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All's Not Wells

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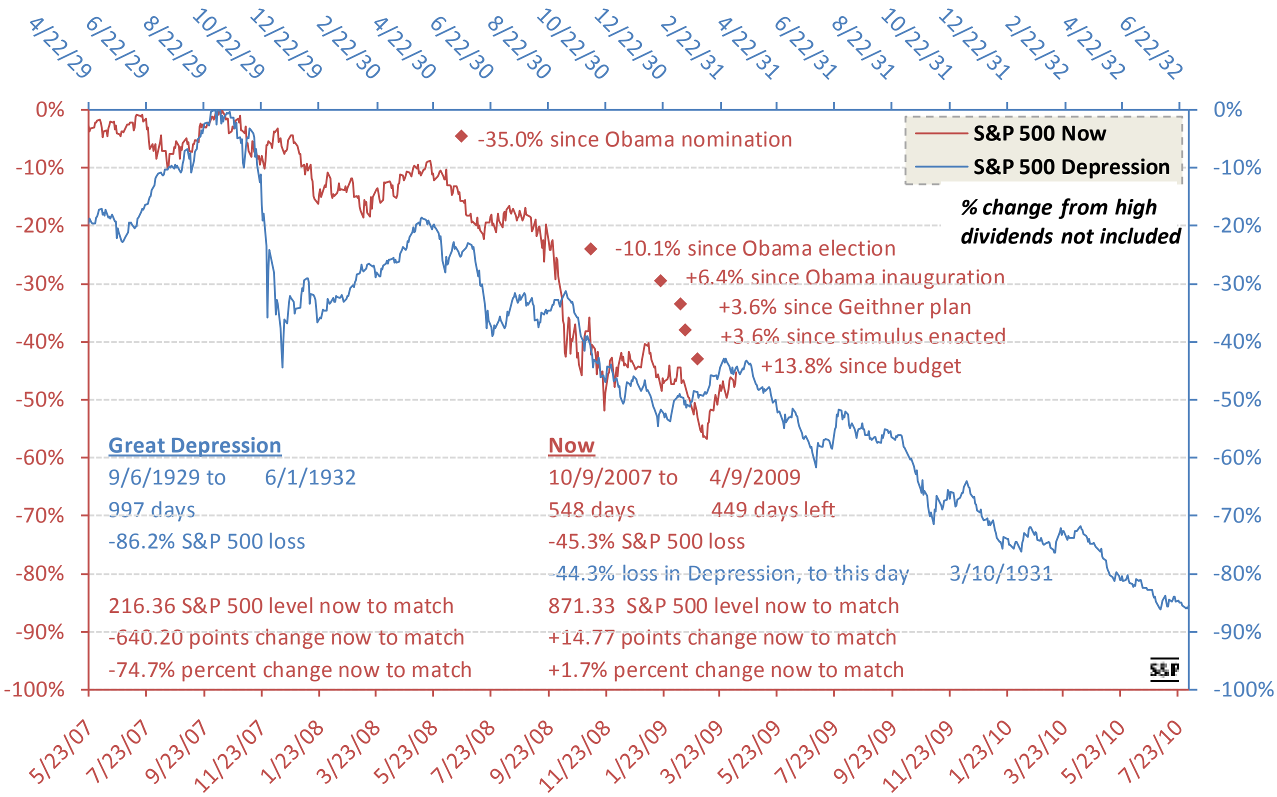
Wells Fargo's pre-announcement is encouraging, but don't generalize it to all banks.

Update to strategic view
Please see the top of the following page

On the morning of March 10 we called for "a tradable rally commencing almost immediately" (see "Quantum of No Solace" March 10, 2009). The S&P 500 has since rallied 26.9%, by some definitions a whole new bull market. At least it's the best rally stocks have seen since the October 2007 top, and on the chart it breaks the S&P 500 out of its steep downtrend of the last six months. It feels to us as though sentiment has improved dramatically -- but that's as likely an effect of the rally as it is a cause. At the same time there is evidence that the credit crisis that has been at the center of the bear market is clearing, symbolized by last week's preliminary announcement by Wells Fargo of better than expected earnings. But is any of it real and lasting? Let's review the bidding.



