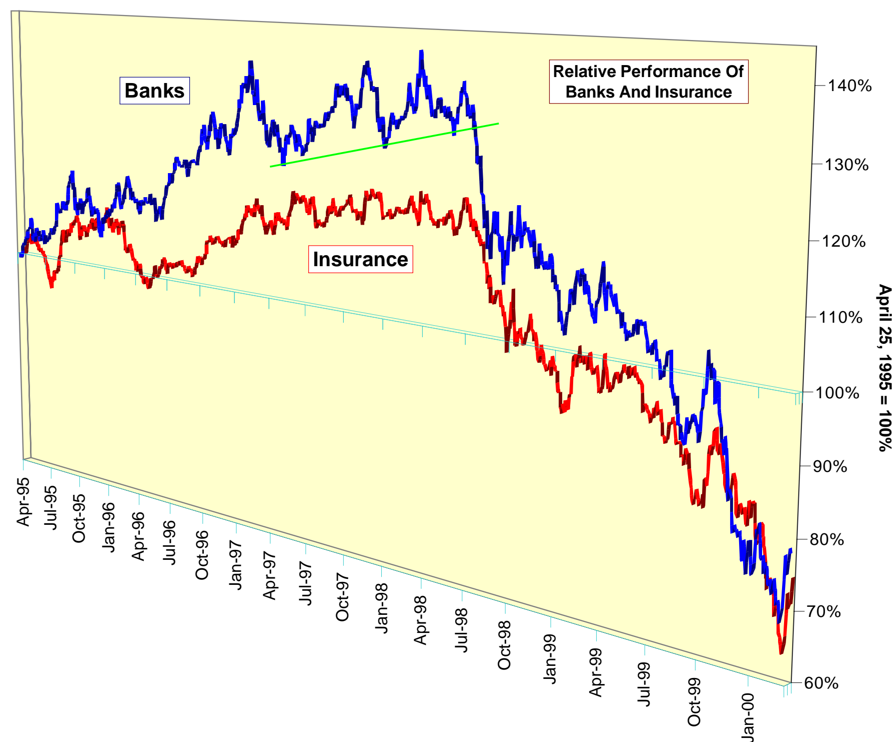
Romance Without Finance Ain't Got A Chance

Who loves ya, baby? If you're a bank or an insurance company, this question might prompt an embarrassing silence. No other segment of the modern economy has been viewed so consistently with suspicion by demagogues of both left and right.

But they were always good businesses to own, no? They had nice operating margins, heavy government regulation of their industry to keep out those pesky competitors, and two product lines absolutely guaranteed to be around forever, management of money and risk. Just as every two-bit celebrity has to buy a restaurant to confirm his status, every would-be mogul gets involved in the money game sooner or later.

During the early phases of the bull market breakout beginning in 1995, financial stocks, banks in particular, were standout performers, as seen below in the graph comparing the S&P bank and insurance indices to the S&P 500. Much of this had to do with a wave of mergers and consolidations in the industry as Depression-era restrictions on interstate banking fell. In addition, banks benefited enormously from lower inflation and interest rates, and from the Bank of Japan's manic creation of liquidity.



Moral Hazard

The relative outperformance of bank stocks ended so precipitously in the summer of 1998 we can draw a trend line to describe the event. The combination of the Russian debt default and the Long Term Capital Management fiasco led to an almost-daily parade of global banks confessing to an array of sins best described as greed combined with a complete lack of common sense. The management of financial risk, the raison d'être of the entire industry, was by definition poor.

