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Financial Sector ETFs Brace For Further Headwinds

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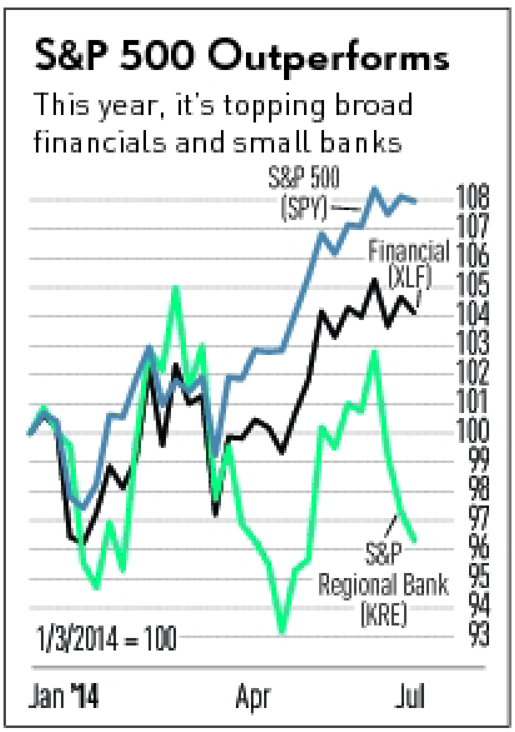
Better-than-expected results from the big banks may give listless financial-sector ETFs just the jolt they need.

Wells Fargo (NYSE:WFC) announced on July 11 that its second-quarter earnings met expectations and that revenue beat analyst estimates. Later reports from its peers, such as Citigroup (NYSE:C), JPMorgan Chase (NYSE:JPM) and Goldman Sachs (NYSE:GS), continued the favorable trend.



The latter three gained 4% to 5% last week, helping improve their lagging IBD Relative Strength Ratings. Wells, already boasting the highest RS of the four, ended the week nearly flat.

“These recent earnings statements appear to have reignited a spark within this subsector, and asset flows into this space have increased,” said Nathan Kubik, a principal of Carnick & Kubik, which manages $300 million in assets.

While investors are likely to reward the results in the short term, that could change, given concerns about “the exposure these big banks have to shifts in the yield curve,” he added.

Compared with 2013 and the stock market, ETFs offering broad exposure to the U.S. financials sector have lagged this year. Financial Select Sector SPDR (ARCA:XLF) has risen 5.6%, Vanguard Financials (ARCA:VFH) climbed 5.6% and iShares US Financials (ARCA:IYF) is up 5.2%.

By comparison, they gained 35.5%, 32.9% and 34%, respectively, last year.

Top holdings of the funds include banking heavyweights Wells Fargo, Citigroup, JPMorgan Chase, Bank of America (NYSE:BAC), U.S. Bancorp (NYSE:USB), Goldman Sachs and BlackRock (NYSE:BLK).

The cushion provided by those stocks is part of why broad-based financial ETFs have outperformed some more specialized ETFs, such as those tracking smaller banks, since earlier this year, according to Neena Mishra, director of ETF research at Zacks Investment Research. Investment banks have benefited from strong underwriting and M&A activities, she says. Rising equity markets have helped drive asset managers. But major subindustries within the sector, including smaller banks and insurance, are expected to show year-over-year earnings declines.

“One of the most important sources of income in recent years — the mortgage refinance boom — is now almost over,” Mishra said.

This year, SPDR S&P Regional Banking (ARCA:KRE) is down 3.4% vs. a 47.5% gain in 2013.

IShares US Regional Banks (ARCA:IAT) has climbed 2.3% vs. 37.7% last year.

And SPDR S&P Mortgage Finance (ARCA:KME) is off 0.74% in 2014 after rising 32.5% the year before. Its top holdings include mortgage, homebuilding and insurance companies such as Ryland Group (NYSE:RYL), D.R. Horton (NYSE:DHI) and XL Group (NYSE:XL).

The banking industry continues to face fallout from the 2008 financial crisis, including stricter regulations and a rise in legal costs.

Market analysts also worry about limited opportunities to lend profitably in a slow economy. Still, “banks are in much better health now with solid capital levels” because of closer oversight and cost-cutting measures, Mishra said. “Interest rates should start inching up in the months to come, which will benefit banks.”

Meanwhile, insurers may offer medium-term opportunities for investors. Despite bland performance year to date, insurers are attractive based on valuation and expected returns, and “are well positioned for the next 12 months,” Kubik said.

http://news.investors.com/investing-etfs/072114-709659-financial-etfs-get-boost-from-big-banks.htm