

FOR PROFESSIONAL AND QUALIFIED INVESTORS ONLY

Expert's view

The case for Financials (equity & credit)

The re-rating of Financials has been rapid since the market turmoil a year ago, spurred by the ongoing recovery in activity and Covid-19 vaccine rollout. Valuations remain attractive, and the reflation theme should support Financials over the medium term. In this report, we look at allocation opportunities both in equity (MSCI World Financials) and credit (ESG filtered Floating Rate Notes).

Facts and overview

- ▶ **A supportive economic backdrop:** The combination of Covid-19 vaccine deployment and a highly accommodative policy mix (fiscal and monetary) have paved the way for a strong rebound in global economic activity since H2 2020. GDP in most developed economies is expected to return to pre-crisis levels by the end of 2021, a much quicker pace compared to the Global Financial Crisis, particularly in the US.
- ▶ **Further curve steepening ahead:** Central bank support will keep short-term rates anchored for now. Recent guidance suggests that they feel no compelling need to counter curve steepening yet. Market expectations, measured by overnight indexed swaps, have shifted following the 16 June FOMC meeting and are now for a Fed rate hike in late 2022/early 2023 while the ECB is not expected to raise rates before 2024.

Our key takeaways

- ▶ **Financials are sensitive to higher inflation and steeper yield curves.** In the subsector of commercial banks, a steeper yield curve and high deposit levels should increase profit margins. Investment banks should benefit from buoyant liquidity conditions, and higher M&A and primary market activity.
- ▶ **Increase Financials exposure via Floating Rate Notes:** FRN indices hold a greater exposure to Financials and credit risk without duration risk, compared to traditional bond indices. ESG filtered FRN indices offer an even greater exposure to Financials.
- ▶ **MSCI World Financials:** The MSCI World Financials Index is dominated by US banks. Lending is a central revenue source in Banking, Capital Markets and Consumer Finance. These three industries make up ~70% of the index, while the US represents ~50% of the country exposure.

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Summary

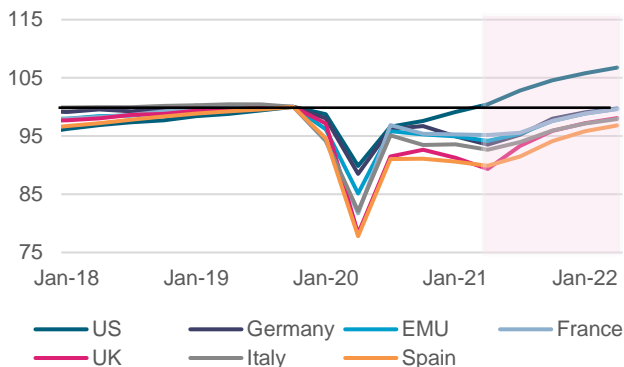
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The global recovery is underway

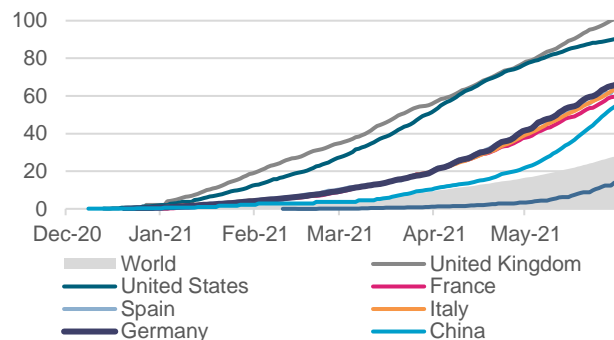
The combination of Covid-19 vaccine deployment and a highly accommodative policy mix (fiscal and monetary) have paved the way for a strong rebound in global economic activity since H2 2020. Economic activity is expected to jump back to pre-crisis GDP levels by the end of the year for most developed economies, a much quicker pace compared to the previous downturn, particularly in the US.

