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Enduring the 'Phoney War'

"We believe that overall, the [bank stress] tests will be positive."

- Unnamed banker in London, as reported in the FT.

"The stress test idea is a shambles. The whole thing is a complete joke."

- Unnamed analyst in London, as reported in the FT.

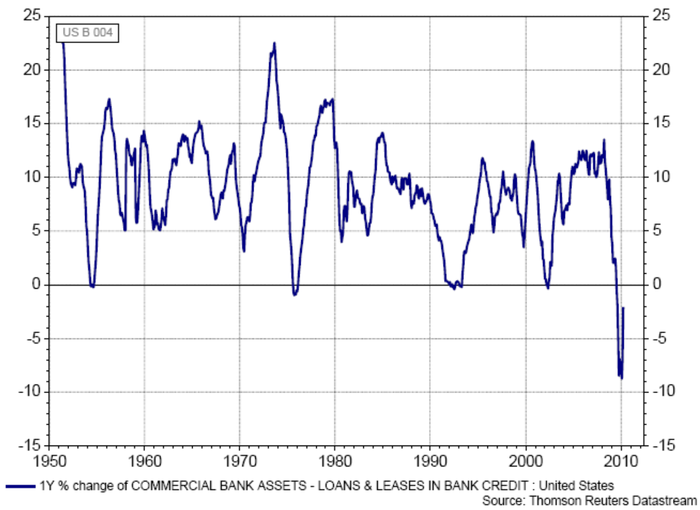
This last week we have been presenting investment seminars across the country. In this note I would like to highlight the presentation given by one of our guest speakers, strategist James Ferguson of Arbuthnot Securities, and a fellow Money Week contributor.

One of the difficulties with investment strategy when the authorities are trying to resolve banking crises is knowing who to trust. Many banks in the industrialised world are insolvent, but the authorities are unlikely to admit the fact since that has the unfortunate tendency of triggering runs on them. So instead we all participate in something akin to a phoney war. The more enlightened – or distrustful – keep at a wary distance from anything approximating to a bank investment, while the more daring – or credulous – flirt uncertainly with a sector still in intensive care.

The pragmatic response, then, is to trust no-one; certainly, to trust no-one from within the banking sector itself (and we include the investment banks also having suckled from the government teat), since the likelihood of getting impartial analysis runs close to zero.

As James points out, an actual contraction in bank lending is unusual in a normal recession; it is a feature of a full-blown banking crisis, as the following chart relating to US banks makes clear:

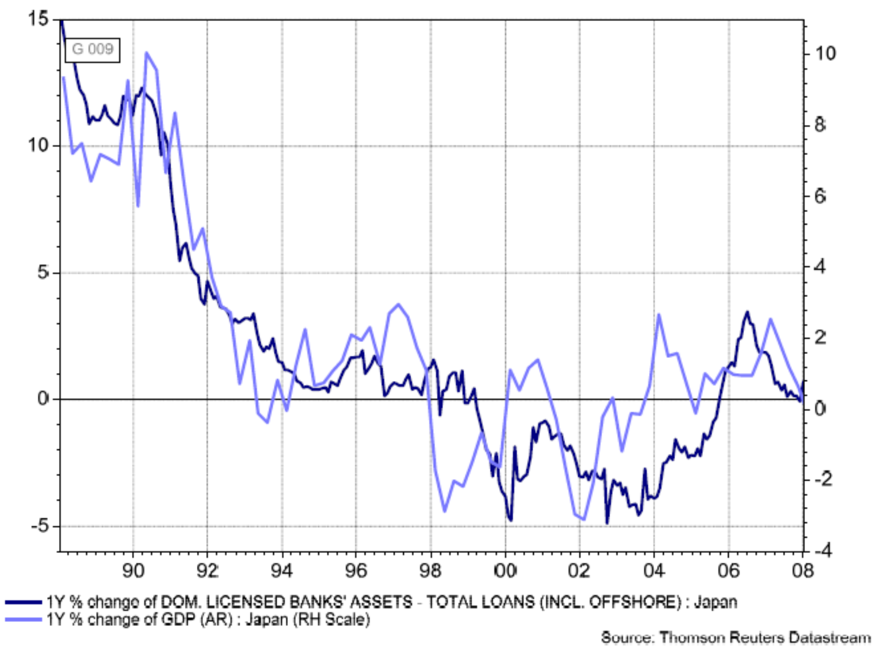
Negative bank loan growth is not normal in a recession – only after a bank crisis



That apparent bounce in bank lending from 2010 is not a recovery, merely an accounting change.

