Manulife Financial Corp.: A Year in Review

Description

This year was the year of surprises, and no one could have guessed that the financial sector would outperform the broader market averages by such a wide margin. In the wake of the stunning Donald Trump victory in the U.S. election, the **S&P 500 Financials Index** (SPF) has returned a whopping 25% year to date, as the narrative of lower-for-longer interest rates was replaced by an aggressive steepening of the yield curve and the threat of inflation under a Trump presidency.

But things haven't always been this rosy for the financials, and **Manulife Financial Corp.** (TSX:MFC)(NYSE:MFC) in particular, whose valuation floundered at 2009 levels (price-to-book of .9 times versus Canadian lifeco sector median of 1.3 times) thanks to a series of abysmal earnings reports.

A victim of market volatility

For the first half of 2016, Manulife was more or less range bound, never quite being able to rally off the February lows from the year-opening sell-off. Despite having a yield of over 4%, the market had overlooked the stock following a disappointing FY 2015 that saw net income drop 37% from 2014 due to negative impacts from the downturn in the equity markets, oil losses, and the low interest rate environment.

Following the report, management adopted a prudent tone based around the assumption of continued volatility in the oil and gas and equity markets, and did not provide 2016 guidance aside from its continued trajectory towards $4 billion net income two years into the future.

The bad news continued in 2016

Unfortunately for Manulife shareholder's, 2015's underperformance would perforate 2016. For Q2 2016, Manulife's core EPS came in at .40 (down 8% year over year) and below consensus of .46. Moreover, Manulife's most problematic business unit, long-term care, once again came back to haunt the company by dragging down U.S. core earnings by 11% year over year.

To top it off, Manulife's management also warned of a $500 million actuarial charge that could hit the books by Q3 2016; the shares sold off sharply in response to the news.

Discounted valuation did not reflect its strengths

After its Q2, Manulife had fallen out of favour with the market. But as it would later become obvious, Manulife's discounted valuation did not adequately reflect some of the company's biggest strengths. For example, its Asia division continued to be the shining star with core earnings coming in 16% higher year over year.

Furthermore, Q2 was a record quarter for annualized premium sales in Asia; the segment generated US$627 million, or a 34% increase over last year, thanks to the company's cross partnerships with major Asian institutions. Moreover, with a Fed rate hike looming in December, Manulife's discounted valuation was not going to last.

The final inning

While the Fed rate hike was a certainty, no one knew exactly how steep the Fed's interest rate path would be in 2017. However, all uncertainty dissipated after Donald Trump's victory in the November elections, as it became clear that a steeper than expected yield curve was necessary to combat the threat of inflationary fiscal stimulus.

With its large exposure to the U.S. interest rates and the U.S. dollar, Manulife finally broke out of its range and joined the sector-wide rally. Adding further fuel to the bull case was a strong Q3 with core EPS of .49 versus consensus .44 and a lower than expected actuarial charge of $455 million.

Currently, Manulife is still trading at a discount to other financial institutions–the banks in particular–but its earlier valuation gap has closed tremendously, as I originally anticipated in September. With the U.S. dollar roaring up and the Fed expected to hike two to three more times in 2017, Manulife is a strong buy going forward.

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