The pace of the recovery goes hand in hand with the Covid-19 vaccine roll out and the end of the pandemic

Real GDP growth (base 100= 01/10/2019)



Covid-19 Vaccination per 100 people



Forecast data based on Bloomberg consensus. Source: Lyxor International Asset Management / Cross Asset Research. Data as at 08/06/2021. Past performance is not a reliable indicator of future performance.

Central banks reiterated that support will remain for now, recent guidance suggests no immediate need for action to counter curve steepening. Market expectations, measured by overnight indexed swaps, have shifted following the 16 June FOMC meeting and are now for a Fed rate hike in late 2022/ early 2023 while the ECB is not expected to raise rates before 2024. The US Fed is expected to start hinting tapering of asset purchases late this summer to kick off in Q4 2021.

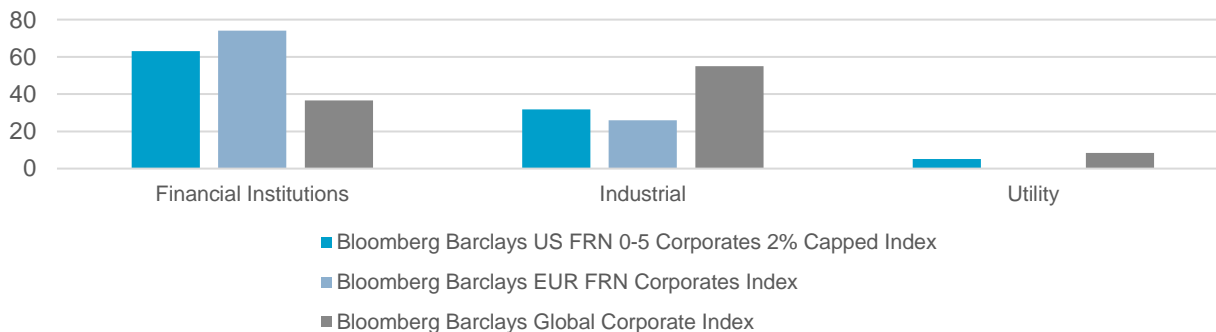
Credit: Floating Rate Notes, another route to play Financials

FRN indices: Greater exposure to Financials vs traditional bond indices

Floating Rate Notes (FRNs) are well suited products to gain exposure to the Financial sector in the credit market. FRN indices hold a large exposure to Financial bonds (60%-70%) compared to traditional nominal corporate bond indices (see chart below).

FRNs universes have higher exposure to financials than traditional corporate bonds indices

Bloomberg Barclays class 2 sector breakdown, (% of market value)



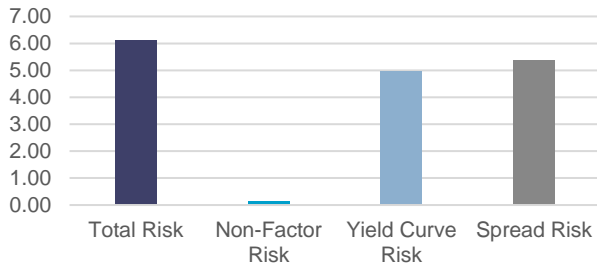
Source: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/05/2021. Past performance is not a reliable indicator of future performance.

FRNs also offer greater exposure to Financials credit risk. There is no duration risk, due to the nature of FRN coupons (explained on the next page). On the other hand, the analysis below shows that traditional bond indices do have an exposure to duration risk.

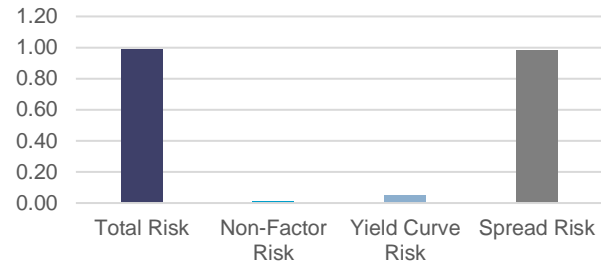
FRN indices: an exposure to Financials and credit risk without duration risk

