

July 21, 2011

Bottom in Bank Stocks As Regulatory Capital Requirements Are Met?

Bank of America's stock has risen 7% since Tuesday afternoon on the view that it may not have to issue more equity (which is much more expensive than debt capital) to meet regulatory standards. Europe seems to be heading in the same direction.

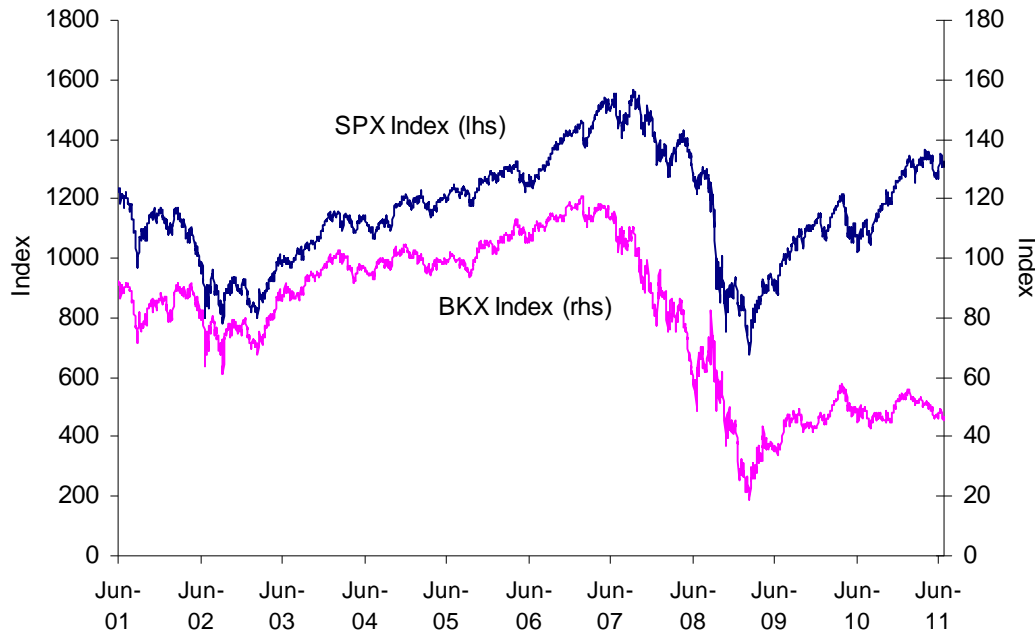
Bank of America Equity Price (last obs. July 21, 2011)



Source: Bloomberg; Encima Global

- Equity prices for banks, normally an important leader in a bull market, have severely underperformed the S&P since the 2009 equity bottom...

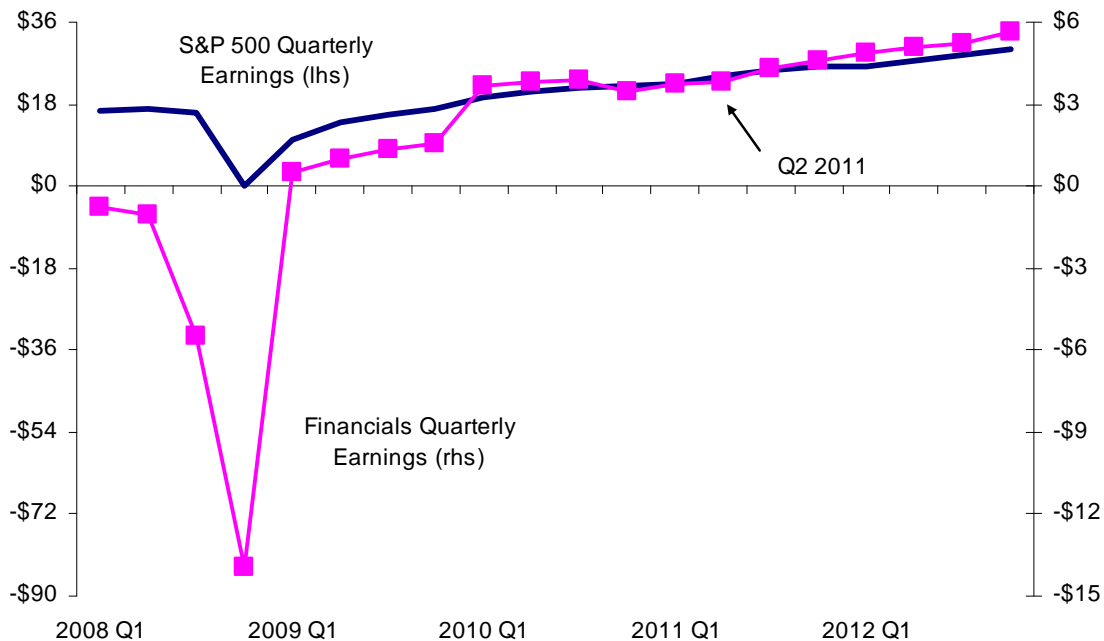
Banks vs. Overall Market (last obs. July 20, 2011)



