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# Viewpoint

US financial system turnaround bolsters economy
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**Cormac Weldon**
Head of US Equities

**The US banking system is recovering strongly from the sub-prime debt crisis and businesses and consumers are poised to reap the benefits. The new found liquidity of American banks should help to underpin the improving economic outlook, while US equities continue to offer good value. We are finding good stock opportunities - not just among financial institutions but across the market.**

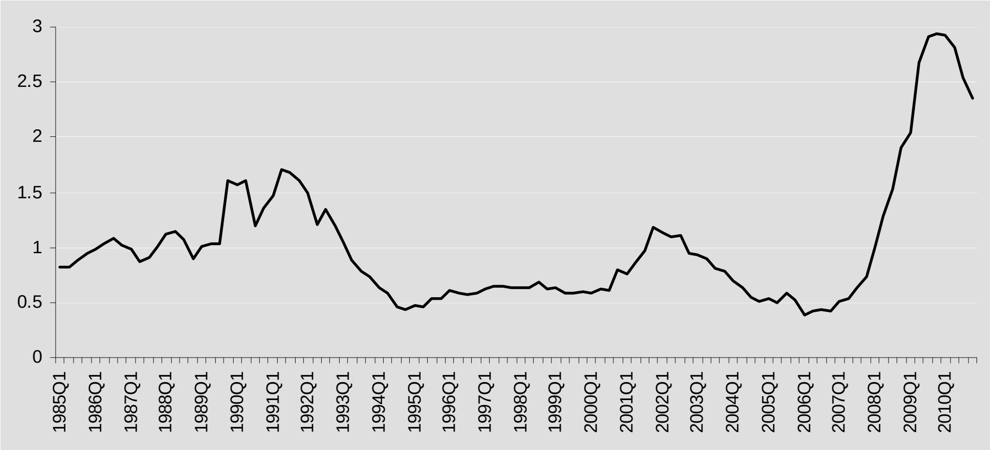
A healthy banking system is crucial to the success of any economy, as the dramatic events of 2008 proved. Following the collapse of Lehman Brothers in September of that year, even the biggest and most robust US businesses found their credit lines drying up, while banks simply stopped lending to each other. With permafrost enveloping the financial network, previously temperate observers began to warn that the US and global economies were teetering on the brink of another 'Great Depression'.

Yet the US banking system has gradually recovered over the past two years or so to the extent that we have recently decided to close our long-standing underweight in financials. The improving economic background in the USA has also encouraged us to make this move - we recently increased our 2011 GDP forecast to 3% from 2%, as capital investment picks up and the labour outlook brightens.

## Banking indicators turn green

Levels of bad debt are a key gauge of the health of any financial system. The bursting of the US housing bubble in 2006 and 2007 left the banks burdened with very high levels of non-performing loans, a factor that contributed to the onset of the global financial crisis. Yet the credit costs related to bad debt peaked in the first quarter of 2010, and have been declining steadily ever since.

**Chart 1: US banks' net charge off ratio**




Source: Federal Reserve/Threadneedle Q1 10 estimate

We are also now seeing signs that lending by the banks – another key pointer to the health of the sector – is picking up. Wells Fargo, the fourth-largest US bank by assets, for example, said in January that quarterly lending had risen for the first time since the financial crisis began. The San Francisco-based institution reported a 21% increase in fourth-quarter earnings. Total lending grew by US$3.6bn to US$757.3bn, while credit supplied to consumers and businesses rose by 20% to US$210bn, compared to the previous three months. Wells Fargo's figures also underlined the improving trend vis-à-vis bad loans. After peaking in the final quarter of 2009, the number of loans deemed uncollectable continued to decline. Non-performing assets fell by 6% in the last three months of 2010.

Furthermore, capital levels in general at US financial institutions have increased markedly, and are now adequate relative to the new Basel III requirements, even though these do not come into effect until the end of this decade. We expect capital levels to continue rising over the next few years to well above the Basel III standards, leaving US banks in a strong position to redeploy capital. These banks are currently benefiting from a surge in deposits and have excess liquidity. As a result, businesses and consumers are finding it much easier to raise funds, a development that will have a significant impact on economic growth.

The improvement in the US banking sector vindicates the Federal government's policies. In early 2009, Washington had imposed stress tests on financial institutions that had forced banks to raise capital, and the economy is now poised to benefit from this process.

**Regulatory issues clarified**

Greater clarity in terms of the regulatory outlook is another reason why we are more optimistic about the US financial sector. Measures to deal with the issues raised by the sub-prime debt crisis have now been implemented, and their effect on financial institutions can be gauged in stock prices. Moreover, for a period of time last year, there was a significant risk that American banks would be forced to buy back hundreds of billions of dollars of mortgages that they had securitised, and which had been sold on to investors. That prospect now seems unlikely, and the amount of securities they will be required to repurchase will be manageable.

**Large banks offer good value**

The sectors that we favour within financial services include the large money centre banks (institutions differentiated by their size, scale and diversified business lines), which not only weathered the crisis but exploited the financial turmoil to make highly advantageous acquisitions. These banks are well placed to win market share from weaker competitors, and are emerging from the sub-prime debacle in robust financial health.

Examples include the aforementioned Wells Fargo and JP Morgan Chase. Wells Fargo acquired Wachovia, then the fourth-largest bank in the USA, at a discounted price after the government forced the latter into a distressed sale. We expect Wells Fargo to receive increasing benefits from the acquisition for many years. Wells Fargo, which is already delivering solid profits, also has the potential to grow earnings significantly in the coming years, yet its stock price is trading at historically cheap multiples. Similarly, JP Morgan Chase, which is well placed to win market share from rivals and grow earnings at a rapid pace, offers very attractive value. It too made astute acquisitions during the financial crisis, such as Bear Stearns and Washington Mutual.

**Opportunities among life insurers**

Life insurance is another area that we favour. Some of these companies, which generally have large capital positions that they can now exploit, also made attractive acquisitions. MetLife, the largest insurer in the USA, is one of our holdings. In 2010, MetLife bought the leading international life-insurance business, Alico, from AIG on very good terms – a deal that has transformed MetLife from a dull US life insurance-focused company to a business with excellent exposure to fast-growing international markets.

Yet we are focused not only on the financial sector. Certainly, while economic growth of between two and three percent may not be high by US historical standards, we are able to find exciting opportunities in a range of sectors, within quality companies that deliver rapid earnings growth and remain attractively valued.

**Summary**

The health of the financial sector is clearly not the sole criterion governing the prospects of US equities. However, the improving fortunes of US financial institutions will play a key role in propelling the economic recovery, and there are other encouraging signs that 2011 should be a good year for investors. The positive economic outlook is clearly one of them. True, the US economy faces significant headwinds in the form of high levels of government and consumer debt, but the corporate sector remains in rude health, with many companies delivering excellent results. In addition, the position of consumers will improve as employment trends strengthen, and faster economic growth boosts tax revenues and leads to lower benefit payments, aiding the government's fiscal position. The fresh round of Quantitative Easing will also benefit stocks, and we believe that the US authorities will be supporting the economy in monetary terms for some time to come.