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Bank stocks are rising, but bottom may await

By Dan Wilchins

NEW YORK — U.S. bank stocks surged last week, even amid some dour earnings reports, but that move makes sense only if the economy is close to recovering, which is a tough argument to make. Citigroup and Merrill Lynch both set the tone last week for a surprisingly positive week for major bank stocks. Both reported billions of dollars in write-downs, but investors shrugged off the news, bidding Merrill up 8.4 percent for the week and Citi 7.5 percent. Some other banks and brokers had an even better week, with Regions Financial and Wells Fargo up 9.3 percent and 8.7 percent, respectively, and Lehman Brothers up 14 percent.

Bank and broker stocks tend to recover about six to nine months before the economy recovers. Investors buying bank stocks now are hoping the economy is close to righting itself and write-downs are closer to ending. But those hopes may be misplaced.

"I think this market is being irrational. We are entering a consumer-led, slow turn in the U.S. economy and when that happened in the early 1990s, bank stocks fell more than 50 percent," said James Ellman, a portfolio manager at Seacliff Capital, a financial-stock hedge fund. Lenders acknowledge that the economy is difficult. Executives at Capital
One Financial, a credit card lender, said the economic downturn might be deeper and longer than they expected. Gary Crittenden, the chief financial officer at Citigroup, said Friday that he believed the bank was setting aside appropriate amounts of money to cover future losses, but admitted that Citigroup might have to re-evaluate that notion if a big increase in unemployment takes a further toll on the housing market.

"We are in uncharted territory," Crittenden said. U.S. growth is weakening. The economy grew at a meager 0.6 percent in the fourth quarter of 2007 and corporate profits fell 3.3 percent. Early this month, unemployment-benefit rolls hit their highest level in almost four years.

The Standard & Poor's/Case Shiller index said home prices in 20 major metro areas dropped 10.7 percent in January from the previous year. As long as banks continue to foreclose on homes, the supply of homes left to be sold should rise, further pressuring home prices. These economic headwinds are likely to result in more mortgage, credit card and auto loan defaults on the consumer side, and will make it harder for corporations to pay back debt.

Meanwhile, bank stocks as measured by the Philadelphia KBW Bank index have fallen just a third from their peak in February 2007. In the early 1990s, commercial and residential real estate suffered, which hurt banks. This time, banks have even more exposure to real estate as a percentage of their total loans, which means the pain should be even worse, Ellman said.

Some investors evidently believe banks are putting their problems behind them and have written off most of their biggest problem assets, which may be based on shaky assumptions. Citigroup shares trade around a price-to-book ratio of about 1.2, which by historical standards looks attractive because banks often trade at twice their book value or higher. But given the potential for more write-downs at Citi, which would cut into book value, it is much more difficult to determine whether that valuation is attractive.

Still, some analysts argue that now is precisely the time to buy. Charles Peabody, an independent analyst at Portales Partners in New York, has been bearish on financial stocks for three years, but said Friday that he was selectively upgrading banks now, in part because he believed the economy would bottom out midyear.

The U.S. Federal Reserve has lowered interest rates, Congress seems likely to soon pass legislation to help the housing market and accounting watchdogs are easing rules on marking assets. "Our feeling is, we're in the trough of the recession right now, but these measures should pull us out of the recession by midyear," Peabody said.

For investors who can wait a year for their investments to pay off, now is the time to buy these stocks, Peabody said. Some investors agree.

"You don't want to jump in with both feet, but it does make sense to start to pick away at some of these names," said Walter Todd, portfolio manager at Greenwood Capital Associates. But even selective picking is at the buyers' peril, others say.

"Economic fundamentals continue to deteriorate and yet people say the losses banks are taking now are the worst of it. I don't get it," said Dan Alpert, a banker at Westwood Capital in New York.