LongTail alpha

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Things Could Get Much Worse For The Banks Before They Get Better

"The performance of the banking sector this year has been dismal..."

Despite the sharp corrective rally of the last week the sector remains one of the worst performers. A number of European banks have already plumbed through the lows seen during the financial crisis. A few others globally look set to follow. It might be tempting to think of the sudden "value" provided by the beaten-down sector. But based on longer term analysis of the fundamentals of what drives bank profits, my view is that careful investors might still want to wait before they try to find a bottom in this sector.

A review of the bank business model and the risks the business model is currently facing provides support to the defensive view.

Banks primarily profit from intermediation, which also means taking and keeping some risk on their own books. Since the financial crisis, however, the limits put on banks' ability to warehouse risk (which would require them to take proprietary positions), has been seriously curtailed. Less positioning means less intermediation, which means lower profits from transactions. This trend towards less risk taking is gathering more strength.

Next, banks depend on fees charged for services. With the emergence of new technology, and competition, service charges have collapsed. Lower pricing power means lower profits.This technological shift is secular, and not likely to abate any

Vineer Bhansali, Ph.D.
Founder & CIO

time soon. In fact, the impact of technology and virtual banking will likely bring down costs for financial services at an increasing rate. Banks also depend on yield curve arbitrage, or “maturity transformation” for generating profits. In other words, borrowing short and lending long. With the specter of rising short term rates, and falling, even negative long term rates (note Japanese government bonds went negative last month), this carry trade is not very profitable any more, and will become even less so. If there is a wholesale race by every country to push their long term rates negative to stimulate their own demand, the heart of the banks’ business models comes under attack.
Another source of some risk is that the emergency powers of the U.S. Federal Reserve and some other global central banks have been significantly curtailed since the crisis. A partially straightjacketed Fed that has just begun to tighten policy has removed the implicit downside protection that the banking sector has enjoyed for so long.

And finally, one cannot ignore the rumblings out of policymaker and political circles that raise the possibility of bank breakups, or at least a significant reduction in the reach of larger banking entities. Only time will tell whether any of the proposed new measures are actually implemented, but given that this is an election year, the risks appear to be on the downside.
Banking stocks had been the darling of the post-crisis rally fueled in large part by low short term interest rates and a very friendly Fed. These conditions made up for some of the profit potential lost through lower intermediation, and lower costs from higher efficiency in financial markets. As the balance shifts with rising short term rates, a less protective Fed, low or even negative long term rates, and an increasingly unfriendly political climate, the risks in the sector becomes more visible and in some cases even more severe than tested in the 2008 crisis. While there certainly are individual investments in the sector that might provide tactical opportunity, investors would be wise to steer clear of the sector until many of the structural impediments described here show a sign of abating, although it’s hard to say exactly when that might happen.