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Financials Stink Up the Joint

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Earnings are coming in strong, except for financials -- and the Fed will take care of that.

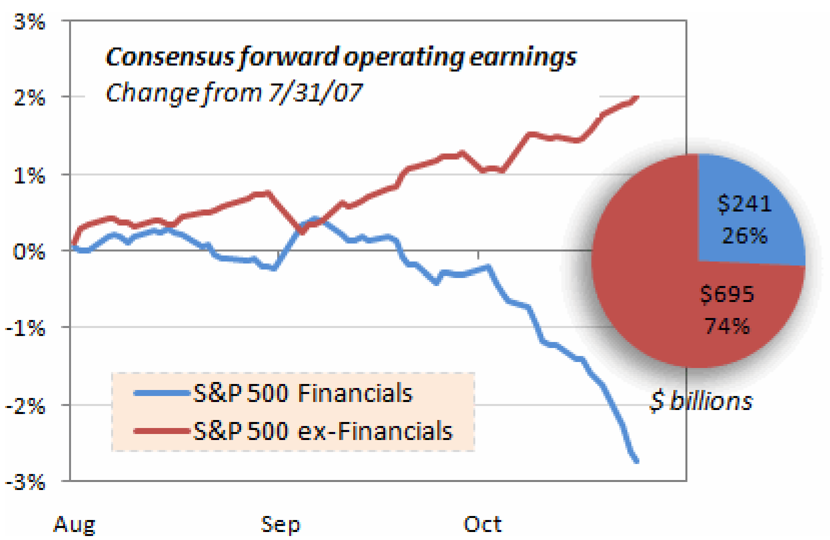
The correction in equities that we anticipated has happened, and with a vengeance (see "Easier and Easier" October 12, 2007). We had thought that record oil prices would be the news hook that would trigger it. But that consideration has been trumped by increasing concerns about the health of the financial sector -- from Citicorp's troubled attempts to create a vehicle to rescue its failing SIVs, to Merrill Lynch's revelation of large losses in CDOs. The financial sector has been a blotch on what has otherwise been, from our perspective, a very strong earnings season. We are not troubled, as markets apparently were last Friday, by Caterpillar's repetition of the well-known fact that the US housing sector is in recession.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: The expected correction has occurred, driven by exaggerated perceptions of weakness in the financial sector. That sector is more resilient than generally believed, and in any event the Fed will stimulate it -- indeed, likely overstimulate it -- with at least one more rate cut, and a long period after of too-easy policy. We expect stocks to stabilize from here, and work toward attaining new highs.

[see Investment Strategy Dashboard]

Instead, we're focusing on S&P 500 consensus forward operating earnings, which have continued to grow despite the current credit crisis. They reached all-time highs two weeks ago. And the main reason that they've now slightly pulled back from that level is a marked drop in forecasted earnings for the financial sector. Those earnings peaked in early September, and are now off 2.7% from the end of July at the onset of the turbulence in credit markets. In sharp contrast, S&P 500 earnings *ex-financials* now stand at an all-time high, and are up 2.0% over the same period. So the good news is that, so far, the overall earnings environment



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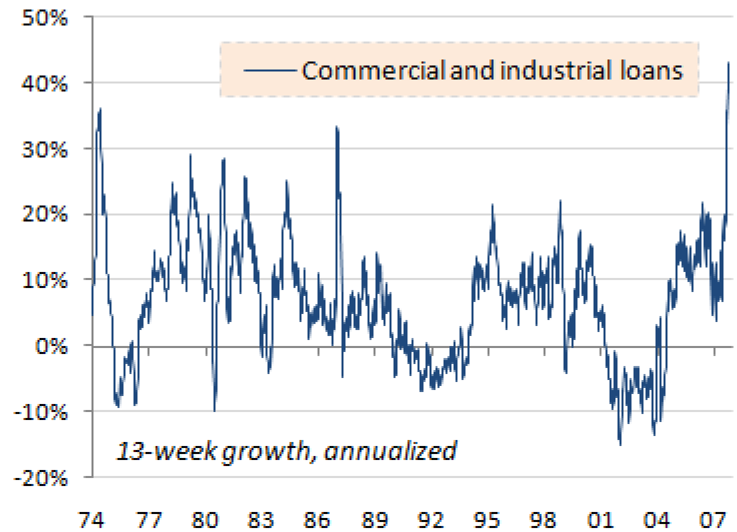
seems to be immune to infection from the financial sector -- just as, so far, the overall economic environment seems to immune to infection from the recession in housing (see "Two Economies, One Funds Rate" May 1, 2007). Yet financials are the largest S&P 500 sector, at 20% of market cap. They contribute an outsized 26% of forward earnings, $241 billion out of a total of $936 billion. Can stocks advance if the S&P 500's largest component and largest earnings contributor is impaired? For that matter, can the US economy grow if this key enabler of capital formation and risk-taking is impaired?



