Our Outlook for Bank Stocks

Bank stocks have staged a comeback—
but aren't home free yet.

by Jim Sinegal, Equity Analyst

After plummeting on fears of nationalization in the first quarter, many bank stocks rebounded with a vengeance in the second. The pendulum of emotion momentarily swung from fear back to greed following some positive comments from Citigroup C CEO Vikram Pandit, the results of the "stress tests" conducted by regulators, and a round of successful capital-raising efforts. As a result, the number of banks we rate 5 stars is now much lower, with former recommendations like Wells Fargo WFC and US Bancorp USB more than doubling off their lows.

However, we don't think the industry is out of the woods yet. Barring a miraculous turnaround of the economy, banks undoubtedly face rising loan losses throughout the rest of 2009 and perhaps longer, as commercial real estate continues its slow-motion crash and the recession forces more companies out of business. We think many lower-quality financial companies could still face serious problems in coming months and believe caution should outweigh thoughts of potential profit when it comes to these names.

Valuations by Industry

Our reservations about large portions of the financial sector are evident in the industry valuation data presented in the accompany table. The rally in high-quality stocks resulted in an increase in our price to fair value ratios for some industries, while riskier stocks—like those in the distressed specialty finance industry—still display low prices accompanied by high uncertainty.

Bank Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Brokerages & Exchanges	2.92	1.15	0.80	44	93.2
International Banks	2.90	0.95	0.52	83	96.6
REITs	3.07	0.89	0.62	44	88.6
Specialty Finance	3.39	0.70	0.39	79	85.2
U.S. Money Center Banks	3.03	0.94	0.47	100	97.7
U.S. Regional Banks	3.22	0.78	0.51	53	86.4

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

In the case of specialty finance stocks—seemingly the cheapest stocks in the sector—we believe the future of the business model is still very much in question. The securitization markets that these companies depend on are still essentially frozen, and despite the development of government programs to restart them, we don't expect these firms to see the growth rates and profitability they achieved in the past for quite some time, if ever. For more than a few companies we cover, the survival of the business itself is still uncertain.

On the other hand, we think that fears are still excessive with respect to certain financial stocks, most notably the credit card companies. American Express AXP, Capital One Financial COF, and Discover Financial Services DFS are still trading well below our estimates of fair value. Though often lumped together, we think each of these firms has unique advantages that will allow it to weather the storm of rising credit losses.

Our Top Bank Picks

In addition to the credit card companies, we think there are a few opportunities remaining in smaller regional banks, and we're certainly not ruling out another dip in the market, especially with rising credit losses on the horizon for most companies we cover. We think investors would be wise to keep an eye on high-quality banks like US Bancorp and Wells Fargo in case the market serves up another shot at these stocks.

Top Bank Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Price/ Fair Value
American Express	★★★★★	54.00	Wide	High	0.43
Discover Financial Services	★★★★★	30.00	Narrow	High	0.30
Capital One Financial	★★★★★	70.00	Narrow	Very High	0.30
Valley National Bancorp	★★★★★	18.10	Narrow	Medium	0.60
U.S. Bancorp	★★★★	31.00	Wide	High	0.56

Data as of 06-23-09

American Express AXP operates the most successful closed-loop credit card network in the United States. We think the firm's long-term prospects remain attractive, although a tough economic environment will produce declining revenue and increased credit losses in the short run.

Once inferior to peers', Discover's DFS credit card network is catching up as merchant acceptance levels approach those of Visa V and MasterCard MA. We think the firm will be able to successfully navigate through the current economic recession and earn healthy long-run returns well in excess of its cost of capital.

Thanks to its national scale, strong brand, and ingenious marketing campaign, the Capital One COF brand is one of the most recognized in financial services. In addition, having national scale allows Capital One to extract valuable information on consumer spending trends. Furthermore, Capital One's banking operations are well-managed and efficient, and have a history of solid underwriting—somewhat rare qualities in the financial sector.

Valley National Bancorp VLY is a small Northeastern bank that has experienced nary a losing quarter in its entire history. Though exposed to the New York residential and commercial real estate markets, we think Valley's conservative lending standards and lean operations will help it emerge from the current economic cycle relatively unscathed, much as it did in the early 1990s.

After the recent rally in bank stocks, US Bancorp USB is no longer the bargain it was in mid-March. However, this well-managed, highly profitable business is worth keeping on the radar for the remainder of the year.

Jim Sinegal has a position in the following securities mentioned above: USB AXP