversion and economic growth expectations – in other words, financial conditions and growth both feature as prominent drivers.



Qi is able to explain over 90% of the variance in the [XLF] ETF on both our ST (multi-month) and LT (1yr) time horizon models. Further, on Qi's ST model, sensitivity to credit spreads (negative), economic growth (positive) and risk aversion (negative) have been increasing sharply through this rally. In other words, the ETF's beta to its major macro drivers has been rising - Macro is front and centre for this sector.

Model sensitivity to economic growth is the highest it has been over the last 1yr – 2024 growth expectations have been rising as financial conditions have eased. Ordinarily, our studies suggest that when the sensitivity to macro drivers are accelerating, that comes alongside greater vulnerability – the major macro factors must continue to move in your favour.

The below charts suggest that XLF is already pricing the rise in growth optimism. The first chart shows how XLF strength over H2 2023 has coincided with rising Qi sensitivity to economic growth. The second chart shows that over H2 2023, consensus GDP growth expectations for 2024 have been rising. Street expectations for 2024 real GDP growth today sits in a range of 0.7% to 2.4% y/y (mean 1.3%).



We should watch closely whether earnings expectations imminently follow suit. Credit card lending has been growing rapidly reflecting the growth in consumer spending. However, outside of this, loan growth has been muted as lending standards have tightened, as they typically do in latter stages of the business cycle. There also remains competition from private credit. Financials outperformance typically occurs alongside easing in lending standards and recent price action reflects the expectation this will happen. See the chart below.

From a Qi valuation perspective, macro model momentum has been strong through this rally – the major macro driver moves have been supportive. There is no major valuation dislocation between model price and spot price of the ETF. However, we would note that Qi model price has tentatively dipped from the upper-end of its trend channel from its Spring '23 low.

Bottom-line, Financials leadership is heavily reliant on the continued improvement in the growth / inflation trade-off. Recent strength has well discounted the rapid easing in financial conditions. There is little room for any dent in soft landing optimism.

After the degree of financial conditions loosening we have seen, central banks may now counsel more patience. The risk-reward of interest-rate sensitive sectors likely diminishes with the 10yr now sitting at 3.8%, unchanged since 1 Jan 23 - a level few had predicted.

Read the PDF

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