Ex-ante risk decomposition

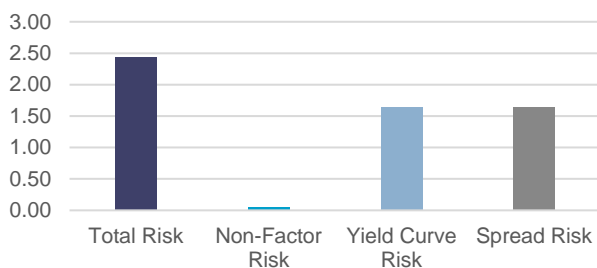
Bbg Barc USD Corporate Index



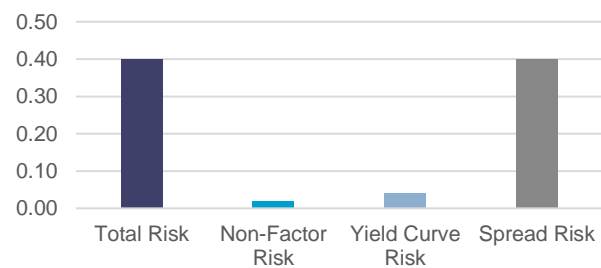
Bbg Barc USD Corporate FRN Index



Bbg Barc EUR Corporate Index



Bbg Barc EUR Corporate FRN Index



Source: Lyxor International Asset Management, Bloomberg Barclays.
Data as at 31/05/2021. Past performance is not a reliable indicator of future performance.

Floating rate notes are based on the combination of investment-grade bonds – issued primarily by corporates – that accrue interest based on a specific spread over a reference rate that resets periodically. As FRN coupons evolve with the interest rate, they are not subject to duration risk, leaving only the credit risk component.

The benefits of ESG filters in an FRN allocation

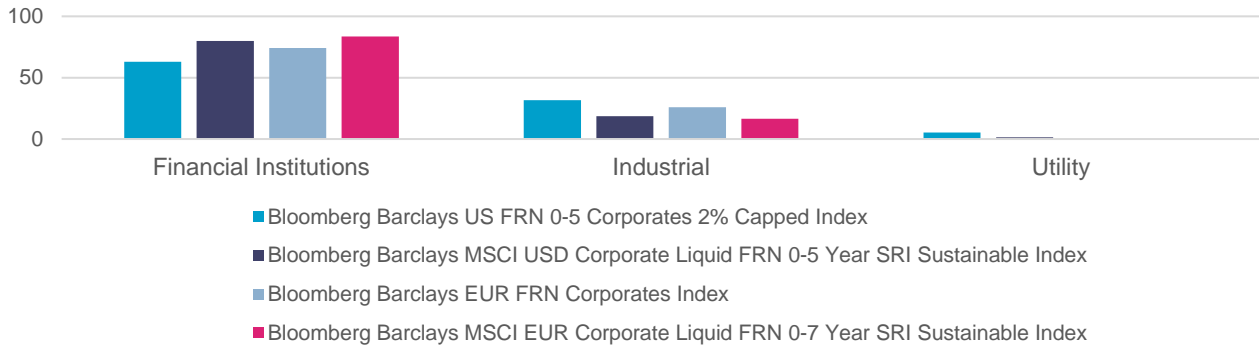
Adding an ESG filter to FRN indices has some benefits. The Bloomberg Barclays MSCI SRI Sustainable Index methodology combines three layers of ESG filters:

1. Exclusions of issuers involved in controversial businesses (SRI exclusions);
2. Exclusions of issuers with an ESG rating below BBB;
3. Exclusions of issuers involved in very severe controversies.

ESG FRN indices tend to have higher exposure to Financials as shown in the charts below. Most Financial institutions have a very limited exposure to controversial businesses (Alcohol, Tobacco, Gambling, Adult entertainment, GMOs, Nuclear power, Weapons, Thermal coal or Unconventional oil and gas), a key criterion of SRI exclusions.