The evidence from post-property bust and banking crisis Japan is not exactly encouraging:

Flat bank lending in Japan over the last 15 years has coincided with roughly zero GDP growth too

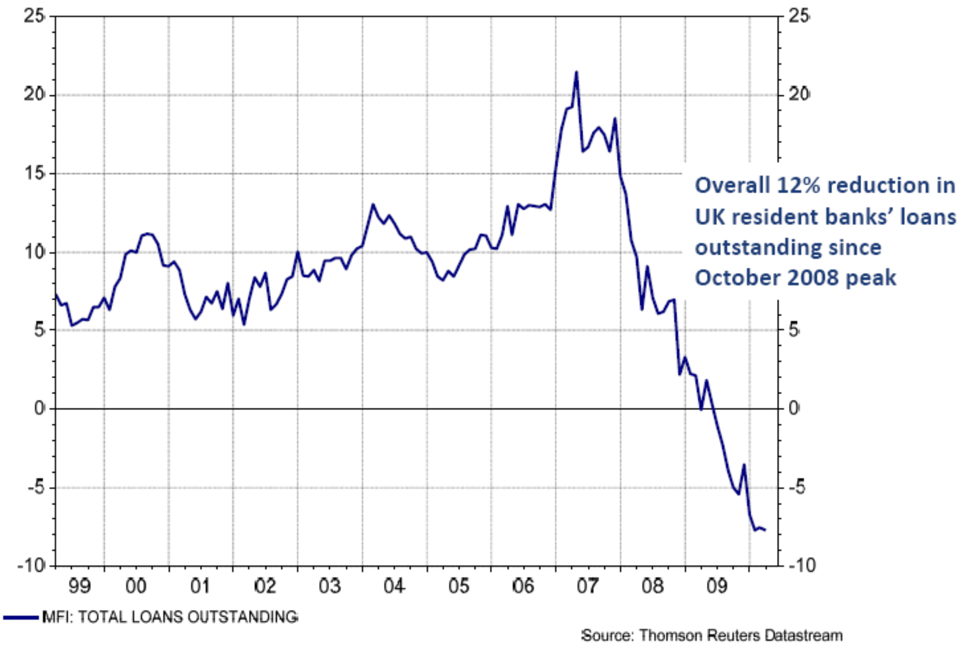


Having suffered from a dysfunctional banking sector for the past 15 years, the Japanese economy has flat-lined. Broken banks make for a broken economy.

But it is not all bad news, as James points out. US banks – helped, admittedly, by an interventionist administration, and how – have been relatively aggressive at reporting loan losses. US bank lending topped $7.3 trillion at its peak in late 2008; non-government securities added another $2.1 trillion to take total risk assets of US banks to $9.4 trillion. Assuming final loan losses of $730 billion (the typical loss rate on loans during previous banking crises has been 10%), and already reported securities losses of $382 billion implies final expected losses of $1.11 trillion. That figure, $1.11 trillion, happens to be almost identical to the April 2009 US Department of Treasury's 'Stress Test' assumptions. Cumulative losses by US banks reported to the end of Q1 2010 total $703 billion. A comparison of $703 billion (cumulative losses to date) versus $1.11 trillion in expected losses implies, ***provided these figures can be trusted***, that US banks may be almost two-thirds of the way through resolving this crisis. We can at least hope.

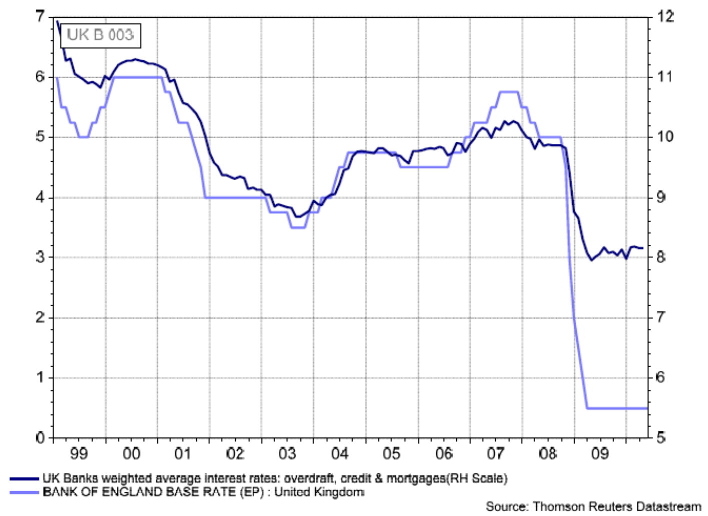
So much for the US. Here in the UK, we are some way behind. Growth in UK bank lending has also turned negative:

UK bank loan growth has also turned negative…



This in large part because real world borrowing costs are not as low as the base rate would suggest:

