Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Subprime Lending Was Their Best Idea

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Donald Luskin

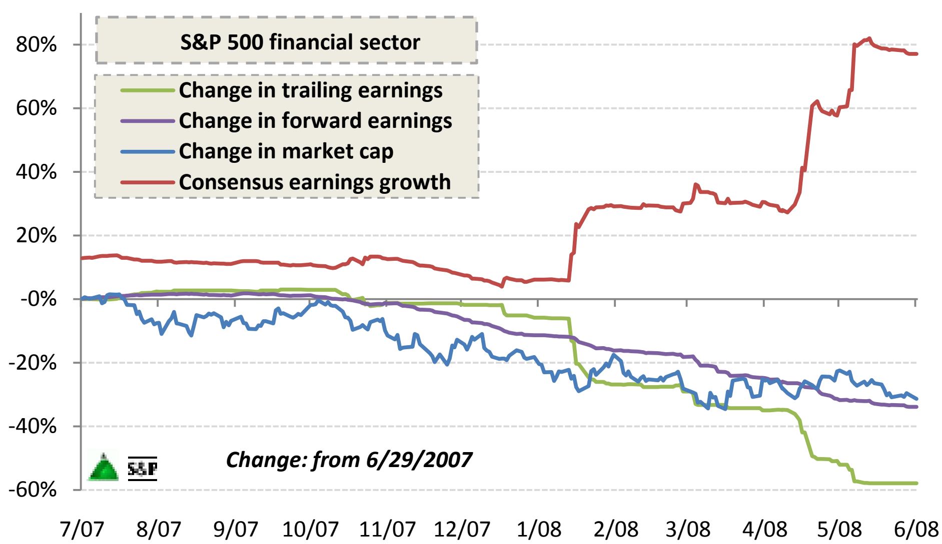
Where are financial sector earnings going to come from? And where's the safety net when the PDCF expires?

Update to strategic view

US FINANCIAL STOCKS: While not predicting doom, we see this sector as being composed of "broken" businesses that will have difficulty generating earnings growth in a post-crisis world. At the same time, the sector will struggle with the decision of whether to pay the regulatory price for the extension of the Fed's Primary Dealer Credit Facility.

[see Investment Strategy Dashboard]

After March 17, when the Fed facilitated the orderly liquidation of Bear Stearns and staved off a global financial meltdown, the credit crisis became merely a bad problem. The knee-jerk reaction was to buy the financial sector. But we argued against being "an equity holder in still troubled credit intermediaries," and said instead to "be a direct creditor in beaten-down debt markets" (see "Inflation Inflection" March 25, 2008). Now the S&P 500 financial sector is back down pretty much to where it was on March 17 (it's up only 3.7% from that crisis low). But at the same time, the S&P 500 ex-financials is up 8.7%, and those "beaten-down debt markets" -- senior securities with less risk than stocks, which could have been bought using leverage -- have recovered from the firesale prices driven by March's forced liquidations. For example, plain-vanilla junk bonds have returned 6.1%, and are near all-time highs, and leveraged loans have returned 7.7%.



There are two reasons we still don't like the financial sector, though we are confident that the worst of the credit crisis is indeed over. First, we see banks and brokers as "broken" businesses, with no immediate way to

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

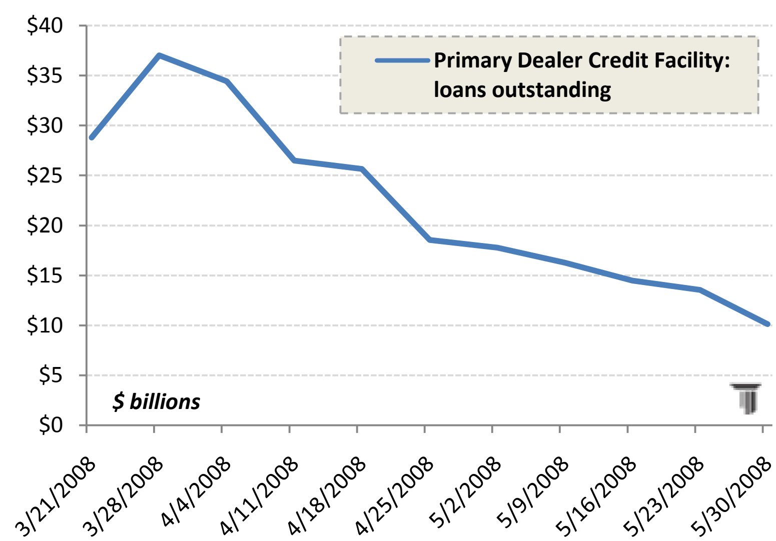
Phone:
650 429 2112
973 335 5079
704 552 3625

reinvigorate their earnings growth. Remember, *subprime lending was their best idea*. And now it's gone. Yes, as exotic credit products such as SIV's have blown up, there has been substitution into more traditional ones such as commercial and industrial lending. But such commodity credit products fell into disuse in the first place in large part because they were less profitable for banks. Now, substitution of exotics for commodities is a perfect recipe for thin margins and stagnant earnings.