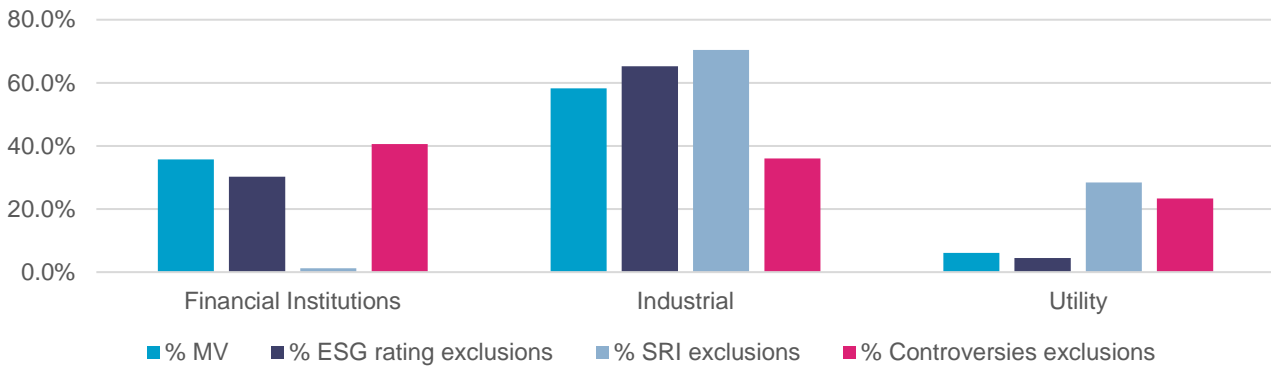
ESG FRN indices have higher exposure to financials than their parent

Bloomberg Barclays class 2 sector breakdown, (% of market value)



Bloomberg Barclays Global Corporate index – Sector & ESG exclusions breakdown

Bloomberg Barclays class 2 sector breakdown, (% of market value)

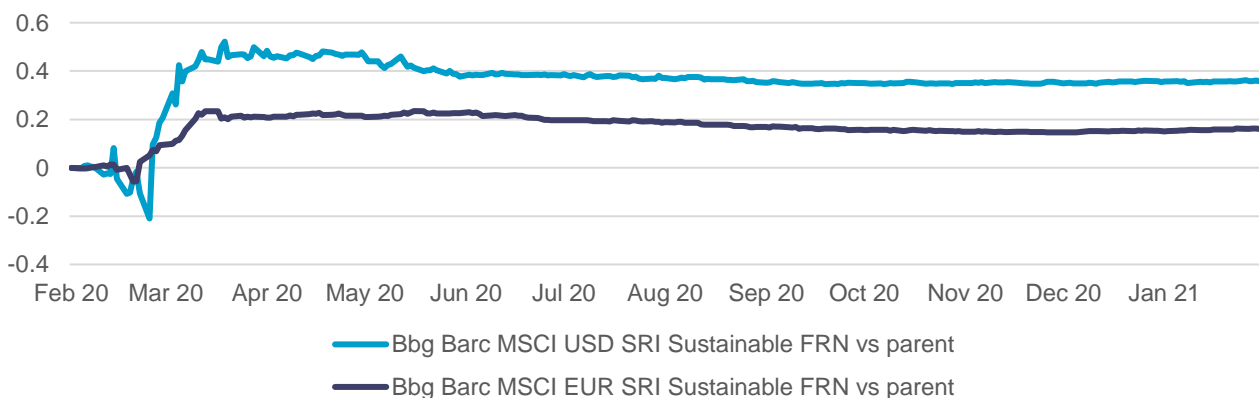


Source: Lyxor International Asset Management, Bloomberg Barclays. Data as at 31/05/2021. Past performance is not a reliable indicator of future performance.

ESG filters can also be beneficial during periods of heightened market stress. The chart below shows that while the ESG and non-ESG indices performed similarly before the Covid-19 crisis, an allocation to ESG FRNs would have performed better at the height of the crisis in March 2020. ESG FRN indices outperformed their parent index by 0.2% to 0.5% at that time.

