Financial Stocks Follow The Money

The financial services industry has a terrific business model. So long as we don't bomb ourselves back to the Stone Age, money will not become obsolete. Each and every one of us is a borrower or a lender, sometimes simultaneously at different maturities, and we always are either paying or getting paid for goods and services. The disappearance of the financial services sector might not be as dramatic as the recent power blackouts, but the effects would be at least as damaging.

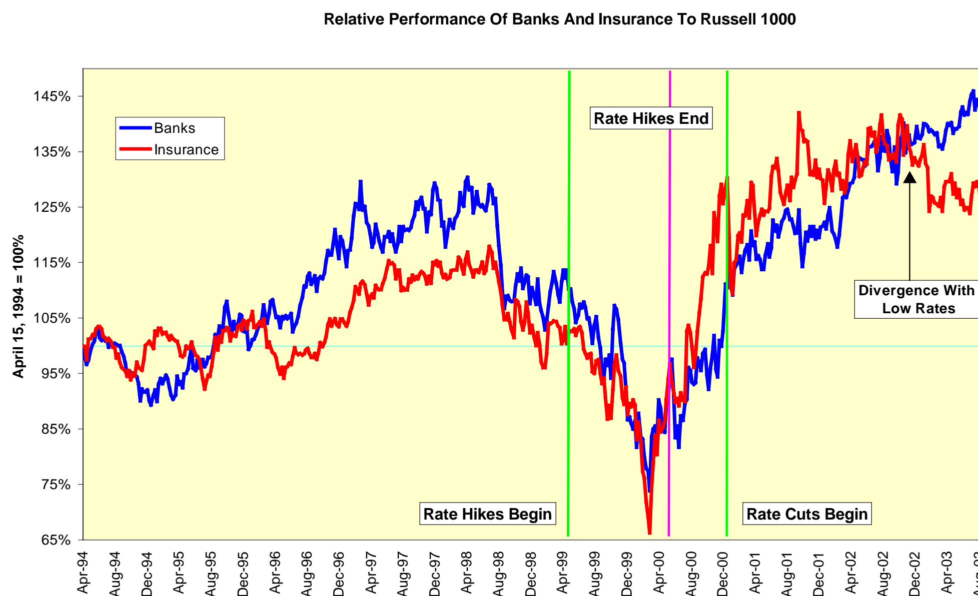
But solid businesses do not necessarily produce strong performing stocks, as witnessed by the energy sector or by food processors. We need to heat and we need to eat, but it is the Nasdaq Composite, which still has a negative P/E ratio, which is up close to 40% on the year.

Banks, insurance companies and securities broker/dealers all have low margin core businesses whose principal barriers to entry are high regulatory costs. This both creates an incentive for consolidation - how many bank and Wall Street mergers can you recall in your lifetime? - and for the assumption of additional risk. All of these firms push the envelope with a well-founded certainty they are too big to fail.

This implied put option and other factors discussed below have allowed the financial stocks to outperform the Russell 1000 (RIY) over the past decade. However, macroeconomic factors argue against a continuation of this trend for much longer.