Source: Bloomberg; Encima Global

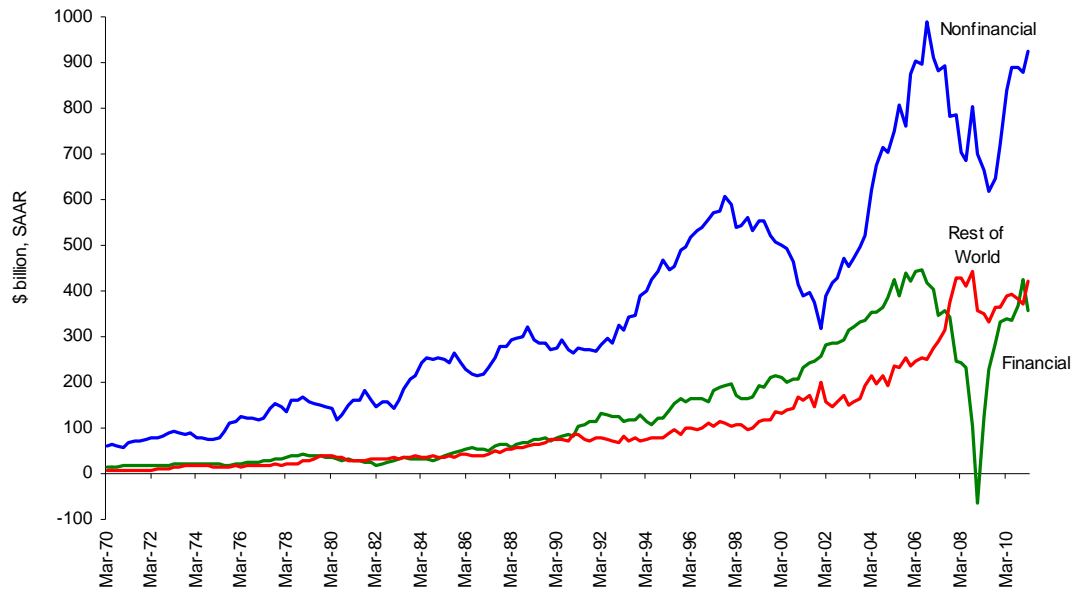
... despite a stronger rebound in financial sector profit than in other sectors.