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SENTIMENT IS A SUFFICIENT EXPLANATION We'll discuss the possible improvement in the banking sector in a moment. But first we must observe that all that is really required to explain the bull move in stocks over the last month is how ridiculously oversold stocks became in the panic atmosphere of one month ago. To give it context, at the worst on March 9, stocks had fallen 56.8% from the October 2007 highs, making the drop the second worst bear market since 1900. That's 7.8% further than stocks had fallen in the Great Depression the same number of days from the 1929 peak (see the chart on the previous page), though conditions on the ground a month ago were incomparably better than they were in the early 1930s. Yet a month ago the level of panic was worse, with S&P 500 volatility running at about 40%, almost twice what it was at the same point in the Great Depression.

Update to strategic view
US STOCKS: The last month's massive rally needs no more explanation than the reversal of extreme sentiment, and that factor has more room to run. At the same time, the runaway train of anti-growth policy that drove stocks to the March lows has slowed, suggesting that those lows could be a durable bottom in this bear market. **US FINANCIAL STOCKS:** We caution against generalizing Wells Fargo's good news -- Wells is the best of the bunch. As economic conditions deteriorate less slowly, and bank rescue policy comes into clearer focus, the sector can stabilize, which itself will enable further economic recovery -- a new virtuous cycle. We see the sector overall as an ongoing opportunity for "value speculation," not investment. This is where the differences between arguably good banks like Wells, and arguably bad banks like Citigroup, will permanently diverge -- the former headed back to growth, the latter stagnating.
[see Investment Strategy Dashboard]

If the Depression benchmark is any guide, sentiment can support further gains for stocks. Even after the last month's rally, stocks are *still* off more from the top than they were at the comparable point in the Great Depression, and volatility has only increased. So while the sentiment case for stocks is far less intense than it was a month ago -- obviously, with stocks having rallied 26.9%, the easy money in bottom-fishing is gone -- it's still in play to some extent.

THE POLICY ENVIRONMENT STABILIZES The panic of a month ago was energized by extreme uncertainty about the economic policy environment. First, it seemed then that the populist agenda of the Democratic majority in Congress was an unstoppable runaway train, and we said that stocks would keep falling until that train was slowed down (see, among others, "Obama: '…today does mark the beginning of the end.'" February 20, 2009). Even stipulating that Congress's agenda isn't anti-growth (but, to be clear, we believe it *is* anti-growth), the sheer quantity of "change" in play a month ago, much of it being promoted aggressively in the name of "emergency," threatened to further destabilize an already reeling economy. At the same time, it seemed that Treasury Secretary Tim Geithner was utterly out of his depth in dealing with the continuing crisis in the banking sector (see "Two Strikes for Tim" February 11, 2009).

Over the last month, the runaway train of anti-growth policy has slowed considerably, with the Senate emerging as a surprisingly effective brake. For example, mortgage "cramdown" and punitive banker bonus legislation passed in the House have stalled in the Senate, and the likelihood of filibuster has now derailed "card-check" legislation. And the Senate has pushed back against some key anti-growth provisions in the White House's budget, including the limit on tax deductions for philanthropy and the cap-and-trade carbon tax.

Geithner surprised on the upside with a credible toxic asset plan -- including clever deal-structuring designed to avoid imposition of punitive executive compensation guidelines on participants (see "Geithner Gets a Do-Over" March 24, 2009). And the Fed has redoubled its commitment to maintain a generous balance sheet posture, as though to signal it will support