ESG FRN indices outperformed their non ESG equivalent in March 2020

SRI Sustainable FRN indices performance relative to their parent



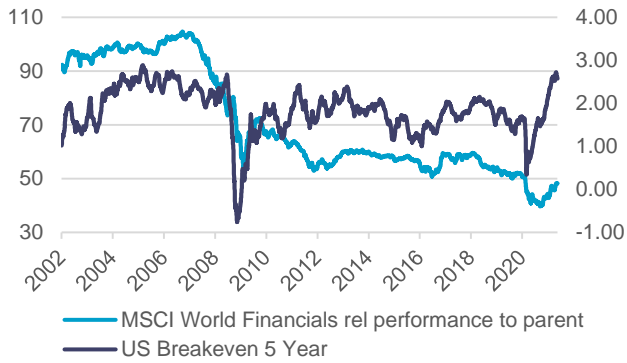
Source: Lyxor International Asset Management, Bloomberg Barclays. Data as at 26/02/2021. Past performance is not a reliable indicator of future performance.

Equity: Allocating into World Financials

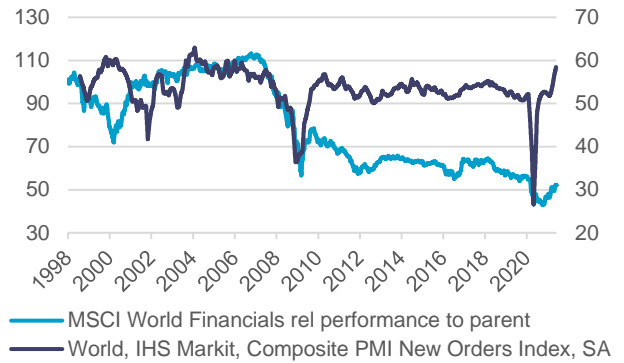
With long-term government bond yields likely to head higher as global activity recovers, the Financials sector should remain supported, given its sensitivity to higher inflation and steeper yield curves.

Financials are sensitive to the global recovery and inflation

MSCI World financials relative performance vs US inflation breakeven



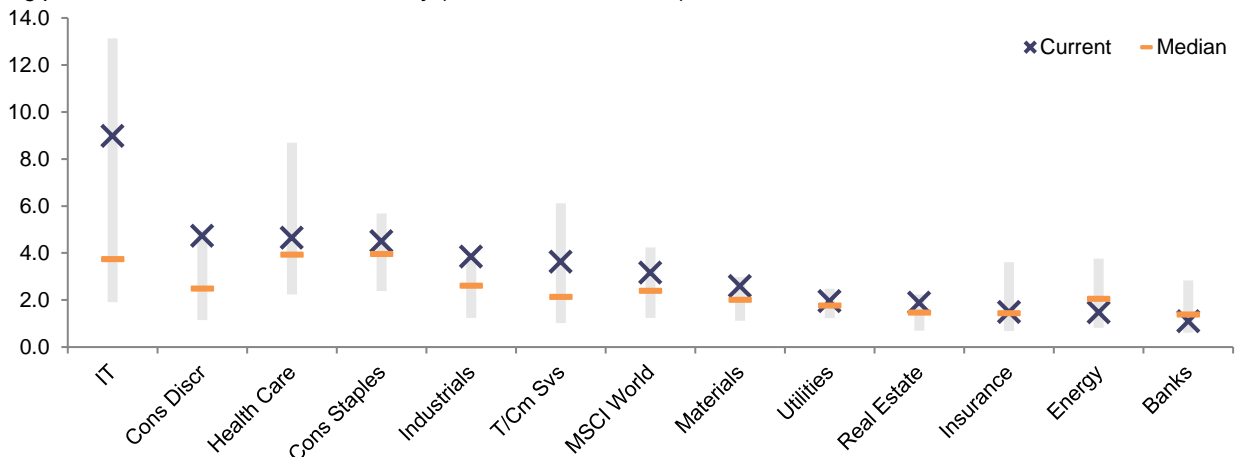
MSCI World financials relative performance vs Global new order books



Source: Lyxor International Asset Management Cross Asset Research. Data as at 07/06/2021. Past performance is not a reliable indicator of future performance.