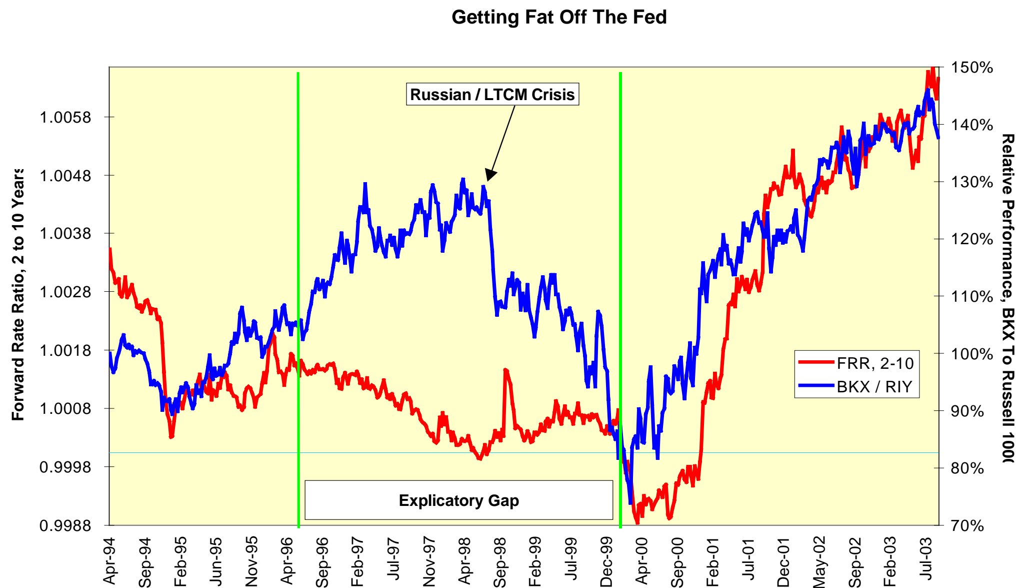
Borrow Low, Lend High

All else held equal, we should expect banks and insurance firms to benefit from a loose monetary policy and the resulting positively sloped yield curve. These stocks also should be hurt by higher short-term interest rates and by financial crises. If we compare the Keefe, Bruyette & Woods bank stock (BKX) and S&P insurance (S5INSU) indices' performance relative to the broad Russell 1000 index, we can see a massive drop in their relative performance from the summer of 1998 to the start of 2001. The underperformance accelerated when the Fed started to raise the overnight funds rate in May 1999, and reversed as the rate hikes stopped and turned into a series of rate cuts.



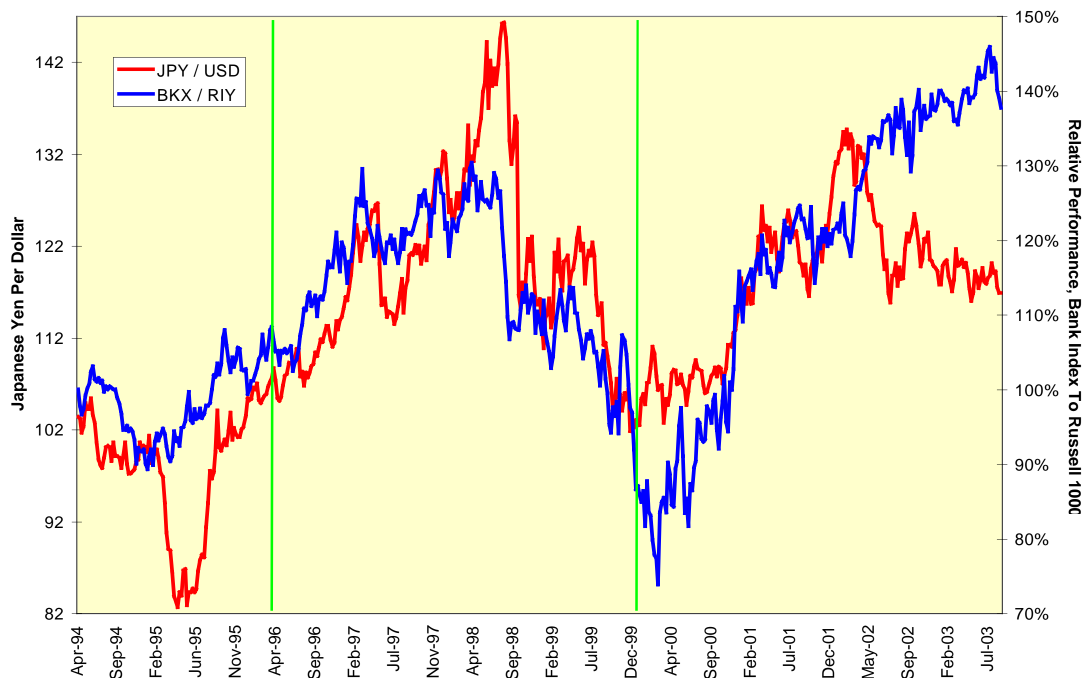
The insurance sector has been far weaker in 2003 than has the banking sector. Insurers have large commercial mortgage holdings and other portfolio investments that have been hurt by the drop in bond yields. All insurance companies have to match income to actuarial obligations on their policies, and this task was made quite difficult by the drop in corporate bond yields and the refinancing of mortgages. This same phenomenon has caused problems for defined-benefit pensions; on an individual scale, the Fed's rate cuts have wreaked havoc on retirees and others seeking safe portfolios.

The BKX' relative performance has tended to lead changes in the shape of the yield curve since the Russian default and Long Term Capital Management crisis of 1998. The shape of the yield curve is defined here as ratio of the forward rate between two and ten years, the rate at which you can borrow money for eight years starting two years from now, to the ten-year rate itself. While the relative performance of the BKX has tracked this forward rate ratio closely for the past three years and between early 1994 and early 1996, a big gap in the correlation exists between April 1996 and January 2000.