As sharply as the market capitalization of the S&P 500 financial sector has declined, it probably doesn't reflect how difficult the earnings challenge will be. Since mid-year 2007, forward 12-month earnings for the sector have fallen 34% and market cap has fallen only 31% (please see the chart on the previous page). So in terms of the forward earnings multiple, the sector is valued today in the aftermath of the credit crisis *more highly* than it was before the crisis even began. In terms of equity risk premium (that is, the forward earnings yield relative to long-term Treasury rates), our model shows the financial sector to be slightly undervalued versus its long-term historical norm. But it is one of the two *least* undervalued of all ten S&P 500 sectors, and it is less than one-third as undervalued as the S&P 500 ex-financials.

Over the same period since mid-year 2007, *trailing* earnings for the sector have fallen 58%. For the *forward* earnings consensus to be achieved, earnings over the *coming* 12 months will have to be 77% higher than over the *last* 12 months. We appreciate that all the sector's write-offs have established a low base of comparables, but with no assurance that there will not be further write-offs, and with the sector struggling to find new profit-centers -- ones that, hopefully, won't depend on reckless credit policies -- today's valuations seem generous, to say the least.

Second, over the coming months, brokers will have to come to terms soon with potentially losing access to the Fed's discount window through the new Primary Dealer Credit Facility. Most investors we talk to seem to believe that the facility is permanently in place, and that the only question is under what regulatory regime it will ultimately operate. The Fed is encouraging such belief by saying on the New York Fed's website that "PDCF will remain in operation as long as is needed," but the reality is that it will likely cease to operate after September, because the Fed does not have statutory authority to operate it permanently. PDCF was created on Sunday, March 16, as part of the package of emergency initiatives that included facilitating JP Morgan's takeover of Bear Stearns, under the authority of section 13(3) of the Federal Reserve Act. That section requires counsel to issue an opinion that circumstances are exigent, and to issue a finding that the money to be loaned by the Fed would not otherwise be available to potential borrowers on any terms. According to a highly placed Fed source who was present when PDCF was created, it could not be created under the less exigent circumstances that exist today, or that will hopefully exist in September when PDCF expires.



Since it was first introduced, the PDCF has been used less and less. From a high of $37 billion in late March, loans outstanding had fallen as of last week to $10 billion (though it was rumored that Lehman Brothers was borrowing yesterday). Nevertheless, PDCF has doubtless been a stabilizing presence in the aftermath of the Bear Stearns crisis. As Ben Bernanke put it in a speech yesterday, markets have benefited from the "increased confidence created by the assurance that backstop liquidity is available." According to our source, the Board of Governors is very worried about what might happen to confidence if that backstop were to go away, and it were to become once again what it was before PDCF was established: a matter of uncertainty as to whether the Fed would be there in an emergency -- perhaps an emergency precipitated by the very fact that the PDCF wasn't in place.

But assuaging those worries would come at a cost. Making PDCF permanent would require an act of Congress, and would no doubt involve more stringent regulatory oversight of broker-dealers by the Fed -- and who knows what other mischievous new financial regulations, once that Pandora's Box was opened. Already, banks are insisting on a "level playing field" as the price for broker discount window access -- that is, that brokers' capital ratios would kept in check by Fed regulation just as those of banks already are. That would align the Fed with the European Central Bank's traditional practice of recognizing no particular distinction between banks and brokers. We have argued that, similarly to Bernanke's "backstop liquidity" analysis yesterday, this has helped spare Europe a major bank failure during the credit crisis, while allowing the ECB to be less accommodative than the Fed (see "Fed vs ECB -- the ECB Wins" April 23, 2008). But at what regulatory price? As our Fed source put it, "Is Deutsche Bank anybody's idea of financial dynamism? Is Société Générale?"

And ultimately, our source wonders, what is the point? In a more highly regulated regime, the riskiest and most profitable activities of brokers will be spun off and moved offshore, where they won't be regulated and they won't have access to PDCF. Should the entities conducting these activities become insolvent in a crisis, they would still be a risk to the world financial system thanks to their interconnectedness via default-sensitive counterparty contracts.

As the PDCF nears expiration in September, these issues will be debated with increasing prominence, and it won't be an uplifting experience for the financial sector. It will seem like a menu of bad choices, because that's what it is. PDCF could be allowed to expire, in which case the "liquidity backstop" goes away until the next emergency. Or it could be made permanent by act of Congress, and the most dynamic elements of the "broken" businesses in the financial sector get regulated down to the level of the rest or forced offshore -- all perhaps to no purpose, since there's ultimately no way to fully regulate away systemic risk in an interconnected global financial market. It's a debate that will put the financial sector in a very bad light, and as it plays out it wouldn't surprise us to see some of the rather ambitious forward earnings assumptions currently in place get revised away. We're not end-of-the-world bears on the sector by any means. But the idea that, in the environment we're envisioning, there is likely to be any large-scale or sustainable snap-back recovery even as the worst of the credit crisis recedes in the rear-view mirror seems pretty fantastical.

BOTTOM LINE: While not predicting doom, we see the financial sector as being composed of "broken" businesses that will have difficulty generating earnings growth in a post-crisis world. At the same time, the sector will struggle with the decision of whether to pay the regulatory price for the extension of the Fed's Primary Dealer Credit Facility.