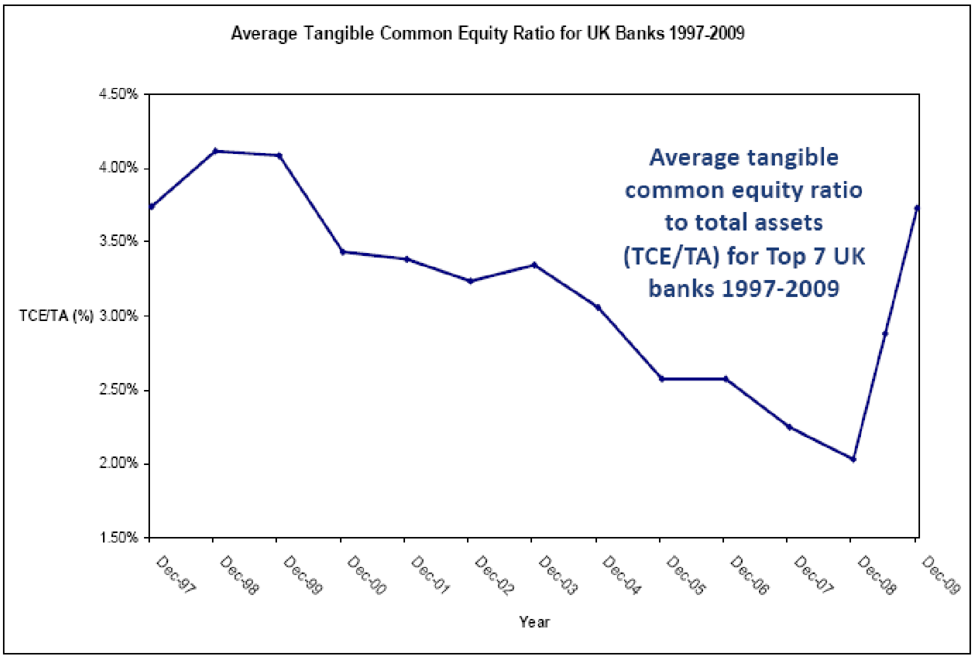
…not least because in the wider economy, actual borrowing costs haven't gone down much



James suggests that given the pace of UK bank loss workouts, their earliest return to growth would come towards 2013. UK banks' peak loan and securitised loan assets at the end of 2008 totalled some £3.9 trillion. In "typical" historic bank crises, non-performing loans reach 25% and loan losses after recoveries total around 10%. Expected UK bank losses therefore total roughly £390 billion. Realised gross losses to the end of December come to £180 billion (i.e. we're not even half way there yet). Expected losses are still to realise a total of roughly £210 billion. The run rate in annualised gross retained earnings since July 2007 has been £69 billion. UK banks will achieve full loss realisation at this continued rate of profit generation in around January 2013, still some two-and-a-half years away.

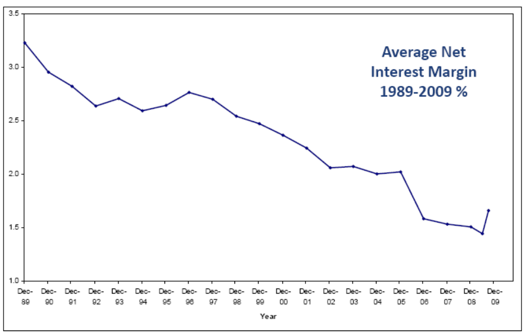
Again, there are some reasons to be cheerful:

The good news: £72.3bn in capital raisings during 2009 & survivor bias have combined to recapitalise the sector

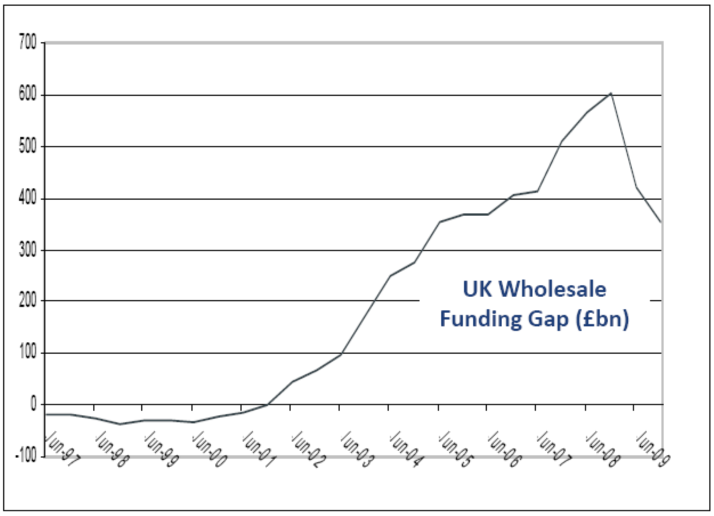


But equally, some off-setting bad news:

