June 1, 2009

ING Investment Weekly

U.S. Financial Stocks: "Are Those Green Shoots, Or Just Mold?"

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Are you as sick as we are of seeing the term "green shoots" used in media discussions of the economy? Thought so. And yet, at the risk of perpetuating the phrase even further, it occurred to us that green is obviously a color that has been long associated with financial companies, and we are definitely seeing more of it these days on our monitor screens.

But is this the green of a return to normalized earnings, or the green of moldering assets beset by still-deteriorating credit?

Our rather unsatisfying answer at this point is… both.

Having largely survived their near-death experience in 2009's first quarter, financial stocks more than doubled off their March 6th lows (as measured by the S&P Financials Index), but remain quite depressed in historical terms, being still off by over 65% from the early 2007 highs (Chart 1, next page). Unprecedented government action in too many forms to list has helped investors discount the likelihood of worst-case scenarios and start thinking again about valuing the stocks based on a steady climb back to normalized earnings by the 2010-2012 time frame. While we do not disagree with this approach in general, we tend to be a bit less clear than the bulls on both the timing and magnitude of earnings improvement, leaving us with a more balanced view of how investors should position themselves in the Financials.

It still bothers us that credit metrics continue to worsen, as evidenced by the continued steep increases in loan delinquencies (see example in Chart 2, next page). Though we were taken by surprise at the strength of the recent credit-driven rally, in retrospect it made sense if only because financials had gotten dirt cheap and were discounting Armageddon. With government support and a slew of public capital raises having ostensibly taken Armageddon off the table, attention has started to turn to what companies can earn as write-downs fade and the economy starts to grow again. However, we aren't as willing as some to look past ever-larger credit losses and delinquencies, which, despite benefiting from seasonality in the always-better first quarter, are still growing in virtually all consumer and commercial loan segments.

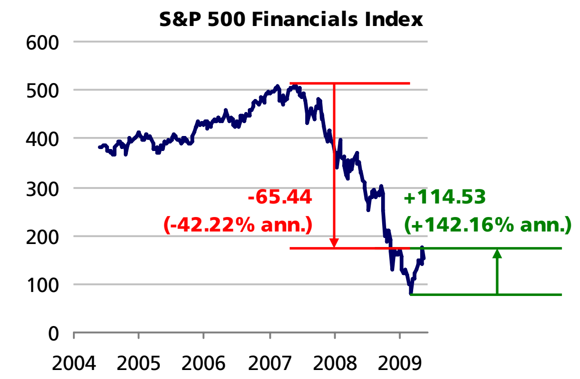
The bull case goes something like this: the government has defined the worst-case scenario with its stress test methodology, so we can safely downplay the risk of a big retrenchment and start playing the second-derivative trade on credit (i.e., getting worse, but at a slower rate). Further, the economy has bottomed, so companies will be able to start earning their way out of the remaining problems. The recent tightening of credit spreads validates a lower risk premium and increased confidence in the improvement in the capital markets and the economy in general.

Conversely, the bears think we've come too far too fast, and with credit still an issue, increased regulation looming over the industry, and earnings visibility still poor for at least 2009-10, the sector is due to slide back or at best tread water for awhile. Bears also argue that returns on equity are going to be quite a bit lower going forward, owing mostly to de-leveraging, which may prove permanent as regulators seek to prevent a recurrence of this financial crisis.

We would love to make a definitive call to favor one viewpoint or the other. But both sides have some valid points and the timing and magnitude of peak credit losses are still unknown despite the stress test. Consequently, although we are more constructive on our space than we've been for quite some time, we're not ready to declare the financial sector totally "shovel ready" (although that depends on just what you're shoveling, if you catch our drift…) and push all our chips in on a recovery, though that time may come later this year.

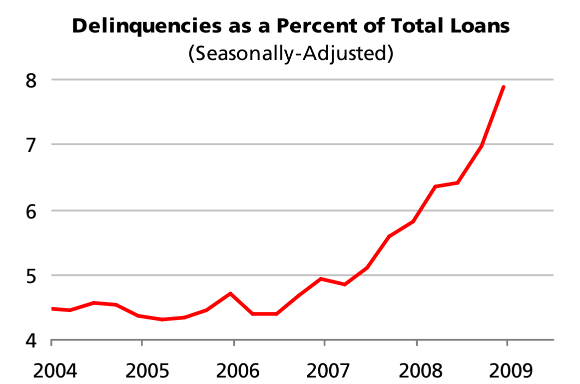
We think the right way to play the financials at the moment is to roughly market weight the group and its component sub-sectors and try to win on stock picking rather than making a big macro call. We favor quality companies that are not solely focused on their survival and are well positioned to seize opportunities that arise in their markets, and/or companies whose stocks are still discounting a very negative economic scenario but that have demonstrated the operational and capital flexibility to work through what may be several more years of problem assets and a slow economy. We do not think it is appropriate to go to the far end of the risk curve and make bets on companies that we believe might still face catastrophic downgrades or massive government intervention. When and how will we know if we are wrong? On the bear side, if credit metrics begin to track at — or worse than — the levels assumed in the government's much-ballyhooed adverse-case stress test, then financials will sell off and pure defense would have been the right call. On the bull side, if credit deterioration continues to trend as significantly "less bad" at the end of Q2, the financials could easily rally another 30% or more, led by some of the same credit-sensitive stocks that have moved by large percentages over the past month.

Despite Rebound, Financials Are Still Down Deep



Source: Standard & Poor's

Magnitude/Timing of Peak Credit Losses Is Unknown



Source: Mortgage Bankers Association

Longer term, history is supportive of the wisdom of overweighing the financial sector as the anticipation of economic recovery grows. The sector may have another "double" in it for those who are patient and willing to live with the heightened volatility, but we think it would be prudent to see further signs of a turn in credit before doubling down. ■