S&P Financial and Composite Index Earnings (last obs. Q1 2011, estimates to Q4 2012)



Source: Standard and Poor's; Encima Global

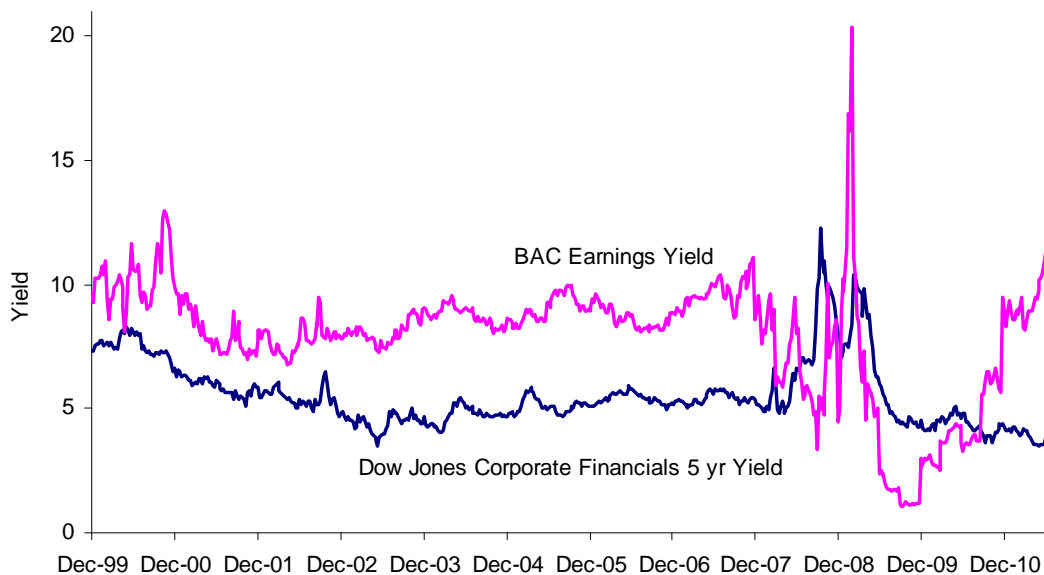
Corporate Profits with IVA and CCadj (last obs. Q1 2011)



Source: Bureau of Economic Analysis; Encima Global

- One reason bank stocks have underperformed is the risk that regulators will make them increase their equity capital. In normal environments, equity capital is more expensive than debt capital. In the current environment, it's much more expensive since interest rates and bond yields are low (debt capital is cheap) and the PE multiple for bank equities is also low (equity capital is expensive.)

BAC Earnings Yield and DJ Financials Bond Yield (last obs. July 20, 2011)



Source: Bloomberg; Dow Jones; Encima Global

- Relative to the cost of debt capital, the cost of equity capital for banks is at a record 2.4 times as expensive, making bank stocks very sensitive to regulatory decisions on their capital adequacy.

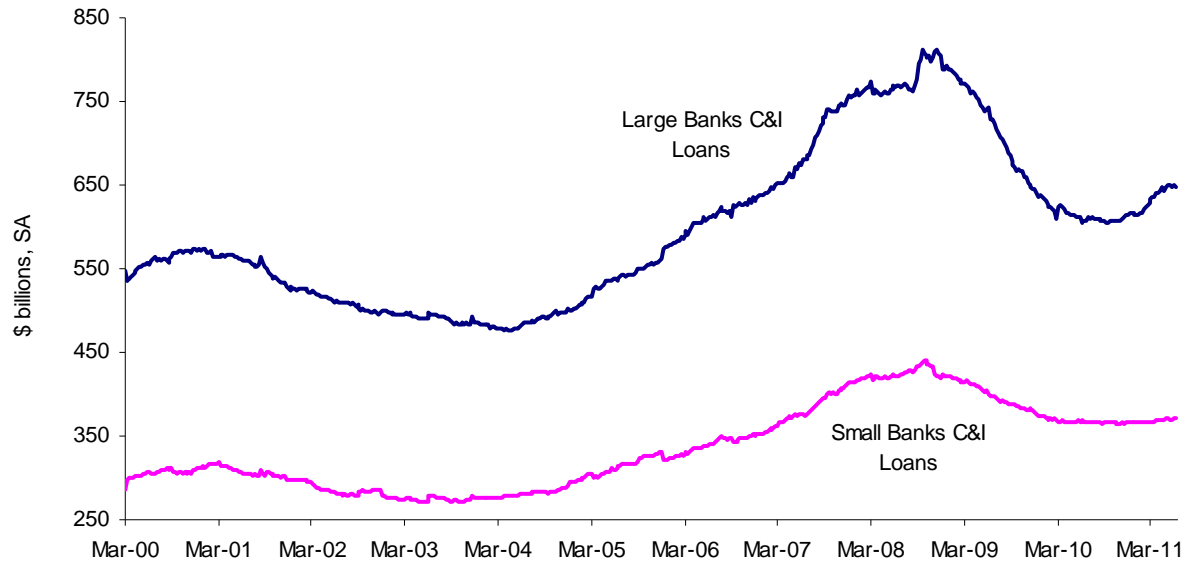
**Ratio: S&P Banks Earnings Yield / DJ Financials 5 Yr Corporate Bond Yield
(last obs. July 20, 2011)**



