

February 2012 Alvine Newsletter

Why banks stocks are not the best way to play the new equity bull market.

Key issues: Fuelled by further Central Bank largesse and an oversold position, bank equities have rallied sharply since the autumn lows leading the equity bull market

Key recommendation: Investors should reduce financial stock holdings into this move– as a barrage of regulatory and capital adequacy issues remain outstanding. There are better ways of remaining ‘risk on.’

After a torrid 2011 bank stocks have staged a sharp surge led by over sold conditions particularly in Europe. The near 1/2trn euro LTRO facility issues by the ECB in December helped to ameliorate the immediate funding credit crisis. As general risk appetite returned investors had looked to the attractive discount to book value. However, regulatory issues, deleveraging balance sheets and increased transparency over fees make the prospects for further gains more limited. For a better bullish play, heavyweight European industrials such as ABB and Siemens, are more likely to lead the charge higher, see FT’s Lex column 26th February ‘European industrials: quiet optimism’.

A bad year for Banks stocks



Source Bloomberg

After a reasonable start to 2011, the Euro crisis was never far away. As the Greek debacle continued to fester, serious questions were correctly asked about the size and quality of banks' balance sheets. Investors were quick to fear that the Europeans were mired in peripheral sovereign debt, while big money-centre US banks were still digesting the mortgage mess from the financial crisis. By the summer a financial blow up was brewing, spurred on by fears of a recessionary double dip. Even in AAA Germany, banks performed disastrously losing as much as 70% of their value.

ECB to the rescue

'We avoided a major credit crunch' - Mario Draghi (source Market News International 9/2/12.)

By the autumn interbank lending, particularly in Europe, had seized up. With wholesale markets consequently closed the risks were for a disaster.

While the long-term refinancing operation 'LTRO' programme had been in existence since the birth of the euro in 1999, it was only in 2009 that maturities were extended to 12 months. This move was considered as 'non-standard' by the ECB.

Senior Draghi's move to extend the programme further in December 2011 to three years, at an interest rate of 1%, gave a significant much needed shot in the arm to the European banking patient. Further value had been made by reducing the quality of the collateral requirement. The result was that 523 banks participated, taking 489 billion euro of funds.

The LTRO programme really did solve the incipient inter-bank funding issues for European banks. At the same time the US economy seemed to shake off its mid-summer torpor and push forward with some decent broad based growth, vitally including employment. While concerns about a hard landing in China remain, general growth rates amongst emerging economies continued throughout the year.

Problems ahead---regulation

'Before 1980, it was basically illegal for U.S. banks to invent new products' - Scott Cook Chairman of the board Intuit (source Brainyquote.com.)

The Thatcher/Reagan revolution was never more important than in financial services. A whole plethora of restricted practices/regulations and controls were ripped up. This 'light touch' regulation that then replaced it, essentially meant that as long as revenues/employment and hence tax revenues were increasing then **everyone had a vested interest** in not looking too hard at the practices of participants. Market forces and competition would do the rest.

'Those of us who have looked to the self-interest of lending institutions to protect shareholder equity, myself included, are in a state of shocked disbelief' Alan Greenspan (source New York Times 23/10/08.)

Where do we start with the incoming flood of regulation---Basle III, Dodd-Frank, Vickers, the Volcker rule, possible Tobin financial transaction tax. The freewheeling days of yesteryear that brought to an industry a whole host of ever increasingly complicated products with **bizarre acronyms**; CDS, CDO, synthetic CDOs, CLO, ABS, MBS etc had to end. Problems were inevitable when so many of the products were not understood by investors or even regulators. Just as in the 1930's after a major financial crisis that necessitated huge bail outs, it is understandable that reform of the entire industry would be on the table.

Irrespective of the damage to financial innovation, all this regulation will cost. Jamie Dimon, CEO of JP Morgan has estimated this as a hit to his institution of \$400-600mio pa (source The Economist 18/2/12.)

One consequence of this new regime is that banks' earnings will be constrained by a reduction in leverage. It was to some extent the huge expansion in those balance sheets which gave opportunity with various carry trades to generate income. While it may be laudable to see such bloated risk is now reined back, earnings are likely to suffer. As John Authers writing in the FT explained;

