The Yield Curve And Financial Stocks

Let's say just for the sake of argument you woke up one day and found yourself transformed, Kafka-like, not into a giant cockroach but rather a giant bank. How would you get on with your life at this point? Food will not be high on your list of necessities, but funds would be. You would hang out a shingle and offer the public a safe place to keep their money, pass on the benefits of federal deposit insurance in the form of lower interest paid thereon and then look for someone willing to pay you a higher rate on longer-term loans you would make.

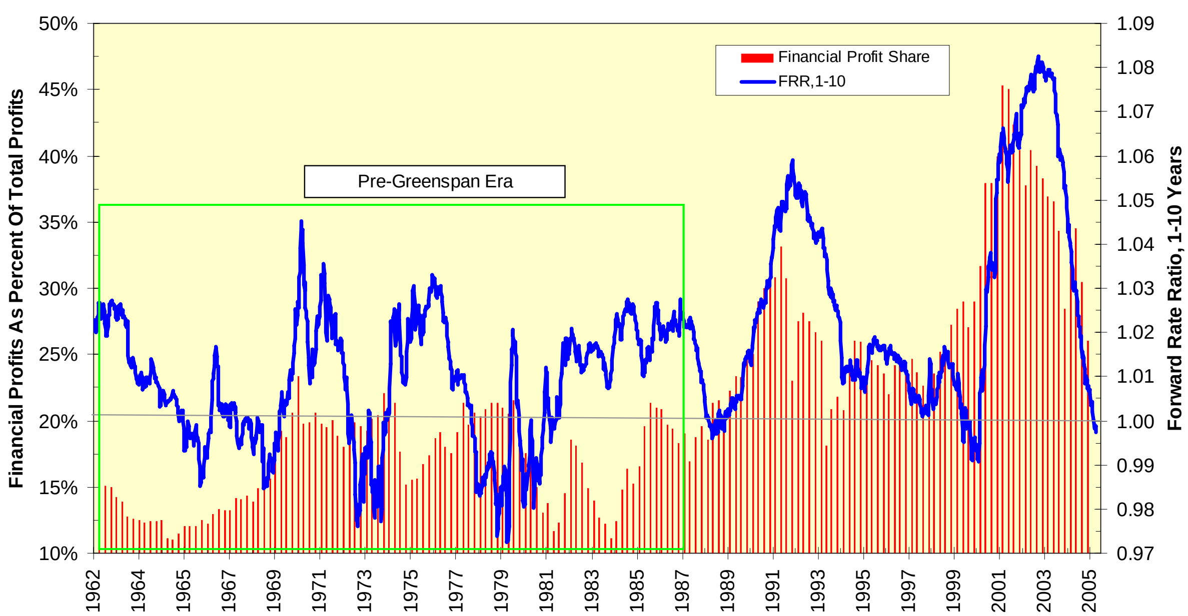
This is the basic banking business model: Borrow short and lend long. So long as the yield curve is positively sloped, with short-term interest rates lower than long-term interest rates, life can be good. But this environment does not present itself all the time. Let's drill down into the world of financial firms and the world they live in to find the winning investment formula.

This business model applies in one form or another to many classes of financial firms. Trading firms, investment banks and securities dealers finance their inventories with short-term money. But this is not to say all financial firms' profits are determined by the yield curve. Fee-based income, trading income, premium income, asset-based fees and services all account for an increasing percentage of this sector's health. All of these combine to make the financial sector a worthy target of your investment dollars.

The Profit Connection

And this is a good thing, too, for otherwise the well-being of this important sector of the U.S. economy could be jerked about on a whim by the Federal Reserve. We can compare the percentage of total U.S. corporate profits accounted for by firms in the financial sector and map them against the yield curve as measured by the forward rate ratio between one and ten years. This number is the rate at which you can lock in borrowing for nine years beginning one year from now, divided by the ten-year rate itself. The more the forward rate ratio exceeds 1.00, the steeper the yield curve; numbers less than 1.00 indicate inversion.

Chart 1: Financial Profits And The Yield Curve



Please note in Chart 1 how much the correlation between the financial sector's claim on total U.S. corporate profits and the yield curve changes after 1988. The level of financial profits changed too; prior to this date the financial sector accounted for a much lower percentage of total corporate profits – an average of 15.2% from 1948-1987 versus a post-1987 average of 28.1%.