The answer to both questions is *yes*, because the financial sector is less impaired than panicky markets presently seem to think. Even with the recent drop, the forward consensus for the financial sector implies 10.9% operating earnings growth in the coming year. Yes, some investment banks such as Merrill Lynch are taking significant mortgage losses, but these are not lethal in the context of their large balance sheets. And yes, the near-future profits of such banks may be constrained as they undergo a period of risk-aversion while they come to terms with their past errors. But at the same time, other investment banks such as Goldman Sachs have thrived on the recent chaos and have emerged in superior competitive positions, poised to accelerate their profit growth. We're seeing not the impairment of a sector, but rather the realignment of the competitive landscape -- which is usually a healthy thing. Large commercial banks are ostensibly challenged by the risk that their capital ratios will be weakened by having to take assets from SIVs onto their own balance sheets. But that hasn't prevented a surge in commercial and industrial lending, currently running at a 43% annualized growth rate, the fastest pace in the 33-year history of the data (see "The Unloved Buck" October 23, 2007). As commercial paper and other securitized credit markets have run into difficulties, it seems that this traditional bank lending channel has risen up to fill the breach. That's a sign that the banking system is very well capitalized, and that there is confidence that the Fed stands ready to backstop banks that stretch a little bit to meet the needs of urgent borrowers.

And now the Fed seems destined to do even more, with market-based expectations showing yesterday the certainty of a 25 bp rate cut at the October 31 FOMC. The market action of the last week -- panic in the face of what has really been no news at all -- can be seen as a kind of tantrum, giving the Fed a glimpse of the consequences of disappointing the demand for another cut. Yesterday, stocks recovered from their panic sell-off when the fed funds futures on the CBOT moved beyond full expectations for a 25 bp cut, and into a small probability of 50 bp. If there had been any doubt about another cut, these expectations now erase it. So the Fed is now destined to print even more money, and drop it out of even more helicopters, to support a financial sector that was already well on the way to recovery. What will be the consequence? Inflation is the obvious one, as we have already commented repeatedly -- or at least obvious to us, if not the Fed, with commodities making new highs and the dollar making new lows as expectations for a too-easy policy posture deepen (see, for example, "Honey, I Shrunk The Dollar" September 28, 2007).

While we still have hopes that growth surprises on the upside will forestall the Fed's rate-cutting campaign before it becomes a full-blown easing cycle -- perhaps something as brief as the 75 bp in cuts made in the financial crisis of 1998. But we mustn't underestimate the predilection of the Bernanke Fed to take a very activist approach to risk-management, and to use non-convention means to implement policy. With his notorious speech in November 2002 about printing presses and helicopters, Ben Bernanke became the spokesman and thought leader for the Fed's radical approach to hyper-ease in 2003 and 2004. At that time the Fed pulled out some very big guns -- 1% interest rates for a "considerable period," mobilized not against deflation, but against the mere *risk* of deflation. What radicalism might the Fed employ in the current environment, in which a housing-led recession is the risk to be mobilized against? To visualize the possibilities in today's mortgage-driven credit crisis, it's useful to recall one particular radical idea Bernanke talked about in that same 2002 speech:

> A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt… Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example, mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association).

In the spirit of the contrarian strategic exercise in which an investor imagines the outcome that *nobody* thinks could *possibly* happen -- but, in fact, actually *might* happen -- consider the idea that an activist Fed throws so much money at the financial sector that it not only completely recovers from the shock of the recent credit crisis, but then reverts to the same practices that got it into trouble in the first place. It may seem crazy, but why not? After all, it's the Fed's money. At least some degree of this is highly likely to happen, and indeed it's precisely what the Fed is trying to engineer with its present easy money posture, in order to spare the economy paying the full consequences of its previous easy money posture. In this view, the risk to the financial sector isn't next year's profits -- it's the risk that we're about to embark on yet another cycle of moral hazard.

BOTTOM LINE: The expected correction has occurred, driven by exaggerated perceptions of weakness in the financial sector. That sector is more resilient than generally believed, and in any event the Fed will stimulate it -- indeed, likely overstimulate it -- with at least one more rate cut, and a long period after of too-easy policy. We expect stocks to stabilize from here, and work toward attaining new highs.