The bad news (1): UK banks' average Net Interest Margins aren't recovering nearly as fast as is widely believed

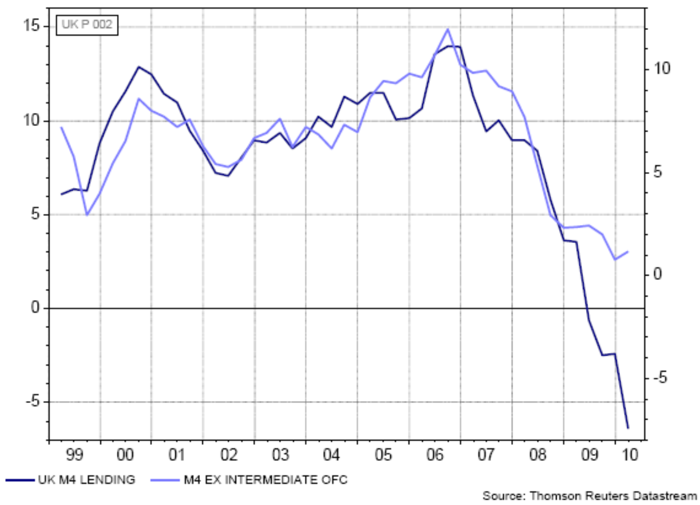


The bad news (2): Top 6 major UK banks' wholesale funding gap is still £350bn, or 25% of GDP



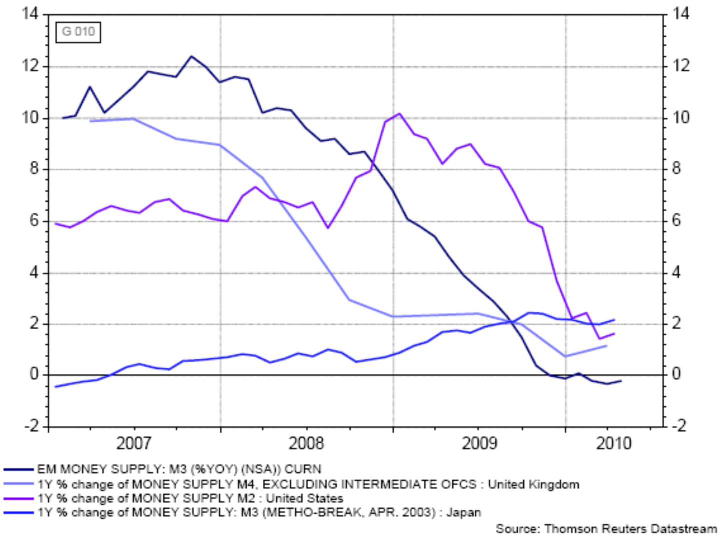
And one of James' most striking charts shows the effects of "failed" Quantitative Easing:

The dog that didn't bark: in the absence of QE, UK M4 (ex-sec & intermediate OFCs) would now be -7%



Although we have no strict counter-factual, there is reason to believe that without QE, UK broad money would now be shrinking at a rate of 7%. And this trend in collapsing broad money growth is not restricted to the UK; rather, it's an international problem:

Money printing has failed: First World broad money growth is now either negative, or soon will be…



All of which points to profound deflationary pressure in the months to come. The implication for equity investments in particular is not positive.

Among James' conclusions:

- Expect QE to re-emerge before year-end / early 2011
- As banks continue to rebuild their balance sheets, Gilts will be underpinned
- Favour income strategies (Gilts, bonds, high yield stocks) over growth
- Favour FTSE 100 stocks over FTSE 250 stocks (given Sterling hedging from international exposure and lower operational gearing)
- Favour safe, boring defensives over deep cyclicals
- **Remain underweight the banks** (we would still suggest avoiding them entirely). Multi-year balance sheet repair means that any dividend payments will be token at best; banks face an extended period of rolling loss realisation and banks still need to raise significant capital, leaving current shareholders facing the potential for further dilution.

Speaking of phoney wars, the original 'Phoney War' started in September 1939, when Britain declared war on Germany shortly after the German invasion of Poland. In the absence of fighting, people were minded to believe that the actual situation more closely resembled peace. Then in April 1940, the people of Europe were shaken from their complacency when Nazi forces attacked Denmark and Norway. The Euro zone banking stress tests are set to be published at the end of this month. Whether or not we believe them, many of Europe's banks are in even worse shape than those of the US (likely to be the first developed economy out of the crisis), or the UK (lagging the US by some margin). Either way, the phoney war looks set to be hotting up.

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