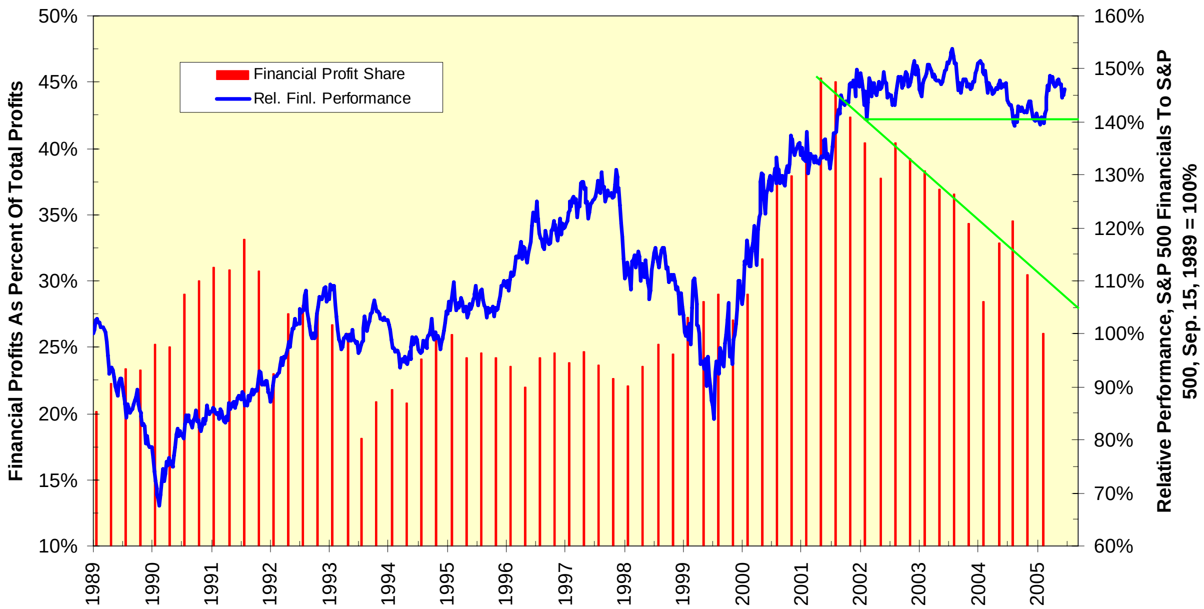
That the series break at the end of 1987 is no accident; the changes coincide with the beginning of Alan Greenspan's long tenure as chairman of the Federal Reserve. Many have commented on Greenspan's risk-management approach to monetary policy and his strong and apparent efforts to defuse financial crises before they could spread elsewhere in the economy. Whether he intended to increase the financial sector's profitability via rate cuts we cannot say. All we can do is observe how the two major rate-cutting/yield curve-steepening episodes of his tenure, those between 1989 and 1992 and again between 2001 and 2003 were accompanied by an increased share of American corporate profits being claimed by the financial sector.

The opposite is not true during the yield curve-flattening episodes. Here we see the financials' profit-share decline prior to the flattening of the yield curve; once again this is more apparent in the total profits chart. If lower rates and a steeper yield curve led to improved profitability elsewhere in the economy, the Federal Reserve might have taken it as an all-clear signal for the economy and removed monetary stimulus in response.

Financial Stocks

Now let's bring financial stocks into the picture on an aggregated basis. Incredibly, we do not have long-dated consistent histories of Standard & Poor's sector data. Their financial sector index begins in September 1989. Many of the groups comprising this index have no history prior to May 2003. We have to play the cards we are dealt. Chart 2 depicts total financial profits as a percentage of all U.S. corporate profits mapped against the relative performance of the S&P 500 Financial index to the S&P 500 index.