Source: Bloomberg; Dow Jones; Encima Global

- The effect of regulatory uncertainty over capital adequacy has been to restrain bank lending at a time when it should be growing in order to help fund jobs, inventory and new capital expenditures. Commercial and industrial loan balances at U.S. domestically chartered banks are still only \$1.0 trillion, \$232 billion below their peak in October 2008.

C&I Loans (last obs. July 6, 2011)



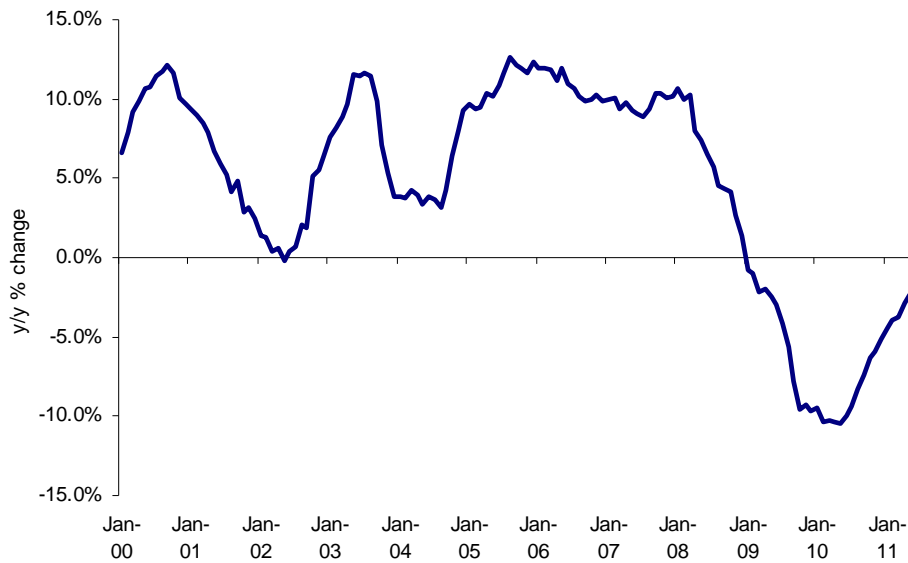
Source: Federal Reserve; Encima Global

- This is a pattern problem for the U.S. called procyclicality. Regulators tend to allow ever-riskier loans during a boom because the growth makes the loans look good and Washington is well funded to look the other way. They tend to restrict loans when growth is weak. In late 2008, senior policymakers openly recognized this procyclicality problem – that there was a harmful, momentum-driven interplay between the regulatory demand for more capital, lagging downgrades of bond ratings, the CDS market and the push for arbitrary mark-to-market accounting even in thin distressed markets. This caused an exodus of capital from bank equity, exacerbating the downturn.

There's been a sharp contrast between U.S. procyclical regulatory policy causing weak growth and China's counter-cyclical regulatory policy and strong growth.

- U.S. regulatory policy swung from overly loose to tight after the 2008 crisis, contributing to a decline in bank lending and deepening the economic downturn. There's been an interagency battle between the FDIC's desire for almost unlimited capital and growth-oriented economic goals at Treasury and the Fed (see our June 24 piece, Bank Capital Requirements Fueling Uncertainty, But Global Growth Outlook Still Intact.)