Recommended reading
The Panic of 2008 Kevin Warsh, Council of Institutional Investors 2009 Spring Meeting, April 6, 2009
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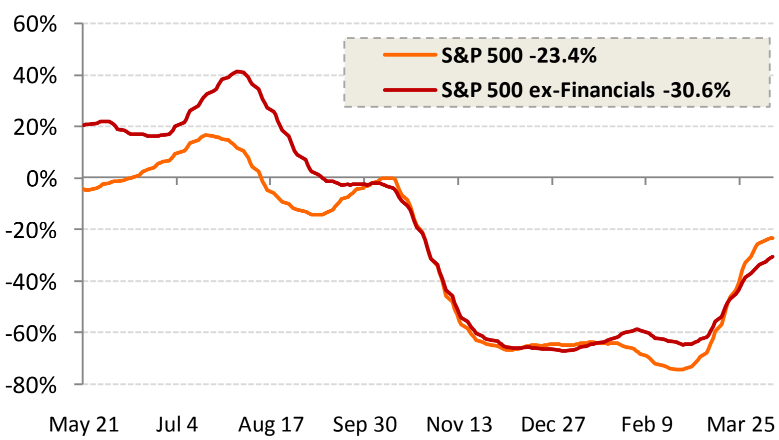
the credit markets and the economy no matter how much the Treasury and the Congress screw up (see "Ben Boldly Goes" March 19, 2009).

We don't recommend that clients permit themselves a lot of illusions about how much the policy environment can continue to improve from here. It is encouraging to think that the political class so bent on driving "change" at all costs just a month ago recognized they had pushed markets to the "edge of chaos," and that they were sensible enough to pull back from that brink before it was too late (see "Number of the Beast" March 18, 2009). That should give us some confidence that the S&P 500's intraday low on March 6 at 666 was the bottom in this bear market. But the policy train is still going very much in the wrong direction, even if it's no longer a runaway. We are skeptical about how strong any economic recovery will be, and how far any new bull market can carry, given the very high likelihood of substantive anti-growth initiatives in taxation, trade, financial regulation, housing, autos, energy and health care.

WELLS FARGO AND THE BANKS Wells Fargo's positive earnings surprise raises the question of the extent to which the bull move of the last month has been due to a fundamental turnaround in the beleaguered and critically important banking sector. No doubt about it, there has been a turnaround in sentiment, at least, with the S&P 500 financial sector up 71.5% since March 9. Consensus earnings expectations for the sector have changed tangibly, too. While the annualized month-on-month revision rate for the S&P 500 is still falling at about 24% a year, for the financial sector it is *rising* at more than 50%. But that's off a *very* low base, and it's very volatile. And we don't really know what's driving it (there's even a narrative floating around the trading community that it's a one-time anomaly driven by AIG unwinding its derivatives book in a hurry). Perhaps its sufficient to say that the economy has stopped getting worse, or stopped getting worse as quickly, so naturally the economically sensitive banks would do the same.



Annualized earnings revision rate	
Consumer Discretionary	-68.9%
Consumer Staples	-3.6%
Energy	-61.6%
Financial	+52.5%
Health Care	+2.8%
Industrials	-51.0%
Information Technology	-12.5%
Materials	-59.2%
Telecommunications	-13.9%
Utilities	-5.8%

At the moment Wells's pre-announcement provides the clearest window into the first quarter for the sector, but its particular results may not generalize well across other banks. Of the largest banks, Wells has always been one of the most conservatively managed, and throughout the credit crisis has had a relatively small problem with so-called "toxic assets." In the sector's travails of the last nine months, in which even the best banks were trashed by investors, the Wells baby got thrown out with the bathwater along with all the rest. It was easy to rationalize because of Wells's acquisition of Wachovia, through which it inherited a large legacy toxic asset portfolio from Wachovia's own prior acquisition of Golden West Financial. But investors apparently overlooked that Wells virtually invented the bank consolidation/acquisition game, going all the way back to its 1982 Crocker acquisition -- it very much knows what it is doing in this domain. It may well have recognized Wachovia as a diamond in the rough.

Remember, Wachovia was initially to be acquired by Citigroup last September, in one of those panicked over-the-weekend regulator-brokered deals that characterized that tumultuous month -- Wachovia was the last domino to fall, following Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG and Washington Mutual (see "Death by Rescue" November 17, 2008). Originally, Citi was to pay $1 per share for Wachovia, with over $10 billion in capital assistance and $40 billion in guarantees against loss from the FDIC. Just days after, Wells came in with a $7 per share bid, requiring no FDIC capital or guarantees -- apparently having made the clear-eyed judgment that some losses in toxic assets were a small price to pay to acquire Wachovia's vast deposit base. Considering that in the coming months Citi had to accept two large capital contributions from the Treasury, a massive asset guarantee from the Fed, and inflict upon itself the wholesale dilution of its common shareholders, we have to wonder whether the FDIC -- which surely knew of Citi's true condition in September -- saw Wachovia as a way to prop up Citi, rather than Citi as a way to prop up Wachovia. Wells got in the way of that plan, and according to its pre-announcement last week, is now generating significant earnings from Wachovia, having kitchen-sinked its toxic asset portfolio in the prior quarter.

