



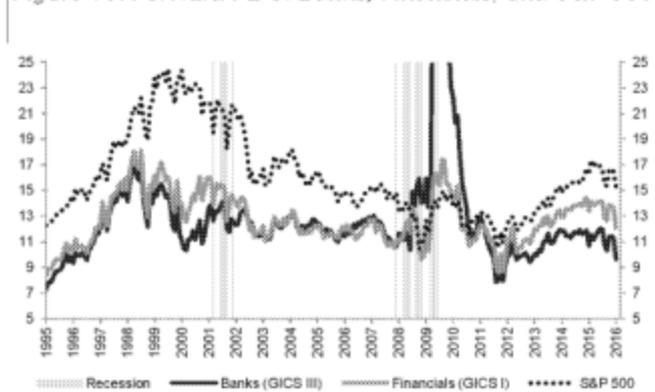
In defense of Banks, despite a tough 2016 and delay in hikes

We cut 2016E S&P EPS from \$120 to \$118 almost entirely at Financials. We also cut our 2016E S&P DPS (dividend per share) from \$44 to \$43 mostly at Energy and Financials. We raise our allocation to Banks and lower our allocation to Telecom from OW to EW and make our OW on Utilities smaller.

Bank EPS is likely down 5% in 2016 rather than up 5% as we previously thought, as only 1 or 2 Fed hikes in late 2016 won't raise the average 2016 Fed Funds rate much. This makes Banks vulnerable to down EPS if markets business stays weak for longer and credit costs rise from low levels to more normal levels led by energy exposures.

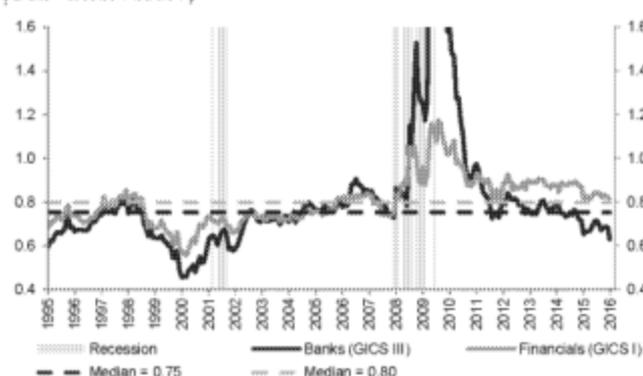
However, big Banks are now 10x or less our lowered 2016 EPS vs. a 13 average PE since 1995. On a PB basis, S&P Banks trade at 0.9x vs. ~2x on average since 1995.

Figure 16: Forward PE of Banks, Financials, and S&P 500



Source: ISES, Deutsche Bank

Figure 17: Banks are trading at a larger discount to the S&P than history



Source: ISES, Deutsche Bank

Valuing Banks: No greater torture for investors, but intrinsic value concepts still help

We think 12-14x normalized EPS is fair and attractive for Banks with possible upside as dividend payout ratios climb. Given heightened monetary and other macro uncertainties we raise our real CoE for Banks to 7% from 6.5%. We think a 7-8% real cost of equity is high enough even for the big systemically important banks. Like any stock, value is a function of cash flows to equity and the same is true for Banks: fair PE on steady state $EPS = 1 / \text{real CoE}$, fair PB = steady state ROE / real CoE, fair DPS yield = fair EPS yield * payout ratio. For S&P Banks in aggregate we use a 7% real CoE, which supports as fair a ~14 PE, ~1.25 PB and ~2% dividend yield. These all suggest 25% price upside.