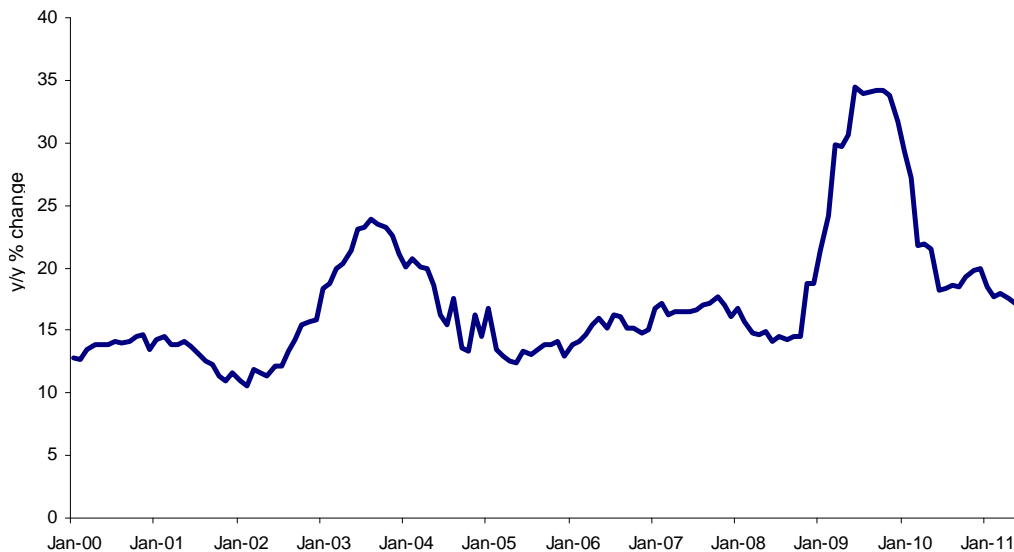
U.S. Bank Lending Y/Y (last obs. June 2011)



Source: Federal Reserve; Haver; Encima Global

- In contrast, China encouraged a surge in bank lending after the 2008 crisis, softening its economic downturn. (China's GDP growth bottomed at +6.2% in Q1 2009 year-over-year versus a U.S. bottom at -4.1% yoy in Q2 2009.)

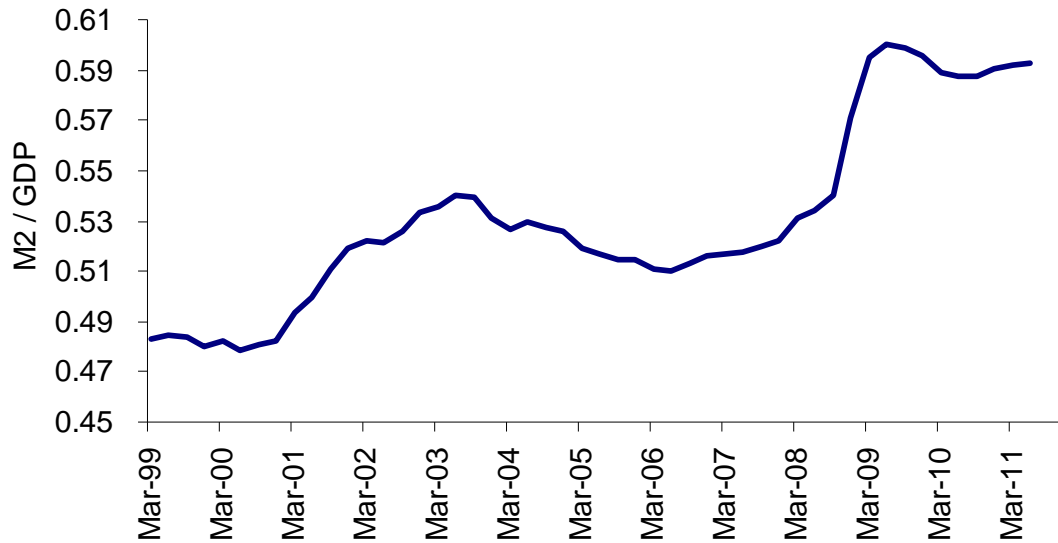
China Bank Lending Y/Y (last obs. June 2011)



Source: Bloomberg; Encima Global

- In the U.S., the money supply shrank more than GDP after the 2008 crisis.