And incidentally…

Wells Fargo's winning bid for Wachovia was assisted by a change in tax rules, liberalizing the use of loss carry-forwards in bank acquisitions, put in place by Treasury Secretary Henry Paulson specifically to facilitate consolidations. But then, in the so-called "stimulus bill," Congress set the rules back to what they had been before, thus dismantling the one policy the government put in place last year that demonstrably engaged a public/private partnership to relieve the stress in the banking system.

Also remember that Wells was one of the banks that said it didn't want TARP money in October, but accepted it at the insistence of the Treasury (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). Some evidence of Wells's strength has been the candor of its chairman Richard Kovacevich, who last month dared to say publicly that the Treasury's so-called stress test of the 19 largest banks is "absolutely asinine," and asked "Is this America?" in reaction to the retroactive imposition of executive compensation controls as the price for having accepted TARP money he didn't even want (see "On the New Bank Bonus Restrictions" February 15, 2009).

Contrast Kovacevich's mastery of the game to the floundering of Citi's Vikram Pandit. Near the very bottom in March, Pandit masterminded a coercive exchange offer of preferred for common, which bolstered the abstract accounting measure of tangible common equity without actually raising a penny of capital (see "Citi's Common Misconception" March 2, 2009). Then two weeks after he had wiped out 75% of common shareholder's value with the exchange offer, designed to allow Citi's capital structure to absorb large losses, he announced that there would be no losses, that Citi was having its most profitable quarter in two years (again, see "Number of the Beast"). When Kovacevich called the Treasury's stress test "asinine," he noted "We do stress tests all the time on all of our portfolios. We share those stress tests with our regulators." Does Pandit?

At the moment, all the banks are poised to at least do less badly this quarter, reflecting the fact that the economy is doing less badly -- and therein lies the potential for a new virtuous cycle, in which a more stable economy supports a more stable credit market, which in turn supports more growth, and so on. We should take a step back and appreciate how remarkable this prospect is, when just three months ago a nearly monolithic consensus held that we were in the iron grip of a *vicious* cycle of decline that simply could not be broken (see "Vicious Cycle Visions" November 10, 2008). This underscores our belief that, for the banking sector, the once very real risk of outright systemic collapse is completely off the table, leaving in its place questions of the extent and cost to shareholders of future government involvement, and the ability of banks to find new business models in a world in which many of the growth drivers of the last decade are permanently shut down (see "Passengers Survive, But Plane Sinks" Friday, January 16, 2009; and "We Can Build on This -- But How High?" February 27, 2009). So we continue to disagree with the ultra-bears who fear the banking sector will go to zero, but we also disagree with the bulls who think that growth is just around the corner. This is where, among banks, the men will be separated from the boys -- high quality plain-vanilla banks like Wells can get back on the rails, but those who thrived best in the credit binge of 2003-2007 pretty much have no future at this point.

BOTTOM LINE: The last month's massive rally needs no more explanation than the reversal of extreme sentiment, and that factor has more room to run. At the same time, the runaway train of anti-growth policy that drove stocks to the March lows has slowed, suggesting that those lows could be a durable bottom in this bear market. We caution against generalizing Wells Fargo's good news -- Wells is the best of the bunch. As economic conditions deteriorate less slowly, and bank rescue policy comes into clearer focus, the sector can stabilize, which itself will enable further economic recovery -- a new virtuous cycle. We see the sector overall as an ongoing opportunity for "value speculation," not investment. This is where the differences between arguably good banks like Wells, and arguably bad banks like Citigroup, will permanently diverge -- the former headed back to growth, the latter stagnating.