The Yen Carry Trade

There is more to market analysis than just blaming the Fed for everything. Sometimes you can blame other central banks. The Bank of Japan and indeed the entire Japanese government reacted fearfully to the massive revaluation of the yen during the first two years of the Clinton administration; Treasury Secretary Bentsen had gone on record as favoring a weak dollar and a strong yen. The revaluation threatened the Japanese economy - sound familiar? - and was met by a drive toward 0% in Japanese interest rates.

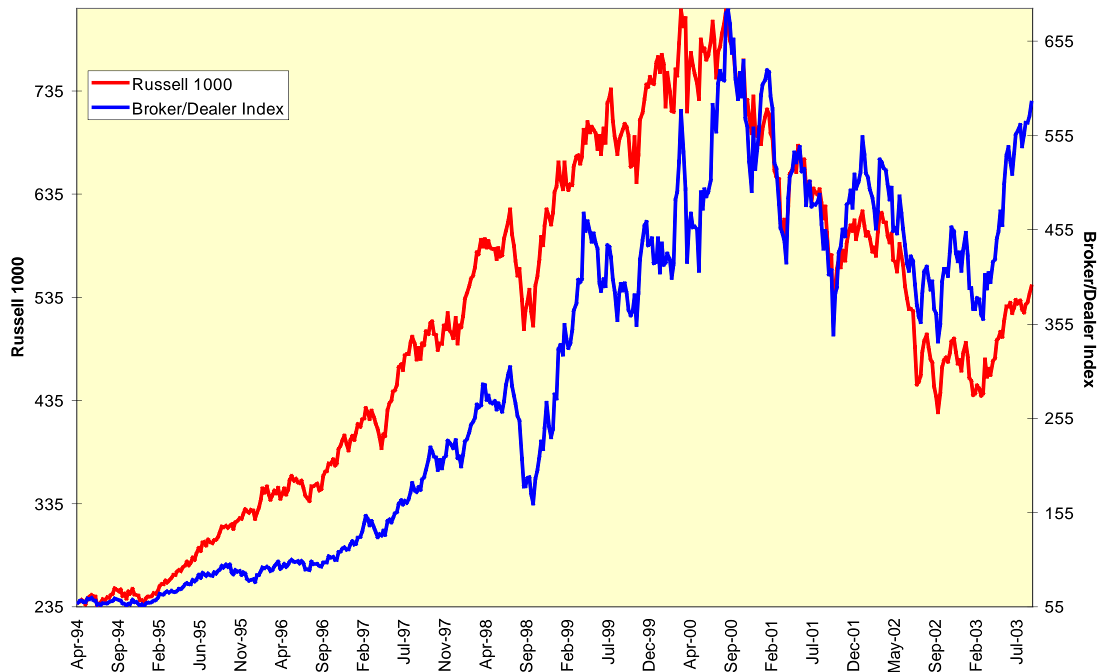


The weakening of the yen and the low interest rates in Japan provided an immense source of liquidity to the global financial system, and the movement in the relative performance of the BKX over the 1996-2000 period appears to correspond nicely to the yen's movements. Simply put, banks love free money and they do not care all that much who the source is.

For now, all central banks are still highly accommodative, and everyone wants to keep their currency weak, a situation that cannot persist indefinitely. The yield curve is already starting to flatten by short rates rising, which will reduce banks' and insurers' portfolio carry. In short, the good news is largely in the past for this group.

Brokers Beat The Game

While banks and insurers have to surf currencies, yield curves and esoterica such as commercial mortgage-backed securities, the other major segment of the financial industry, broker/dealers, here represented by the Amex' index (XBD), seems affected negatively only by the movements of the stock market.



The XBD rose sharply throughout the late 1990s bubble, pausing only for the Russian crisis, and continued higher all the way to the August 2000 broad market peak. It then matched the RIY down to what now appears to be the bear market nadir in October 2002. Its rebound since then has outpaced that of the RIY, 75.8% to 29.3%. Brokerages are trading like tech stocks.

Is this a bullish note, or simply a resigned recognition that whether investors win or lose, the middlemen take their cut? The strength of the XBD so far has left it overextended and probably reliant on underwriting revenues that could disappear rapidly at the first sign of market weakness. It seems a very fragile time to buy brokerage stocks as well.