Chart 2: Financial Profits And Financial Stocks

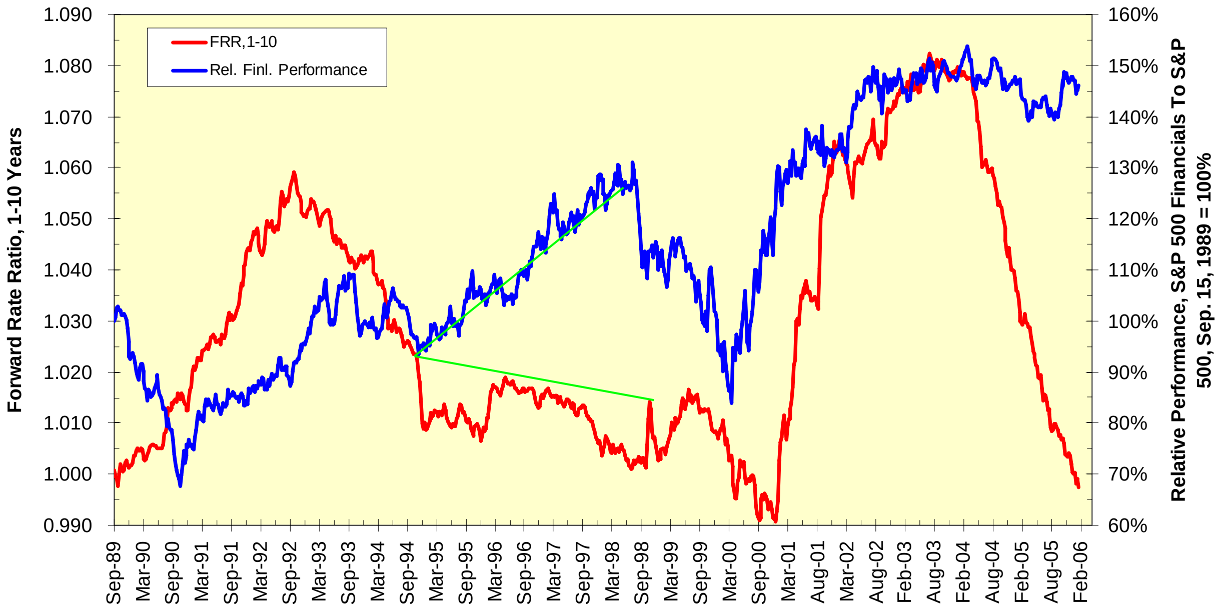


The financial stocks increased their relative performance to the broad market from 1990 until the Long Term Capital Management debacle of 1998 even though their share of total U.S. corporate profits declined during this period. Investors were willing to reward financial firms with higher multiples in the belief their earnings were low-risk. While that belief was proved mistaken, a second belief that financial firms' costs of production were low and declining proved correct. Not only is financial engineering well-paid indoors work, advances in information management allowed for vastly improved operating efficiencies.

The bursting of the stock market bubble and low profitability in many sectors of the economy between 2000 and 2002 allowed relative financial profits and relative financial stock performance to increase apace. The lower costs of funding enabled by the Federal Reserve can be credited for these developments. But after 2002, something interesting occurs as highlighted by the green lines. Financial firms' profits as a percentage of overall U.S. profits declined steadily while the relative performance of financial stocks remained fairly steady.

The relationship depicted in Chart 3 between the relative performance of the financial sector and the yield curve not only confirms the observation made above that financial stocks' performance has exceeded expectations post-2002, but it reveals how the financial sector disconnected from a flattening yield curve between 1995 and the LTCM debacle of 1998.

Chart 3: The Yield Curve And Financial Stocks



We are left with two perplexing observations; first, that relative profitability does not affect relative stock market performance, and second that relative financial stock market performance appears immune to a more hostile monetary environment.

The Devil Is In The Details

Just as stock market pundits who find clichés more reliable than original research are fond of saying, "It's a market of stocks, not a stock market," we need to go beneath the aggregate S&P 500 financial sector and into the more specialized groups composing this index to explain what we have seen. Standard & Poor's has twelve financial industry groups under its financial sector umbrella. They are:

Insurance Brokerage	Multiline Insurance	Life & Health Ins.	Property & Casualty Ins.
AON	AIG	Aflac	ACE
Marsh & McLennan	Genworth	Jefferson-Pilot	Allstate
	Hartford Financial	Lincoln National	AMBAC Financial
	Loews	Metlife	Chubb
		Principal Financial	Cincinnati Financial
		Torchmark	MBIA
		UnumProvident	Progressive
			Safeco
			St. Paul Travelers
			XL Capital

