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the US financial sector in an environment of turbulence

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The following reflects the views of the authors. They do not necessarily represent the views of the firm. Given the nature of capital markets, views can change quickly.

US financial companies have spent the past three years trying to meaningfully improve their balance sheets. In the first half of 2011, we saw this trend reflected in company reports of asset quality improvements, increasing capital and strengthening liquidity. However, these improvements were not enough to insulate the financial sector from the maelstrom of economic and political news that buffeted the capital markets during the past four weeks and incited investors to challenge stock and bond valuations.

Heightened anxiety about the European debt crisis, a potential slowdown in the global economic recovery and the US credit downgrade appears to have overshadowed financial company fundamentals. *In our view, fundamental improvements by financial companies have fortified the sector, leaving it substantially stronger than in 2008. Currently, we think financials are well positioned to withstand market turbulence.* Below, our equity and credit analysts share their insights on the financial sector, including:

- Equity and credit performance over the past month
- The impact of the European debt crisis
- Bank fundamentals and the changing regulatory environment
- Outlook and key factors to monitor

IN YOUR VIEW, WHY HAVE FINANCIAL COMPANIES SOLD OFF SO DRAMATICALLY?

Lower-than-expected US GDP growth, expectations for continued employment weakness, the European debt crisis and the Federal Reserve's announcement that it will hold short-term interest rates at low levels for at least two years have unnerved investors in financials. The *Standard & Poor's (S&P)* downgrade of Treasurys to AA+ added insult to injury, sending stocks tumbling and credit spreads soaring.

Since their recent peak on July 21, financial stocks plummeted 20% through August 18, underperforming the *S&P 500*, which was down 15% over the same period. Within the financial subsectors, the bank indices were among the worst of the group, with regional banks down 25% and investment banks down 23%. Likewise, overall, US investment grade and high yield financials have underperformed broad corporate indices since the selloff began. Yield spreads on investment grade finance have widened out 78 basis points since July 21, and investment grade banks, a subcomponent, have posted worse results. High yield finance companies have seen yield spreads surge 231 basis points relative to a 184 basis-point spread widening for high yield corporates.

EQUITY MARKET PERCENT CHANGE

	S&P 500 Index	S&P Financials Index	Regional Bank Index	Investment Bank Index	Life Insurance	P&C Insurance Index	Consumer Finance Index
July 21 - August 18	-15%	-20%	-25%	-23%	-23%	-10%	-16%

OPTION ADJUSTED SPREAD CHANGE

	US Investment Grade Corporate	Investment Grade Finance	Investment Grade Banks	Investment Grade Insurance	High Yield Corporate	High Yield Finance Companies
July 21	152	196	197	198	525	491
August 18	201	274	284	252	709	722
OAS Change	49	78	87	54	184	231

Sources: Equity market performance, Standard & Poor's; OAS, Barclays Capital. Data as of August 18, 2011.

We believe a more stringent regulatory environment, as well as uncertainties associated with legacy mortgage liabilities and foreclosure penalties that continue to plague some of the country's leading financial institutions, are also weighing on investor sentiment and valuations. Given the recent decline in the equity markets, many analysts are lowering earnings estimates across the financial sector. Stock prices of insurers, banks, asset managers and other financial companies reflect the impact of lower equity values on trading revenues (banks and investment banks), equity-linked products (insurance companies) and investment portfolios. On a positive note, we believe the probability of major impairments on investments and loans is remote, particularly when compared to the 2008–2009 financial crisis.

Valuation measures for financials have dropped. As of August 18, the *S&P Financials Index* price-to-book-value was 0.90x, much lower than the mid-crisis September 2008 level of 1.36x. But, relative to 2008 when asset levels were inflated and had not been marked to market, we have more confidence in the quality and stability of current book values.

After reaching a two-year low in late May 2011, option adjusted spreads between investment grade corporate bonds and investment grade Finance corporates have returned to the high levels seen in the spring of 2010, when anxieties surrounding Europe first surfaced. In the high yield market, the sudden jump in yields on the change in investor sentiment has been breathtaking considering that many high yield financial companies are in much better shape fundamentally now than during the financial crisis. Similar to investment grade banks and financial companies, high yield issuers have made great strides in bolstering capital, raising liquidity, and stabilizing credit performance and loan growth. Recent market volatility could threaten this progress and delay ratings upgrades that were in the works. Though high yield finance bond prices have fallen, they are still nowhere near the depressed levels of mid-2009 due to the tremendous rally experienced since the financial crisis. Currently, we view the average high yield finance bond spread of 720 basis points as attractive, but recognize that high yield issuers are highly sensitive to market conditions, as they are still in the midst of fixing impaired funding models. A serious delay in gaining economic funding through ratings improvement and capital markets access could result in long-term credit erosion.

In our view, prices for US financial stocks and corporate bonds are not likely to improve until headlines and rumors subside and investors once again focus on fundamentals.

THE EUROPEAN DEBT CRISIS AND STABILITY OF EUROPEAN BANKS HAS BEEN A LEADING CONCERN FOR INVESTORS. HOW DO YOU SEE THIS SITUATION INFLUENCING THE US FINANCIAL SECTOR?

The European debt crisis highlighted areas of concern within the US finance sector, particularly banks. *However, we do not think this turmoil will upend the long-term fundamental health of the sector.* Among the large, internationally active US banks, direct exposure (net of hedges) to Greek, Portuguese, Spanish, Italian and Irish sovereign debt and corporate issues declined during the past few months and is at "manageable" levels, generally less than 1% of assets and in the range of 6% to 8% of equity. This is probably as low as exposures to these troubled European countries will fall, as these large US banks likely want to retain a presence for when conditions improve.

