

Simon Pryke **Banking Update**

My name is Simon Pryke. I'm one of the bank analysts at Newton, I'm going to be talking about our current views on bank stocks in the light of the recent rally in bank share prices over the last few weeks.

Our fundamental views haven't changed; we remain very cautious about banks in the west. I think a key investment theme for understanding what's going on at the moment is *more government*; we're really seeing politics rather than economics determine how share prices are moving.

Some confidence has returned to markets, as investors are beginning to think that maybe government solutions are the right ones and will bring some longer-term stability to banks and financial stocks.

We think western government policy is wrong; it can be characterised as 'one more push and somehow the system will return to where it was 18 months ago before the crisis'. We're very concerned about the current expansion of the state going on with huge amounts of borrowing to support demand. We think this will be a drag on economies for many years into the future.

There are several factors we should consider as we decide how to invest in bank stocks in this environment. Firstly, how long will the crisis continue. Historical precedent is not encouraging and suggests we should be thinking in terms of years rather than months or quarters.

We've come to the end of an extraordinary period of debt-fuelled consumer excess. We're not going to return to that any time soon. Despite government intervention over the last 18 months, we've seen a huge collapse in consumer and corporate demand, driven really by the huge collapse in the supply of debt.

Whatever government does, this supply of easy credit isn't coming back. What can be termed the 'shadow banking system' (hedge funds, the world of securitisation) has gone, and apparently gone for good; at least for a number of years.

The conventional banking system also remains shy of providing credit. At the same time, consumers and corporates are understandably reluctant to borrow and are much more focused on paying back existing debt. Now, one could debate whether this behavioural change is short-term or long-term, and actually in the short term everyone has become more concerned, given the uncertainty of the crisis, about their current debts.

But we would suggest that there is a longer-term behavioural change going on. Consumers have realised the debt fuelled lifestyle they lived in the past is just not ultimately sustainable. Rather than seeing Asian consumers who have traditionally been savers converge to a western lifestyle, it's entirely possible now that we can see western consumers live a life far more along Asian consumer lines (focused on saving rather than borrowing).

We actually think that the government response to the crisis remains incorrect. Government is still focusing on a liquidity issue rather than a solvency issue. Government is propping up insolvent financial institutions rather than supporting new financial institutions

To support this, we're seeing a massive expansion in the state; we're seeing huge amounts of borrowing which are storing up problems for the future.

So there are a few points that we should consider when we're examining how we invest in this scenario. The first is how long this crisis will continue.

We still think that, in 2009 and 2010, unemployment will continue to rise as the real economy struggles, and we remain pessimistic about the direction of house prices in the US, the UK and elsewhere in the west. This makes a rather depressing backdrop for banks.

When we analyse specific problems that the banks face, I think we can divide them into two categories. There are the historic problems. The historic problems are largely due to bad debts that have been brought up from loans that they've made in the past and really shouldn't have made. These haven't gone away; bad debts will continue to escalate through 2009 and perhaps into 2010 in a whole range of areas. This will be an ongoing problem for bank profitability and a drag on bank capital.

The second category is future problems. What is the future profitability for banks in the west? I think there are real concerns that retail and commercial lending will become far more utility-like as government regulation increases, pushing down possible profitability for banks in this area.

At the same time, regulation will increase in investment banking too. Many areas of investment banking that were highly profitable in the past have just gone away; others will be made (by new capital regulations) really rather unprofitable compared to the past. So we can expect banks to make far lower returns on equity going forward than they have in the past.

Offsetting this to some degree will be banks that are able to take market share from weaker competitors and there are margins on new business. We're already seeing that, for example, in UK mortgages where margins are far better than they've been for many years in the past.

But, broadly, we remain negative. Banks will be far less profitable in the future than they have been in the past, making them less appealing prospects for shareholders.

So, having criticised governments' response so far, what should governments do? So far, governments in the west have supported debt holders by injecting equity capital. We still think that this attitude doesn't make any sense. Debt holders are also providers of risk capital and should be made to share the pain in failing banks.

Rather than focusing injections of capital and support on failing banks, the governments in the west should be focusing their support on new banks. Bad banks should be allowed to fail, rather than continuing in some sort of zombie state which makes it more difficult for the rest of the banking system.

Now we've seen a huge injection of equity capital from western governments, which will allow banks that should have failed to continue going for a number of months, even years, into the future. We still expect this approach to fail. Ultimately, we think equity shareholders in a number of financial institutions will lose their shirts and debt holders will be forced (through debt-equity swaps) to share some of the pain.

Again, referring to historical precedent, looking at banking crises of the past, it's often taken a number of years before the final solution has been implemented that's really resolved the crisis. In all cases that we can find, this has seen equity shareholders in failed institutions largely wiped out, with debt holders often sharing some of the pain, and this is really a vital stage to allow the banking system to get going again and for new banks to start lending to customers in new credit.

While we've been consistently critical of banks in the west over the last two or three years, we have been a lot more positive about the prospects for banks in Asia. We think something of a road block has now come up in 2009; such has been the scale of the slowdown in the west. This has had a real impact on Asian companies. As a result, we expect 2009 to be a year when many Asian banks suffer severe bad debt problems.

Now all the reasons for being positive on Asia, long term, remain. Asian companies and Asian consumers haven't really participated in this kind of credit boom that we've had in the west, Asian bank balance sheets remain in good shape and Asian consumers remain with lots of savings and very low debts.

However, we think the outlook in the medium term for many Asian banks' profitability is rather poor and we've become far more sceptical about owning some of those stocks.

So, to conclude, we think, despite a number of initiatives over the last few months, government in the west still hasn't solved the banking crisis. Despite the rallies we've seen in recent weeks, we expect many bank stocks to revisit their lows and in many cases bank shareholders to be largely wiped out as part of the ultimate restructuring of the western banking system.

We've also become more cautious about Asian banks too.