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OPINION

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The Recent Rally in Financial Stocks

Highlights

- Financial stocks most likely will trend downward until asset-price discovery occurs and/or the residential real estate market finds its bottom.
- The institutions whose prices have fallen the most are ironically the most overvalued.
- At some point, financials will be great buys. For now, short-term trading opportunities may appear, but the risks outweigh potential rewards.

Overview

The economy is weak. We expect to see continuing erosion. Consumer spending accounts for 70% of gross domestic product ("GDP"), and Americans are hurting. For years, they have financed their binge-spending with home-equity loans. Now, with reduced home equity, they've turned to credit cards and will "hit the wall" as these max out. We will see a significant erosion of GDP, leading to increased unemployment and a full-on recession.

There may be short-term plays in financials, but finding bottoms may be like catching a falling knife. With additional downside in residential real estate and the slide into recession, banks will have trouble generating profits. In the long term, the best sector plays will be well-capitalized institutions that are consolidating market share. There is no rush to buy, however, as ongoing economic weakness will mitigate price appreciation.

The financial stocks that look the cheapest are ironically the priciest. As the most troubled institutions have taken massive write-downs and reorganized their operations, they have lost their key appeal: franchise value. Less-troubled competitors steal their customers and best employees; their managers are distracted; and some have lost their core appeal, which most likely will not resurface for a while (i.e., WAMU in mortgages, Lehman in fixed income). Institutions with little subprime and structured finance exposure—JP Morgan Chase and Goldman—will emerge the strongest, but there is no rush to buy their stock.

Investors are voting with their feet. They don't trust politicians. Politicians, pay heed: You cannot fix a problem with rhetoric. It only makes the situation worse. Our economy is weak and getting worse. The stimulus checks didn't work. Cutting rates doesn't cut it. Freddie Mac really is

undercapitalized. In short, while Congress and regulators were ignoring their oversight responsibilities in Washington, those big political contributors in New York were blowing up the economy.

Unfortunately, there is no silver bullet. Asset bubbles need to deflate. But hangovers do go away, and we will get through this. It may, however, take 18 to 24 months to right the economy.

Smart folks learn from history. Let's not make Japan's mistakes: No zombie banks, please. When assets are overvalued, write 'em down. Markets are illiquid because financial institutions continue to carry illiquid assets at above-market value and refuse to sell at market price—not because of a lack of capital available to purchase assets. They therefore remain undercapitalized, can't make loans and are unable to provide essential liquidity to the economy.

The recent rally in financials is a dead-cat bounce. For financials to take off, we need to see the light at the end of the economic tunnel. Absent real evidence that write-offs are over, new capital is unnecessary and/or the economy is righting itself, we will not see a sustained rally in financials. Along the way, oil prices may fall, or a bank will report terrible earnings that "could have been worse." But these may not be sustainable events. Eventually, we need price discovery in the assets banks hold. Banks must sell portions of their portfolios on an arm's-length basis and mark the remainder accordingly. The residential real estate markets need to hit a bottom (in truth, overshoot said bottom) and show signs of recovery. Once these events occur, buy financials with strong franchises. Until then, the risks of purchasing financial shares outweigh the potential returns.

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