Global banks at discount compared to history

Trailing price to book value relative to history (base date 31/01/1995)

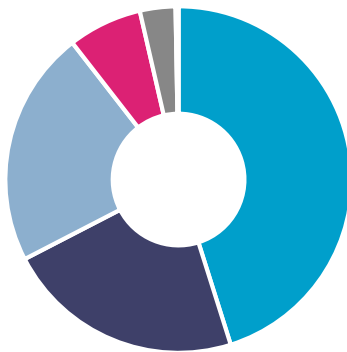


Source: Lyxor International Asset Management, Refinitiv, MSCI. Based on monthly data as at 31/05/2021. Past performance is not a reliable indicator of future performance.

MSCI World Financials Index

The MSCI World Financials Index is dominated by US banks. Lending is a central source of revenue in Banking, Capital Markets and Consumer Finance. These three industries make up ~70% of the index, and the US represents ~50% of its regional exposure.

MSCI World Financials: Sector Breakdown



- Banks, 45.13%
- Insurance, 22.28%
- Cap. Markets, 22.08%
- Div. Fin. svcs, 6.91%
- Consumer Finance, 3.32%
- REITs, 0.28%

MSCI World Financials: Country Breakdown



- United States, 53.98%
- Canada, 8.87%
- United Kingdom, 5.9%
- Australia, 5.43%
- Japan, 4.47%
- Other, 21.36%

Source: Lyxor International Asset Management, Bloomberg, MSCI. Data as at 31/05/2021.

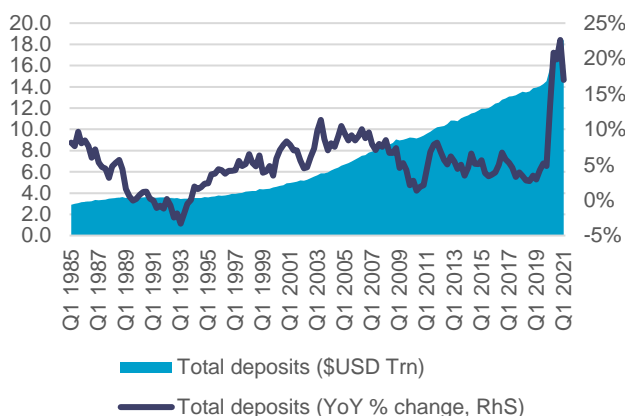
Banks: Benefits from a steeper yield curve and high deposit levels

The increase of long-term interest rates since H2 2020, plus higher deposit levels, are good for commercial banks' margins. Since the pandemic crisis started, US banks have benefited from a rebound in deposit flows. These were supported by aggressive central bank policies (quantitative easing) at the height of the crisis which improved funding capabilities for US corporates via debt and equity issuance.

US banks' balance sheets: Deposits and securities assets surged in 2020

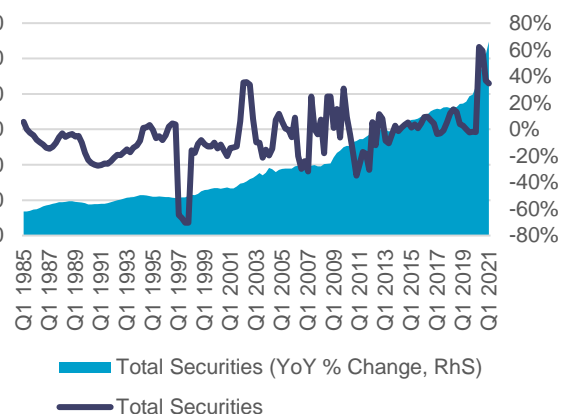
Liabilities account: Total Deposits

Commercial banks and savings institutions



Assets account: Total securities assets

Commercial banks and savings institutions



Source: Lyxor International Asset Management, Refinitiv, Federal Reserve. Data as at 07/06/2021.

Past performance is not a reliable indicator of future performance.