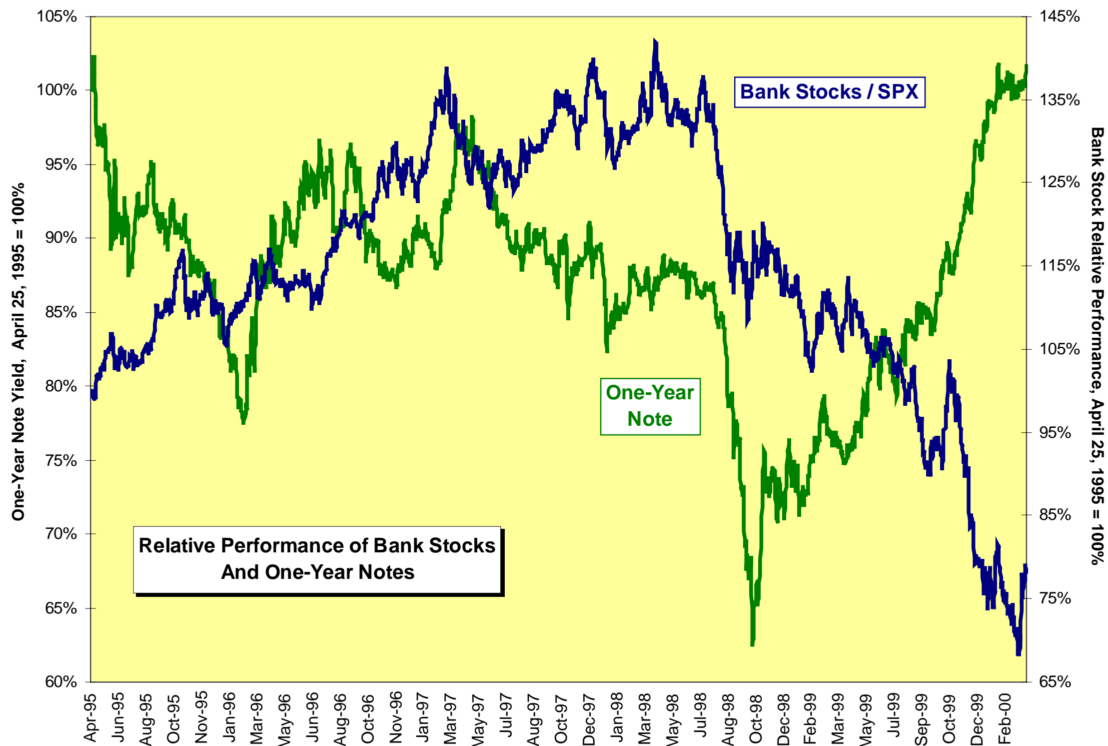
Public financial institutions, led by the Federal Reserve, other central banks, and the International Monetary Fund (IMF) did everything they could to inject liquidity back into the banking system; the Fed explicitly justified its third rate cut in November 1998 by citing wide credit spreads between corporate bonds and Treasuries. Lower short-term interest rates are supposed to be a tonic for banks, but their relative

performance continued to slip in early 1999. By the time the Fed embarked on its series of rate hikes in June 1999, the sector was doomed.

