

Sector Corner

Bank Stocks: Buying opportunity or value trap?

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The performance of bank stocks over the last year has been nothing short of abysmal. As of 8/3/11, The BKX (The KBW Bank index) has declined 14.37% year-to-date and dropped 9.71% over 12 months compared to increases of 0.21% and 12.53% for the S&P 500 over the same time periods. Bank stocks have shown amazing consistency by lagging the general market in 13 of the last 14 months.

Investor concerns for the banks are numerous and include the following: Regulatory uncertainties, high legal and mortgage-related costs, lack of loan growth, increased capital level requirements, reduced fee income, and narrowing margins. On top of all these issues, the biggest concern for most is the banks' high exposure to the U.S economy and housing market and Europe sovereign debt issues – all areas that have deteriorated since the beginning of the year.

But the news is not all bad for the banks. Some of the regulatory clouds regarding capital levels and debit card exchange fees have cleared and the final rulings were more favorable than expected. Additionally, 2Q11 bank results showed improvement in many areas and have been better than expectations. Roughly 75% of banks who have reported as of late July, 2011 have beaten consensus EPS estimates compared to 63% in 1Q11 and 46% in 4Q10 (Source: KBW research). On average, banks showed sequential loan growth (though more is needed), grew tangible book value 4% q/q, and continued to show credit improvement (Net charge-offs and Non-performing assets both down significantly) and better capital ratios. On the negative side, most banks are experiencing negative operating leverage as revenues are still negative year over year however expenses are increasing more than expected. Mortgage and foreclosure related costs for the large banks have yet to decline despite the large reserves taken already.

Bank stocks appear inexpensive compared to historical valuations and the overall market. Many trade under tangible book value and with a P/E ratio of 6-8x next year's earnings estimates. Bank stocks have looked like bargains for a long time and continue to get cheaper. Clearly, a catalyst is needed to improve valuations. While 2Q11 earnings were positive, banks need a better economic and macro environment to gain the confidence of investors (the 10yr treasury yield should serve as a good macro indicator for banks with a sustained move above 3.0% a bullish

sign). If U.S. economic numbers begin to improve and Europe sovereign debt fears subside, banks should enjoy a period of significant outperformance. The rally will be heightened by the fact that banks are under-owned by institutional investors and most retail investors have already capitulated on the group.

Citigroup Inc. (Ticker: C) is a bank stock poised to outperform the market under an improved macro-economic backdrop. It trades at 0.8x tangible book value and less than 8x next year's earnings. Book value has grown 16% in the last year and EPS is expected to grow 16% this year and 26% in 2012. Citigroup faces most of the problems plaguing the industry and needs to improve its expense control but it has a couple of advantages besides its low stock valuation. It has less housing/mortgage exposure than the other large banks and the largest emerging market consumer business. Loan growth in its international division has been very strong and should provide Citigroup with superior total loan growth once the drawdown in its Citi Holdings assets reaches the ladder innings.

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