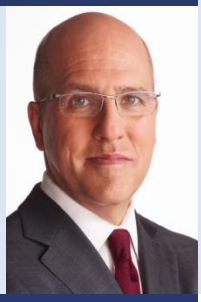

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Investment Commentary

Mood change in Washington to hurt US global bank stocks

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When the troubled asset relief programme was formed in 2008, some thought that a basic assumption underlying the bail-out plan was terribly naive. Washington believed the US's main financial institutions would, on their own initiative, recycle their Tarp funds into the US economy through traditional lending and capital formation.

Washington assumed that in exchange for protecting leading financial institutions from calamity, they would, in turn, act in the US economy's best interests. But rather than lending to small businesses, consumers and domestic companies institutions directed their Tarp funds – and other low-cost financing available from the government at the time – into their more profitable investment banking and trading divisions.

One might surmise that the bail-out funds may have lowered the cost of capital outside the US rather than within it.

Washington recently seemed to have a critical "aha" moment. Tim Geithner, the treasury secretary, said in a television interview that he thought the interests of the US global banks and the interests of the US economy are not always aligned. This, to our reckoning, is the first time in the post-Volcker era that Washington has recognised that global banking and patriotism are not synonymous.

A discussion regarding the merits of banks' interests differing from those of the country as a whole seems to completely miss the point, however. Regardless of banks' global business strategies, Washington's policies must focus solely on lowering the cost of capital within the US and stimulating the domestic economy. Policymakers should only secondarily consider whether regulation enhances or detracts from US banks' franchises abroad.

Global competitiveness is critical, and many US companies have foreign operations, hire workers abroad, and invest and take risks outside the US in order to compete. However, big financial corporations are different, because they have the Fed as a source of cheap funds and the US taxpayer to fall back on. Non-financial companies use the capital markets for their funding, and declare bankruptcy if they take imprudent risks. (Washington's bail-out of the auto companies was a stark exception.)

Given the causes of the recession and the fiscal and monetary policy aftershocks, it now looks as if the US is on the verge of sacrificing its sovereign debt rating largely because of the financial sector's unbridled, and ultimately unwise, risk-taking.

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It is, therefore, highly unlikely that US taxpayers (read: voters) would be willing to insure the financial sector's balance sheets again, especially because those balance sheets' assets and liabilities are increasingly foreign. Bailing out the US financial sector for taking irresponsible risks in the US has been a debatable mission. Bailing out the US financial sector for poor risk-taking outside the US certainly seems a non-starter, and we expect the formation of the associated regulatory restraints.

This backdrop may have significant implications for investors in US global bank stocks. If the US economy does not gain significant momentum soon, Washington is likely to press US global financial institutions to return to their domestic capital-formation roots. Traditional domestic lending businesses are generally slower growing than highly-levered global trading or M&A advising.

Our research suggests that analysts' earnings projections for the US's leading financial institutions may be overly optimistic if we are correct in thinking Washington is increasing its vigilance against global risk-taking. The average consensus long-term earnings growth forecast for the US's global financial firms is 10 per cent. We feel a more realistic long-term growth rate might be about 6-8 per cent a year.

This is significant for valuation, implying that bank stocks should be revalued downward by 10-15 per cent. It is hard to envision the leading financial stocks outperforming for any length of time when secular growth expectations have yet to adjust fully to a post-credit bubble reality.

Investors seem myopic with respect to the important shift that may be under way in financial sector politics. If Washington does begin to recognise that US deposits and capital are being used to foster non-US growth at the expense of US growth, then the outlook seems dim at best for the stocks of the US's global financial institutions.

History shows that stock market leaders during a bubble subsequently suffer an ignominious period of underperformance. Financial stocks were the leaders during the credit bubble, and they have been the worst performers so far this year.

The political environment we foresee suggests that investors should expect continued underperformance over the next several years.

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