Our Outlook for Bank Stocks

Despite the European crisis, economic uncertainty, and financial reform, the underlying credit and earning trends for most banks remain positive.

By Michael Kon, CFA, Senior Stock Analyst

- The sovereign debt crisis in Europe is yet to produce attractive buying opportunities. As the crisis unfolds, we keep our eyes open for potential home runs among European banks.

- Despite the crisis in Europe, continuous economic uncertainty, and regulatory reform, the credit and earning trends of most U.S. banks remain positive.

- The discussions regarding regulatory action approach the final innings. We believe that the reform would mostly affect large institutions while smaller players would probably get to keep their business models and earnings power generally intact.

Tell investors that history doesn't repeat itself, and they would probably laugh in your face. The recent events in Europe dreadfully resemble the horror movie investors watched in 2008 after the implosion of the U.S. subprime mortgage market. The characters are different, the location was changed, and the movie is being played with English subtitles. Nevertheless, the plot seems awfully similar.

Just like at the onset of the subprime crisis, the headlines tell the story of troubled borrowers who went on a spending binge while leveraging themselves to the hilt. The bills for this uncontrolled spending are now coming due, and lenders discover that they might not get back what they are owed. Market participants are once again in a race to identify the lenders that hold the hot potatoes and estimate the damage they would cause to banks' balance sheets. Industry pundits have already started to circulate lists of how much capital European banks need to raise in order to survive the crisis du jour.

In times of crisis, markets sometimes fail to discriminate between strong and weak players. Any financial crisis erodes confidence in financial institutions, and without swift and convincing action from policymakers, an ongoing crisis could evolve into panic. Our loyal readers must have noticed that our list of buy recommendations (5-star rated stocks) tends to swell when Mr. Market is panicking, and it shortens when investors are in euphoria. Hence, we are paying close attention to the events in Europe because at some point, Mr. Market might throw out the baby with the bath water, and we want to be there to catch it.

As the quarter unfolded, the crisis in Europe, continuous economic uncertainty, and heated debate over regulatory reform overshadowed the positive credit and earning trends of most U.S. players. The recovery of banks continues. In general, banks that don't rely on capital markets to fund their business and also have little direct exposure to both European banks and governments shouldn't be affected by the drama that takes place overseas provided Europe doesn't drag the rest of the world into a severe recession.

However, large commercial and investment banks with direct or indirect ties to Europe could see earnings come under pressure for several quarters. That said, we don't expect any of the large U.S. banks to run into solvency or liquidity problems as a result of the financial difficulties of Europe's spendthrift nations.

For most CEOs of U.S. banks, Europe remains a vacation destination, not a source of concern. Unfortunately, you cannot say the same about Washington, D.C. In Washington, industry executives and lobbyists are in the final innings of a battle over the financial reform that threatens to alter business models and in some cases impair earnings power. It's difficult to predict the outcome of this battle, but we think the showdown is near.

For now, we believe that in the worst-case scenario, regulatory reform would mostly affect institutions with more than $100 billion in assets. Small multiregional or community banks would probably get to keep their business models and earnings power generally intact.

Industry-Level Insights
The news from Europe combined with negative economic data points caused a bloodbath in the stock market in May. Bank stocks were among the leaders of this sharp correction as the problems in Europe and the regulatory chatter provided new concerns for investors. European banks remain among the cheapest banks that we cover, but we are more comfortable with the margin of safety in U.S. names.

Our Top Bank Picks
As stocks rallied, all of the low-hanging fruit in our coverage universe was picked by quick bargain-hunters. Nevertheless, some firms continue to trade substantially below our fair value estimates as the market remains skeptical about their long-term prospects.

Top Bank Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
Bank of America	★★★★	25.00	Narrow	High	0.62
J.P. Morgan Chase	★★★★	61.00	Narrow	High	0.62
Discover Financial	★★★★	27.00	Narrow	High	0.52
Wells Fargo	★★★★★	41.00	Narrow	Medium	0.70
Capital One Financial	★★★★	70.00	Narrow	High	0.60

Data as of 6-21-10.

We highlight five names that trade above our Consider Buying price, but still significantly below our fair value estimates:

Bank of America BAC
Bank of America's attempts to expand during this crisis have not turned out as well as J.P. Morgan's. The company paid way too much for both Merrill Lynch and Countrywide. However,

with funds from the Troubled Asset Relief Program repaid and consumer loan losses peaking, the future is bright for B of A. It still has one of the largest deposit franchises in the nation and is a low-cost operator in the commoditized retail banking business. The company's bottom line should receive several major boosts as losses peak, and it no longer has to provision more than it is charging off. With most of the bonus-related Merrill Lynch problems in the rearview mirror, management can finally turn its full attention to the bank.

J.P. Morgan Chase JPM

Despite large loan and securities write-downs and a ton of bad publicity, J.P. Morgan has strengthened its franchise throughout this downturn. Acquiring Bear Stearns and Washington Mutual, J.P. Morgan was able to beef up its retail and investment banks for bargain-basement prices. The company will face some challenges ahead, such as the summer implementation of new overdraft rules that are likely to bite into noninterest income and reduced revenues from the already-suffering card business as a result of the Card Act. However, these challenges should be more than offset by improving results from its consumer loan book. With one of the strongest balance sheets in the market, J.P. Morgan is also likely to be one of the first major banks to raise its dividend.

Discover Financial DFS

About a year ago at the peak of the credit crisis, the market doubted Discover could withstand the severe economic headwinds and sent the stock to single-digit territory. Discover has proved the market wrong by posting lower credit costs than peers and maintaining a very liquid balance sheet. The stock rallied since then, but it remains attractive because we believe the market completely ignores the huge potential in Discover's card network.

Wells Fargo WFC

With the acquisition of Wachovia, Wells Fargo is now truly a national bank in terms of footprint and clearly one of the big four players in the U.S. Wells is superb at gathering and holding on to low-cost deposits, which is the most important advantage for any bank as it takes substantial time and discipline to achieve. Wells is also a master at cross-selling products to its clients, which gives better visibility into client credit quality and helps with retention. Relative to what we expect this bank to earn in a normalized environment, the shares look cheap to us.

Capital One Financial COF

Despite sizable losses in its credit card unit, Capital One emerged from the recession with a strong balance sheet and an ample amount of excess capital. Capital One can now focus on growing its businesses by stealing market share from weaker players and can even consider buying a failed bank in an FDIC-assisted transaction. Given its attractive assets, we think Capital One is an enticing acquisition target for a larger financial district.

Michael Kon, CFA, does not own shares in any of the securities mentioned above.