Federated Clover
INVESTMENT ADVISORS

Banking on the Cycle

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As the Credit Crisis unfolded over the past two years, banks made headlines by reporting unprecedented losses. Some of most prominent financial institutions collapsed or teetered on the brink of insolvency, prompting the government to mount a massive, unparalleled rescue program. While the specifics of this last crisis may vary from those that came before it, we believe that the cyclicality of the banking industry continues to be relevant. As with every cycle, the losses are cleared away to make room for improvement. But the potential for this cyclical improvement, in our view, is currently being underestimated by investors.

The banking industry has an obvious connection to the state of the overall economy. As with the economy, banks move through boom and bust environments over the years, with their earnings and stock prices influenced by the general economic trends. These cycles are clearly evident in the past. At present, we think that investors have lost track of the cycle. We believe that the daily headlines of credit losses and threats of increased regulation have clouded investors' perceptions of the long term outlook for the industry, and they are not fully appreciating the potential in bank earnings and stock prices as the industry moves past the bust phase of this current cycle.

The Healing Process

Federated Clover's research team is constantly looking for fundamental data to assess where we are in a given cycle and to evaluate opportunities for our portfolios. The banking industry is highly cyclical in nature, and there are definite stages that occur as the cycle plays out. We believe that recent events and future inflection points will lead to increased positive views for the industry, and that banks should be able to transition from their depressed state and actually grow earnings over the next few years. To support our view, let us examine the stages of the cycle to determine where we are and what may lie ahead.

Restoration of Capital

This first stage of improvement occurred in the second half of 2009. As the equity and debt markets improved, banks were able to raise precious capital through public offerings and through governmental assistance. This capital enabled the banks to alleviate solvency concerns. As banks repaired their balance sheets, the market reacted and stocks bounced off their lows. The improved liquidity and influx of cash allowed banks to repay their TARP borrowings. Most banks were able to repay the Government in full for the TARP loans, much faster than many had initially expected. The removal of the Government's ownership was a significantly positive inflection point for the industry.

Moderation of Credit Costs

The next stage in the cycle is the moderation of loan delinquencies and losses (credit costs). This is the stage we are in right now. We believe credit costs for many banks are nearing a peak, and will likely begin to moderate during 2010. Delinquency and charge off trends across multiple loan categories are moving toward an inflection point, and the drag on earnings from material reserve additions is starting to abate.

As this anticipated reduction in credit losses occurs, banks will be able to reduce their reserves that they built up during this crisis. The methodology of bank reserving requires that banks build up the maximum amount of reserves at the bottom of the credit cycle. As credit costs improve, the high levels of reserves are no longer necessary. The excess reserves flow directly into bank earnings. These two levers, reduced losses and the reduction in reserves, should bolster earnings for the next several years.

Return to Growth

The final stage of recovery will be renewed loan growth for the industry. Currently, the banking industry is still in a period of deleveraging. Loan balances are shrinking and capital is increasing. But we think that, in the years ahead, there will be significant opportunities for banks to grow their loan business. One of the main reasons for this is the elimination of non-bank competitors from the marketplace. During the last cycle, non-bank lenders such as Lehman Brothers and New Century Financial became major players in extending credit to consumers. By 2005, non-bank lenders represented about half of subprime lending.[1] According to Treasury Secretary Timothy Geithner, in early 2007, non-traditional, securitized loans had a combined asset size of roughly $2.2 trillion. Meanwhile, the entire banking system totaled were about $10 trillion in assets.[2] But many of these non-traditional lenders did not have stable funding and went out of business during the credit downturn. The market for most of these assets have dried up.

Going forward, traditional banks will be the leaders in extending credit to borrowers. Additionally, we think that the securitization market, which is an originate-and-sell model, will be significantly less prominent. This will lead to more loans residing on banks' balance sheets and could lead to strong asset growth in the years ahead.

An Unappreciated Opportunity

Despite the improving outlook, investors have only recently begun to embrace the bank sector. We think there are two main reasons for this: the specter of increased government regulation and psychological biases. As we analyze these two factors, we see investment opportunity.

Most of the regulation that has been proposed appears at first blush to be negative for the growth of the industry. But after further evaluation, we think that the increased regulation will not be onerous enough to stop the recovery process for banks. It is precisely during periods like this, when uncertainty reigns, that the best value investment opportunities arise. Once the public gets full clarity on these issues, stock prices will have moved up considerably from depressed levels. In our opinion, the current fears about the impact of regulation will be worse than the reality.

Many investors have difficulty imagining that, within a few years, banks could actually have excess capital, increase dividends and reward shareholders. This view is not being widely discussed in this period of negative headlines, threatened regulation and depressed earnings. After the severe decline in operating fundamentals over the past few years, many banks have become associated with the economic problems the world is facing. Amid all the negativity, it can be hard to envision a healthy, growing operating environment for banks.

What is valuation telling us today? Using more stable measures of valuation, such as stock price relative to book value, banks look attractive on a historical basis. However, if we look at current earnings based valuations, we get a different story. Current P/E multiples on banks are higher than their previous averages – and this is exactly how we expect them to look at this stage. As with any cyclical industry, earnings and cash flows are materially depressed at the bottom of the cycle. Therefore, any valuation metric based on current results will look high. This is when you want to invest. Improvement in earnings and cash flows will drive stock prices higher. As this happens, multiples will slowly compress to normal levels, but the stock prices will be much higher than current levels. We believe this scenario will play out over the next couple of years. Based on our future expectations of earnings, many bank stocks today appear to be trading at a significant discount to fair valuations.

Conclusion

As noted above, the banking industry's recovery is already underway. The unrecognized potential for improved fundamentals has created a valuable opportunity. We have increased our holdings among related banks over the past six months, and we anticipate continued opportunity as the economic recovery plays out. The industry still has a ways to go to return to profitability, but the time to invest has arrived.

[1]http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4136
[2]http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html

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