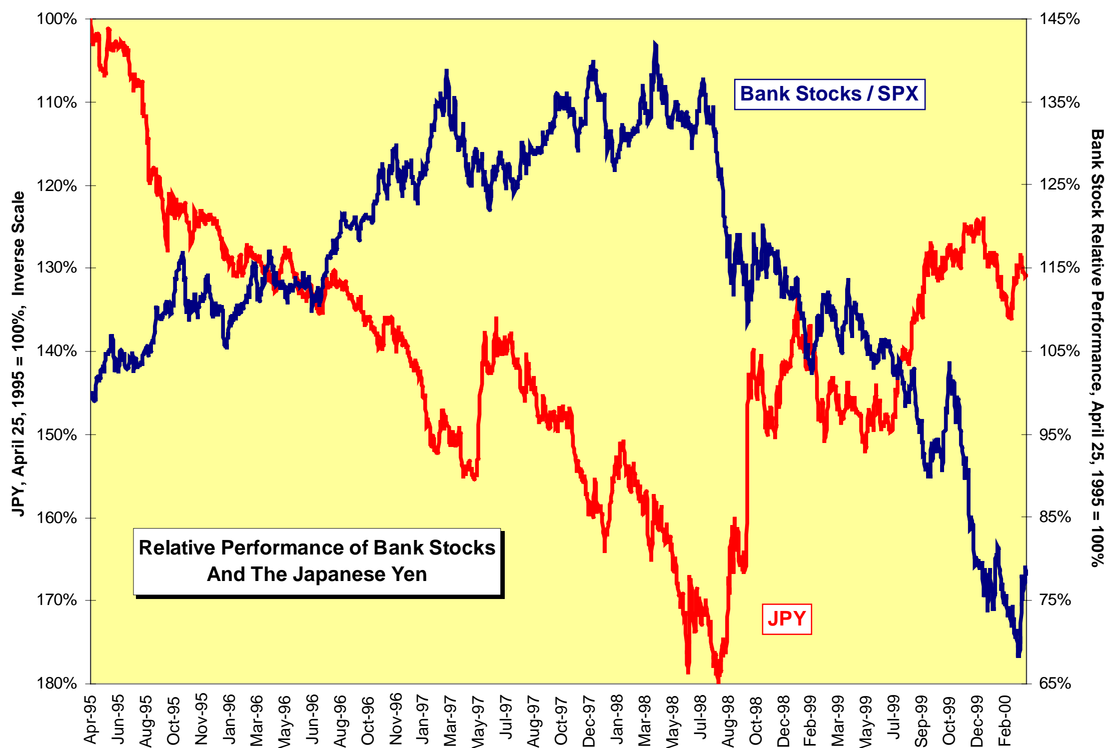
Investors have been a very forgiving lot in recent years as money remains in search of homes that make sense. We have gobbled up firms whose business plans might have embarrassed Charles Ponzi. We have bid valuations to historically unprecedented levels. The financial services sector is an exception. These stocks have been assigned a risk premium and lower multiples. After all, the banking industry's unblemished record since 1974 of taking on excess risk and then running to the IMF for a taxpayer-funded bailout will get us in trouble, big trouble, one day.

One More Chance?

Should we follow the lead of country music heroines and First Ladies and forgive the wayward bankers? Not just yet: First, we have to recall why these stocks were so attractive just a few years ago. Cheap credit, like cheap booze, has a way of making things look better until normal judgment returns. We should expect to see an inverse relationship between the relative performance of bank stocks and short-term interest rates, and we do. While these rates were stable or falling going into the summer of 1998, bank stocks outperformed the S&P 500. These rates were driven lower in response to the banks' losses, and once domestic credit conditions started to tighten, bank stocks underperformed as expected.



Credit is a global, and not just a domestic, phenomenon. The Bank of Japan has been flooding its domestic market with cheap credit for years in a vain attempt to revive the Japanese economy (see "Yen-Dollar Appreciations Aren't Always What They Seem," November 14, 1999). The unwillingness of the BOJ to drive interest rates below zero combined with Japan's persistent trade surpluses with the U.S. has led to a renewed strengthening of the yen. The yen's course, even more than Fed policy, explains the relative performance of bank stocks.



Banks, deprived of low cost money on both sides of the Pacific and forced away from previously profitable lending to emerging markets, have struggled. Management in any industry should earn its keep during tough times; any slob can win a poker hand when dealt a royal flush, and any bank can make money with a low cost of funds. Neither should be confused with talent.

Irrational Petulance

Our friends at the Fed have all but declared war on the NASDAQ, which is an interesting decision for these non-elected servants of the people. They have been notably unsuccessful in slaying the high-tech dragon with higher interest rates, (see "The Energizer NASDAQ," February 9, 2000) but they have succeeded in clobbering the banking sector, the one segment of the economy directly under their purview.

The issue of whether it is wise to concentrate such power into an institution armed only with the blunt instrument of monetary policy cannot be addressed in this space. One suspects, however, when the final history of this great bull market is written, the topic will get fuller attention.