Not only can banks reinvest deposits at higher-yielding levels (securities instead of cash), but they also benefit when cost of funding is low. Cheap deposits allow commercial banks to lower their cost of funding and increase their net asset yields over time as deposits are invested in securities rather than cash.

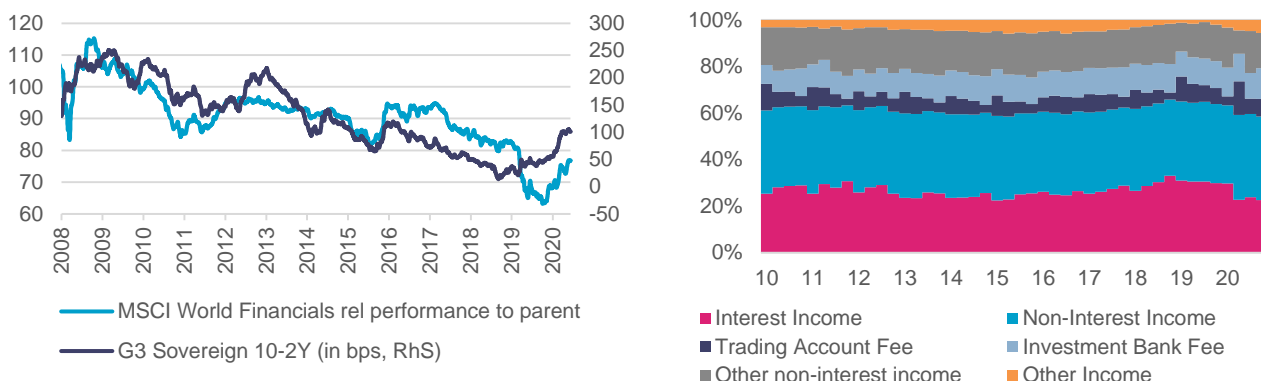
A steeper yield curve should also provide greater upside potential to banks' mortgage portfolios. These are more sensitive to a rise in the long end of the yield curve compared to shorter duration credit-card lending (8% of US commercial banks' portfolios vs 20% for residential loans¹). This should translate into higher net interest income – a major part of banks' operating revenues. Declining mortgage pre-payments can also be counted among near-term benefits. Finally, the greater momentum in economic activity should lead to further improvement in credit quality and lower loan losses for commercial banks.

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Higher yields – a positive impact on banks' interest income and profitability

Government bond yields spread & MSCI World Financials relative performance US top 20 Banks Operating revenues (% Total)



Source: Lyxor International Asset Management Cross Asset Research, MSCI, Federal Reserve, Macrobond. Data as at 07/06/2021. Past performance is not a reliable indicator of future performance.
¹ Sources: [FDIC Quarterly banking Profile. Q4 2020](#)

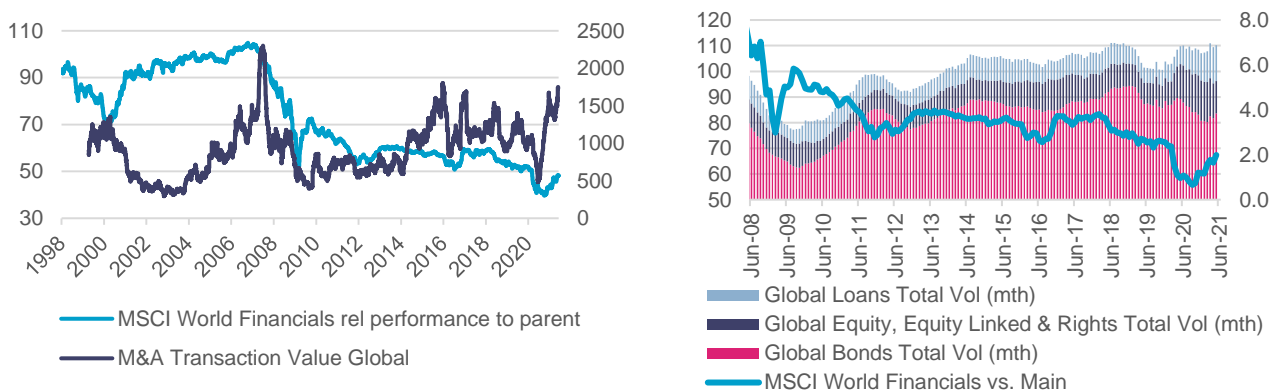
Capital Markets: Shift towards cyclical assets and higher primary market activity

