Investment Strategy Update

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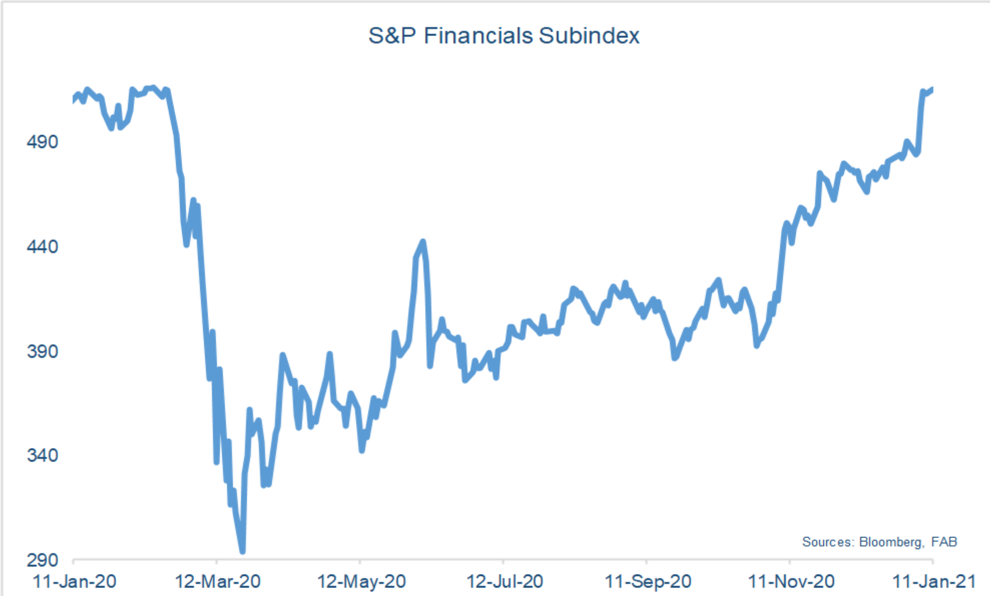
A steeper yield curve can be good, especially for financials

♦ **The yield premium of the 10-year US Treasury compared to the two-year bond rose above 101 basis points today, the highest since 2017.**

♦ **The S&P Financials subindex has risen 5.1% so far this year, and is up 75.6% since 23 March.**

♦ **Some of the biggest banks in the US start to report their full-year earnings this week and will offer further clarity on the sector's outlook.**

♦ **The FAB AAC has a neutral position in equities, and is slightly overweight in IG and EM bonds, and gold.**



The relentless rise in long-term US Treasury yields since the year began could soon start having a wider impact on asset prices, but at least one sector could benefit. Financial companies, banks in particular, stand to gain from a steeper yield curve, and this may also have implications on broader growth.

Banks usually borrow in the short-term and lend for the long-term, making a profit from the difference in rates. Hence, the bigger the difference between short and long-term rates, the better the profit prospects for banks.

If that is the key gauge, the outlook is brightening for the financial sector. The difference between the yield on 10-year US Treasuries and two-year bonds has increased to 101.5 basis points, the largest since May, 2017. Investors will also get a better read of how bright are the future prospects for the sector later this week, as some of the biggest banks start to report their full-year earnings and offer guidance for 2021.

How long the Treasury yield curve stays steep will be key, naturally. However, investors may also question how much more the sector can rally, at least in the US, after the S&P Financials subindex gained 75.6% since 23 March. The subindex is also about to hit an all-time high, which has pushed its trailing price-to-earnings ratio over 18 times, close to its highest since the 2008 crisis.

However, when it comes to stock markets, the future is what matters, and analysts have started to revisit their earnings expectations for the sector. In fact, it now trades at a forward P/E ratio of 15.2 times, in line with its historic average. Hence, if the bull market continues, financials are unlikely to be left behind, especially as the global economy recovers.

A steep yield curve also has broader positive implications. Even though it means that the interest rates banks charge on long-term loans, such as mortgages, go up, it also is an incentive to lend more.

The shares of financials have rallied recently as the US Treasury curve steepened

In fact, this has been one of the things the Federal Reserve had been grappling with. Initially, right after cutting rates last year, the US saw lending slow down. That was both because companies and people did not want to borrow amid all the uncertainty, but also because banks were reluctant to take on the risk of lending for such a small profit. The result was that, as of the third quarter, loans in the US had fallen 5.4% compared to the previous quarter to US$2.3 trillion.

The higher the profit for banks, the bigger their incentive to lend. Hence, if yields are only a bit higher for long-term bonds, it can be good. If executives and other people feel confident enough to borrow and banks find it profitable to lend, credit activity will quicken, and boost the economy further.

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