

Banks and Financials (Oct 12, 2001)

On the fundamentals, most analysts know that a steepening yield curve improves bank operating margins. Normally, that is the case but, as widely touted last year, it was a "New Era", which is not normal. Indeed, conditions continue to be remarkably similar to previous post-bubble years.

In which case, steepening is symptomatic of severely diminishing liquidity. Falling stock, lower grade bond prices, commercial real estate, and industrial commodities reflect declining collateral values as well as earnings with which to service debt.

These circumstances have never been healthy for banking, particularly when they had been participating in the financial mania. For example, an index of N.Y. banks plunged from 370 in September, 1929 to 30.6 in March, 1932. As someone observed in the early 1930s, "The banks provided their clients with everything but the roulette tables".

The BKKX sold off 22% from 918 on August 3 to 713 on September 21 and our proprietary Banking Trading Guide signaled a "sell" on August 6. The bank index has since made a 50% retracement to 816 on October 3 and, after some volatility since September 11, the Guide registered a "sell" on Wednesday.

Our theme through the summer has been that banks and financials would be part of the heavy liquidation expected from mid-September to mid-December and would not provide the safe haven found during last Fall's pressures.

BACKGROUND:

Banks and related financial shares are important as a big and relatively liquid group ideal for trading. In April-May, 1998 we outlined that their vulnerability, native to periods of financial volatility, suggested that they should no longer be considered as long term investments. Great inflations in share prices will always be a financial event and banks, being the conduit of credit, enjoy fabulous participation in the boom and their performance indicates the health of the boom.

Most banks have been volatile due to increasing financial tensions and these quarterly reviews attempt to place this in perspective and lay out the conditions likely to be associated with the next important buying opportunity.

CREDIT MARKETS:

Generally, our model on spreads and the curve has been reliable, particularly in confirming the signals from the Guide.

Spreads were expected to reverse to narrowing around October, 1999. More recently, widening was likely to resume in January of this year. Also with this, the yield curve was likely to accelerate towards inversion.

BANK TRADING GUIDE:

In January/97, we back-tested what we thought would be an important trading indicator on bank shares. It gave a "buy" signal in 1Q91, two months after that horrendous low. Subsequent "buys" have been lagging to coincidental. In 1997, it gave its first, but minor, "sell" two weeks before a minor break in bank indexes (TSE index down 15%) – a test in real time. In 1998, it gave a big "sell" 2 to 3 weeks prior to the high for the year, which was the record high for Toronto and Nasdaq indexes. Our April 1/98 edition noted "Banks, being the conduit of credit, are inevitably vulnerable to a credit contraction forced by declining collateral values in financial and tangible assets."

In order to emphasize the risk, our May 1/98 edition, in noting that credit spread widening could become dislocating in August-September, quipped that "most banks in most countries are a widows and orphans short". Important bank indexes peaked around April 15 – 22 and dropped 30% to 43% in the following five months when a couple of lagging "buy" signals confirmed the next important recovery.

METHOD:

The Bank Trading Guide is a proprietary treatment of a credit spread. Its record, as shown in the attached chart, indicates "buys" at significant lows. Typically, these have been coincidental and the call is backed up by our long-term Boom Indicators, supplemented with Tom Peterson's fundamental and technical assessments.

The outstanding feature has been that, at significant tops, the Guide has been an invaluable leading indicator. An important reversal with a correction signals the next overall move to a possible top and is noted on the chart as "Buy(2)". Then the divergent pattern indicates a "sell" alert some 2 to 4 weeks before the top.

This is ideal for large investors. The critical stage occurs when the Guide breaks below its own rising trend line. Typically, this has been within a week of a significant high on most bank indexes and we call it the "Trader's sell".

The Bank Trading Guide has been back-tested at important stock market highs and lows since 1980. For example, it provided a "buy" in October, 1986 and the advanced "sell" in early August, 1987, with the trading "sell" indicated on August 31.

- The Bank Trading Guide is a proprietary model that provides coincidental "Buys" at significant bottoms. These opportunities are supplemented with fundamental as well as technical backup.
- At important tops, the Guide provides two signals. Typically, the "Investor's Sell" is provided some 2 to 3 weeks before the high. As a leading indicator, it offers institutions time to down weight or the discipline to avoid joining the crowd in creating a top.
- The "Trader's Sell" has been flashed within 5 trading days of the top.
- The model has been reliable in real time since early 1997 and in back-testing to 198

Performance Figures BKX Closing Prices			
Year 1998	Three Trades for 64% gain.	Buy January	29%
		Sell April	35%
		Concluded October	-
Year 1999	Three Trades for 110% gain.	Buy Oct '98	+58%.
		Sell April	+24%.
		Buy October	+28%
Year 2000	Four Trades for 103% gain.	Sell Nov '99	+28%
		Buy March	+37%.
		Sell June	+18%.
		Buy June 26	+20%

The Guide offered an unusually fast "Sell" In August.

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