Buoyant market liquidity conditions and the recovery in economic activity allow corporates and investors to access more opportunities in financial markets. Trading revenues are likely to benefit from higher market activity and reflationary pressures allowing for greater dispersion in asset returns, especially in equities.

Buoyant liquidity conditions have spurred a rise in primary market activity for corporates. The resurgence of M&A activity via SPACs (a 'special purpose acquisition company' with no commercial operations, that is formed strictly to raise capital through an initial public offering for the purpose of acquiring an existing company) have boosted investment banks' revenues and fees from advising on such deals. There have been about 522 SPAC listings between 2020 and 2021 in the US, that brought in over \$300bn, a historical high (source: Reuters/[Refinitiv](#)).

Higher M&A activity and capital market activity bolster investment banks' revenues

M&A Transactions vs. MSCI Financials rel. performance ECM & DCM activity vs. MSCI Financials rel. performance



Source: Lyxor International Asset Management/ Cross Asset Research, MSCI, Federal Reserve, Macrobond. Data as at 06/07/2021. Past performance is not a reliable indicator of future performance.

Related indices for an exposure to Financials

Index Exposure	Index name	Bloomberg ticker
Equity: sector	MSCI Daily Total Return World Net Financials USD	NDWUFNCL
Credit: Floating rate notes	Bloomberg Barclays MSCI USD Corporate Liquid FRN 0-5 Year SRI Sustainable Index	I34979US
Credit: Floating rate notes	Bloomberg Barclays MSCI EUR Corporate Liquid FRN 0-7 Year SRI Sustainable Index	I34981EU

Source: Lyxor International Asset Management, data as at 31/03/2021

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Knowing your risk

It is important for potential investors to evaluate the risks described below and in the fund prospectus on our website www.lyxoretf.com

Capital at risk

ETFs are tracking instruments: Their risk profile is similar to a direct investment in the Underlying index. Investors' capital is fully at risk and investors may not get back the amount originally invested.

Replication risk

The fund objectives might not be reached due to unexpected events on the underlying markets which will impact the index calculation and the efficient fund replication.

Counterparty risk

With synthetic ETFs, investors are exposed to risks resulting from the use of OTC swap. In-line with UCITS guidelines, the exposure a swap counterparty cannot exceed 10% of the total fund assets. Physically replicated ETFs may have counterparty risk if they use a securities lending program.

Concentration risks

Some ETFs, e.g. thematic and Smart Beta ETFs select stocks or bonds for their portfolio from the original benchmark index. Where selection rules are extensive it can lead to a more concentrated portfolio where risk is spread over fewer stocks than the original benchmark.

Underlying risk

The Underlying Index of a Lyxor ETF may be complex and volatile. When investing in commodities, the Underlying Index is calculated with reference to commodity futures contracts exposing the investor to a liquidity risk linked to costs such as cost of carry and transportation. ETFs exposed to Emerging Markets carry a greater risk of potential loss than investment in Developed Markets as they are exposed to a wide range of unpredictable Emerging Market risks.

Currency risk

ETFs may be exposed to currency risk if the ETF is denominated in a currency different to that of the Underlying index they are tracking. This means that exchange rate fluctuations could have a negative or positive effect on returns.

Liquidity risk

Liquidity is provided by registered market-makers on the respective stock exchange where the ETF is listed, including Societe Generale. On exchange, liquidity may be limited as a result of a suspension in the underlying market represented by the Underlying index tracked by the ETF; a failure in the systems of one of the relevant stock exchanges, or other market-maker systems; or an abnormal trading situation or event.

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