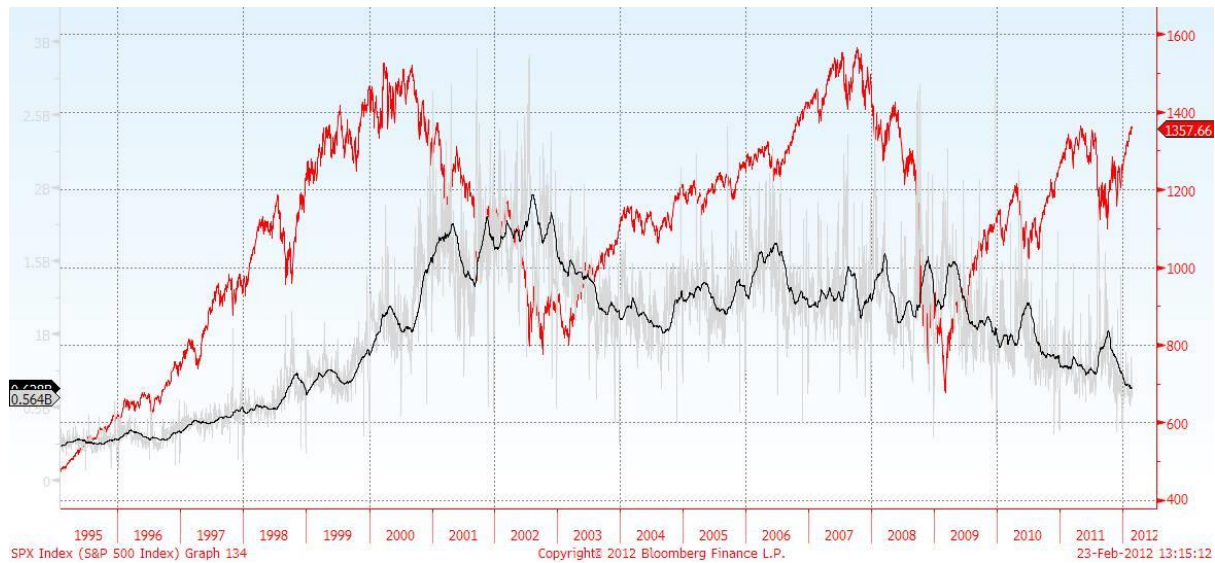
'To reduce banks' risks, profits have to shrink' (FT Weekend 24/5th February 2012)



Citicorp's balance sheet over the past 15 years (source Bloomberg)

As banks are forced to sell off or demerge various proprietary trading businesses not only will this reduce a source of income, but it will also **hit flows**. One advantage for trading desks of having in-house funds has been to better see markets movements, and the liquidity that such trades come with.

Needless to say a decade long bear market has also taken **its toll on trading volumes**; all these factors will erode income.



S+P 500 index (red) and trading volumes (black) (source Bloomberg)

Banker bashing—constraints on business

The recent cross-party British game of banker blame game may be unpleasant, but surely irrelevant. It is not important whether Fred Goodwin remains a ‘Sir.’ However, for the next generation of managers of these huge, very complicated financial institutions, the ability to hire and retain talent is important. The best and brightest graduates may well now look elsewhere for their careers.

Transparency of fees---technology leading a revolution

The days of the bank manager with his bowler hat, and lending being the main source of income are well gone. Banks have morphed into financial services selling everything from insurance, fund management, and other fee generating services. In fact this trend has been actively encouraged as diversifying and enhancing overall revenues without using capital.

Investment management has also suffered as overall poor returns forced clients to be squeamish about fees. As Paula Dwyer put it in an article headed **‘The days of easy money are over...in this era, four percent is a good return. This will not justify paying two percent...as a management fee’** (source Bloomberg.com 23/1/12.)

With so much information now available at all our finger tips ‘the funds facts, performance data and risk analysis programmes that were once the arcane tools of advisers are more widely available to the layman’ (FT.com 22/2/12.) **Money is flooding out of fee paying mutual funds straight into low cost ETFs.** Ergo the financial services industry loses.

Conclusion---the bull market for financial services is over

‘For two decades, the asset management business has enjoyed a tailwind of falling interest rates and growing tolerance for leverage...We now live in a world where second-rate performers have nowhere to hide. Interest rates are low, but will rise once growth resumes. This is a

headwind, not a tailwind' summarised Paula Dwyer. This is the part of a bank's business most sought after. Just about everywhere you look, banks' revenues are under assault and deleveraging will continue to shrink earnings.

A discount to book value as exists for most of Europe's banks may look attractive, however, when an industry contracts other ratings such as PE ratios tend to come in fast. When you go **ex-growth** look at what happened to most pure play print and publication stocks over the last decade.

Markets ---the bull rides

US/Germany and most of EM strong---it is an encouraging sign that despite the Euro crisis and financial shocks of 2nd H 2011 the US, Germany and most emerging economies held in. While within the rest of the Euro zone a mild recession is forecasted, and China's property sector remains a worry, it is this **very resilience in the face of bad news** that encourages us.

Fool in shower---monetary policy continues to ease

During the heat of the financial crisis of autumn 2008, the Federal Reserve and others moved aggressively to shore up the system cutting interest rates even moving to print money via QE programmes. This policy was successful in arresting the real prospect of a 'Keynesian liquidity trap.'

However, with the economy stabilised at worse, and inflation well above zero, this policy has been renewed time and again since those dog days. Recent announcements by the Fed to keep a zero rate policy until 2014 have been matched by the Bank of England's further round of asset buying.

This possible policy mistake is akin to Milton Freidman's fool in the shower. The water is cold, but the fool keeps moving the dial and is not patient to the effect of his previous action. Eventually this overwhelming pressure results in him getting scalded when the hot water arrives.

'Why should we expect the outcome to be any different than the last time, when the Fed held the benchmark rate too low for too long in 2003 and 2004' Caroline Baum Bloomberg columnist (source Bloomberg.com 29/1/12)



S & P 500 and Fed funds rate 1993/4/5 (source Bloomberg)



S & P 500 and Fed funds rate 2003/4/5 (source Bloomberg)

So the charge is on, expect the major rally underway to continue and perhaps **exceed** even these two examples given. *The stimulus is greater, the undervaluation more extreme, investor and corporate cash holdings larger than ever before.*

Accordingly, we will remain overweight equities and gold in our model portfolio.

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