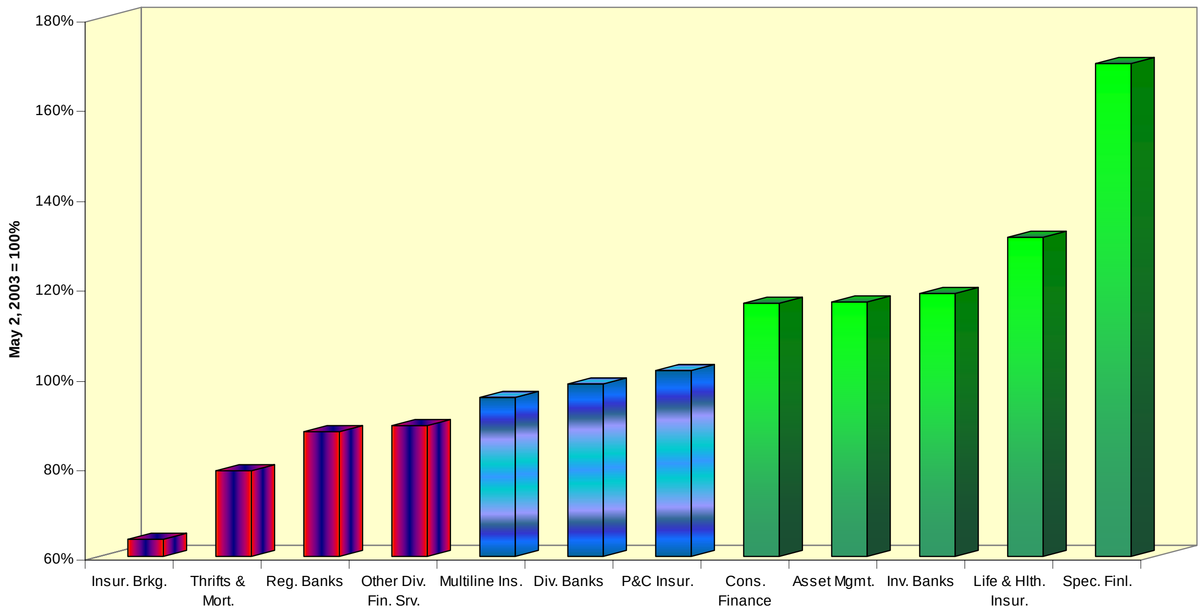
Diversified Banks	Regional Banks	Other Div. Fin'l Services	Thrifts & Mortgages
Bank of America	AmSouth	Citigroup	Countrywide
Comerica	BB&T	JP Morgan Chase	Fannie Mae
US Bancorp	Compass Banchshares		Freddie Mac
Wachovia	Fifth Third		Golden West
Wells Fargo	First Horizon		MGIC Investment
	Huntington Bancshares		Sovereign Bancorp
	Keycorp		Washington Mutual
	M&T Bank		
	Marshall & Ilsley		
	National City		
	North Fork		
	PNC Financial		
	Regions Financial		
	SunTrust		
	Synovus		
	Zions		

Specialized Finance	Asset Management	Investment Banks	Consumer Finance
Moody's	Ameriprise	Bear Stearns	American Express
CIT Financial	Bank of New York	Charles Schwab	Capital One
	Federated Investors	E*Trade	SLM Corp
	Franklin Resources	Goldman Sachs	
	Janus Capital	Lehman Brothers	
	Mellon Financial	Merrill Lynch	
	Northern Trust	Morgan Stanley	
	State Street		
	T. Rowe Price		

Group Performance And The Yield Curve

How have these groups performed relative to the S&P 500 since all became available in May 2003, a date located conveniently close to the beginning of the yield curve's flattening in August 2003? We can divide them into three performance classifications, market underperformers, market performers and market outperformers. The results, depicted in Chart 4, solve our problem.

Chart 4: Relative Performance Of Financial Groups



The worst relative performer, Insurance Brokerage, is a special case; Marsh & McLennan suffered a major regulatory setback in October 2004 related to it Putnam Financial mutual fund group. The remaining three underperforming groups, Thrifts & Mortgages, Regional Banks and Other Diversified Financial Services, are the most yield curve-dependent financial groups. They depend in large part on the classic banking model of borrowing short and lending long and therefore should be squeezed by the flatter yield curve.

The five outperforming groups, Consumer Finance, Asset Management, Investment Banks, Life & Health Insurance and Specialized Finance all have diverged from the yield curve-dependent model. They either have high-margin business such as credit card operations, trading and asset-management business, financial service operations or specialty businesses such as Moody's bond rating unit. Ask yourself whether your health insurance premiums have declined, your credit card rates have shriveled or your mutual fund fees have evaporated since the yield curve began to flatten. The answer should be a resounding, "No."

Several of the greatest investors of our time have stressed the need to find franchise businesses, those whose business models allow for branded products, repeat business and high margins regardless of external circumstances. The market outperformers outlined above certainly appear to meet these criteria. They have allowed the financial sector as an aggregated entity to command an equity market premium despite a falling share of profits and an unfavorable move in the yield curve. What more could you ask for?