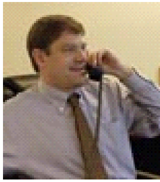
INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

JUNE 2, 2009



William A. Harris, CFA
Portfolio Manager

Having Gone "Boom!" Can the Banks Really Bloom?

"Green shoots" is the fondest cliché in economic commentary these days, and one I promise not to perpetrate in letter again. Even so, the tenor of news flow, capital markets behavior, and some slightly-less-horrific-than-expected economic indicators have indeed made it feel like springtime for risk assets.

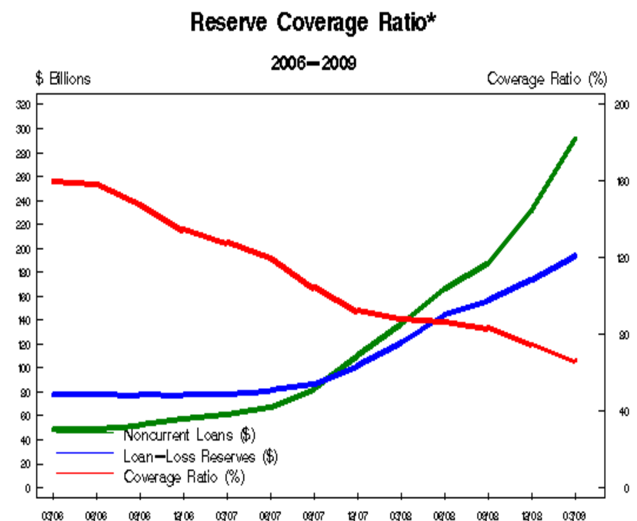
A breathtaking run-up in bank stocks has been headiest of all – though they're still down 3% for the year, the S&P 500 Financials have jumped more than two-thirds since early March. Can this be for real?

In the first quarter, banks and thrifts booked their highest earnings in a year, and successfully floated new debt and equity after long months when the bid seemed dead and buried. A steeply positive yield curve brings the potential for rich carry, and net interest margins should improve. The stress tests are behind us, and fundamental theatricality notwithstanding, their conclusion at least removes one uncertainty, if only "What will the stress tests conclude?" Nothing momentous, it turns out.

Most of all, we're past the stage of serial, overnight calamity among marquee name financial institutions , and Federal backstopping seems an entitlement for any bank with enough girth to scare Messrs. Bernanke or Geithner to attention.

Still, a few things restrain our enthusiasm. The budding restoration of bank capital has derived from dynamics which necessarily hurt shareholders now (dividend cuts), or which will either thin future earnings or jeopardize their stability (namely dilution and leverage via new security issuance and the TARP). Moreover, the first quarter iced the banks' earnings cake with some dubious one-offs. A taste: Goldman Sachs changed from a November 30 to a December 31 fiscal year-end and thereby shifted bad December numbers out of what used to be its first quarter; Citigroup booked the deterioration of its own bonds' market value as a $2.5B unrealized gain, thus transmuting a higher implied cost of capital into a credit value adjustment "profit;" AIG unwound a big chunk of its CDS book at 100 cents on the dollar, juicing bank trading profits an unknowable sum; and FASB unveiled the new mark-to-market accounting standard, a hocus pocus by which banks get to defer recognizing losses.

What restrains us, also, is an old favorite. Here is the latest version of a chart you may recognize from my 2007 newsletters:



Source: FDIC Quarterly Banking Profile, 1st Qtr 2009

Back in 2007, seeing non-current loans converge on reserves led us away from financials, which contributed mightily to our outperformance in 2008. The story is still one of slope, as loans go bad quicker than the banks reserve to cover them, but also one of acceleration, as the slope of delinquency gets only steeper.

In short, the most persuasive thing green we're seeing nowadays is the Noncurrent Loans line above: It's green alright, and shooting higher.

William A. Harris, CFA