The European debt crisis also raised some questions about the strength of the European banks[1] as trading and derivatives counterparties for US banks. US banks, however, appear to have learned some lessons from the 2008 liquidity collapse and have generally increased their risk management concerning counterparties, including limiting concentrations to specific counterparties, countries and currencies.

WHAT IS YOUR ASSESSMENT OF US BANK FUNDAMENTALS?

Fundamentally, we believe US banks are in satisfactory shape. For example, recently reported second-quarter results for the major US banks showed improved profitability driven by lower loan loss provisions.

[1] *See "The European Debt Crisis: Key Points to Consider" by Tom Fahey & Ed Thaute of Loomis Sayles on Loomissayles.com for an overview of what the debt crisis might mean for European banks.*

Returns on assets for these banks are now ~1.00% and appear to be approaching more "normalized" levels. *In our view, weak revenue growth in a meandering recovery is still the biggest fundamental challenge for banks, not credit quality, leverage or funding.*

Asset quality, perhaps the most important variable in bank fundamental analysis, has continued to improve. Despite high US unemployment and a moribund real estate market, US banks have reported a decrease in credit losses, non-performing assets and potential problem credits. Given the Federal Reserve's recent prognostication that economic growth may be tepid over the next two years, the US banks appear equipped from a reserve coverage and capital standpoint to deal with additional problems that may emerge. Further, most of the largest US banks passed a recent round of stress testing under scenarios that assumed higher unemployment, increased loan losses and a more beleaguered housing market.

The markets have again become very concerned about the liquidity and funding profiles of banks globally, as these areas proved to be the Achilles heel for the sector in 2008-09. However, in 2008, financial institutions held very small balances of liquid assets and funded poor quality loans with very short-term borrowings like commercial paper and repurchase agreements.

Currently, beyond the significant reduction in risk assets, US banks overall have at the behest of their regulators, counterparties and the looming implementation of Basel III standards, meaningfully improved their balance sheets in other ways. Banks have reduced leverage via capital raises and earnings retention, materially increased short-term liquid asset stockpiles and lengthened funding maturities as inelastic, sticky core deposit balances have grown and volatile wholesale borrowings have been paid off. This significantly improved profile does have a material profitability offset, as maintaining a liquidity cushion comes at the expense of margin in this low rate environment.

As indicated in the table below, the loan/deposit ratio shows the industry's improved asset liquidity and better core-deposit funding posture at the end of the second quarter 2011. The higher loan loss reserves and Tier 1 capital ratio show the increased cushion the banks have to help in the event of additional credit issues.

	2Q 2008	2Q 2011
Loans/Deposits	0.92	0.73
Reserves/Loans	1.80%	2.84%
Tier 1[2]/Risk-Weighted Assets	10.1%	13.1%

Source: FDIC Quarterly Banking Profile—All FDIC-Insured Institutions.

HOW COULD PROPOSED BANKING REGULATIONS INFLUENCE THE INDUSTRY?

With regard to the implementation of the Dodd Frank Act, the debit interchange fee restriction was recently eased and proposed rules regarding capital, including the inclusion of trust preferred securities, are expected soon. Specifics regarding the Volcker Rule and derivatives clearing and trading regulations have been delayed and are not expected until the fourth quarter of this year.

In late June 2011, the Basel Committee on Banking Supervision agreed that global "systemically important banks" will be required to hold an additional capital buffer of 2.5%, on top of the required 7% Tier 1 common ratio for a total of 9.5%. The additional capital buffer is to be comprised of common equity, not contingent capital. The list of global "systemically important banks" has yet to be released. With complete implementation required by 2019, our analysis shows that the US banks expected to be named global "systemically important banks" have ample time to meet the new requirements. Proposed capital guidelines from US regulators are expected in September. While the Basel III edicts are not dire for US banks, the increased capital and liquidity requirements should cut into profits, thus impairing returns on bank stocks.

[2] *Tier I capital is core capital; this includes equity capital and disclosed reserves. The capital adequacy ratio measures a bank's capital. It is expressed as a percentage of a bank's risk-weighted assets.*

WHAT IS YOUR OUTLOOK?

In our view, continued recovery in the global economy will likely be the key factor for the fundamental trajectory of the US financial sector, so an immediate resolution is unlikely. As we seek to identify and exploit selected investment opportunities, we will keep a keen eye on corporate fundamentals and will pay particular attention to global macroeconomic indicators as well as liquidity and capital levels.

We believe liquidity is probably the most critical measure to watch, especially if the financial markets were to reach a crisis mode reminiscent of 2008. As we noted before, the liquidity profiles of US financial companies are significantly stronger than three years ago. In fact, liquid asset hoards would currently be large enough to allow most banks/financial institutions/insurance companies to meet upcoming debt maturities even if access to the capital markets were curtailed for the next 6 to 12 months. After that, weaker players rated below investment grade could be scrambling, looking to a partial portfolio run-off to help service debt or a stronger M&A partner in order to survive. Capital levels for banks, non-bank financial institutions and insurance companies have reached strong levels by historical standards, owing largely to greater prudence post the financial crisis and looming new regulatory requirements. This cushion puts them in a good position to absorb potentially higher loan losses in a stressed scenario.

Until some degree of calm returns to the global capital markets, credit spreads and stock prices could remain volatile and are likely to be driven more by rumors and news headlines than by fundamental realities. *We reiterate that, in our opinion, recent pressure on financials overlooks sound fundamentals across most of the sector. As we see it, fundamental improvements implemented since 2008 should sustain most financial companies through continued market turbulence.*

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