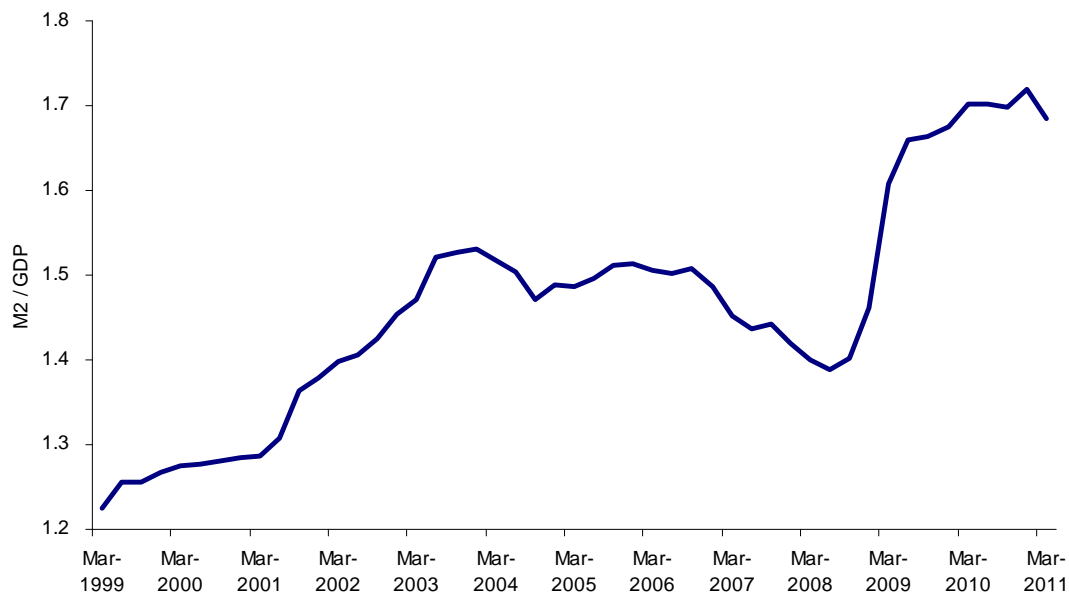
M2 / GDP (last obs. Q2 2011)



Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

- In China, the money supply grew relative to GDP after the 2008 crisis.

China's M2 / GDP (last obs. Q1 2011)



Source: People's Bank of China; China National Bureau of Statistics; Encima Global

International bank regulators have met repeatedly in recent decades, often in Basel Switzerland, to develop common standards on the theory that they could make the global financial system safer.

- The result has often been to make regulatory policy even more pro-cyclical, causing ever-wider swings in regulatory policy at the wrong times in the financial leverage cycle.
- At present, Europe is trying to limit explicit capital raises to a handful of banks while the CDS markets, often backed up by trend-following bond ratings, works to force more equity capital (and therefore more defaults.)
- Meanwhile, the U.S. Federal Reserve has avoided any consideration of an equity capital increase for itself, increasing its leverage to record highs with no oversight.
- We think regulators will continue to muddle through this dilemma, kicking the can hard down the road by letting most banks grow their way into profitability without too much further equity dilution. The cost, however, is weak loan growth and an extended period of austerity for the small businesses that most need bank loans. We think the regulatory pendulum may finally be swinging in the other direction with decisions that regulatory capital is adequate.

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