Philequity Corner (09/19/2011)

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When Titans Fall

Over the past 1 ½ months, global stock markets continued to be volatile as investors remain concerned about the slowing US economy and the unfolding European (EU) sovereign debt crisis. Most global stock indices erased their gains for the year and went negative year-to-date (YTD). The world's biggest banks are at the forefront of this recent market bloodbath as most of them significantly underperformed their benchmark indices, as shown in Table 1. As such, most US and EU banks are trading well below book value and near their 2009 lows. In contrast, Philippine banks have been relatively unscathed from the recent beating that global banking stocks took.

Table 1 - Performance of Global Banks vs. Benchmark Indices

US Banks	YTD	1Y	3Y	5Y
S&P 500	-3%	8%	2%	-8%
Bank of America	-46%	-47%	-73%	-86%
Citigroup	-39%	-26%	-81%	-94%
JP Morgan	-21%	-18%	-10%	-29%
Wells Fargo	-19%	-5%	-20%	-30%
EU Banks	**YTD**	**1Y**	**3Y**	**5Y**
Euro Stoxx 50	-23%	-22%	-30%	-43%
Deutsche Bank	-33%	-40%	-50%	-68%
UBS	-28%	-35%	-30%	-77%
Credit Suisse	-35%	-44%	-39%	-55%
ING	-24%	-28%	-64%	-77%
Societe Generale	-53%	-57%	-69%	-84%
Credit Agricole	-48%	-57%	-61%	-84%
BNP Paribas	-41%	-49%	-52%	-65%
Philippine Banks	**YTD**	**1Y**	**3Y**	**5Y**
PSE Index	2%	8%	69%	76%
BDO	-3%	-6%	46%	50%
BPI	-3%	2%	36%	27%
MBT	-1%	0%	97%	85%

Sources: Bloomberg, Wealth Securities

A Lethargic Recovery

Despite the Fed's quantitative easing series and extensive bailouts of US banks, the US economy delivered a paltry GDP growth figure of 1% for 2Q2011. Along with the EU sovereign debt concerns, the faltering US economic recovery has been discouraging for growth as the 4 biggest US banks have not grown their loan portfolios in the past year, as shown in Table 2.

Table 2 - US Banking Growth for 2Q2011

	Bank of America	Citigroup	JP Morgan	Wells Fargo
Loan-to-Deposit	87.1%	70.8%	65.8%	88.1%
Asset Growth	-4.5%	1.0%	11.6%	2.8%
Loan Growth	-0.8%	-5.1%	-1.4%	-1.9%
Leverage	10.2	11.0	12.3	9.1
Loans-to-Assets	40.0%	31.3%	30.7%	59.7%

Sources: Company Data, Wealth Securities

Ghosts of the Past

Aside from weakening growth prospects, US banks have again been thrust into the spotlight for their role in the 2008 subprime mortgage crisis. The Federal Housing Finance Agency (FHFA) is seeking to recover losses incurred by Fannie Mae and Freddie Mac during the 2008 crisis. These losses were caused by soured mortgage loans that the big US banks originated prior to the crisis. If the housing and banking regulators win this legal battle, the amount of damage to the big US banks may range from $120B to $200B. Losses of this magnitude will put severe pressure on the capital of big US banks and drive most of them to failure and again, in need of bailout money. Further, the implementation of the Dodd-Frank Law and the Volcker Rule may bring about increased regulatory risks as regulators seek to limit bank leverage and proprietary trading activity. These laws aim to prevent a repeat of 2008, where messy bailout packages were needed to save big US banks and financial institutions, as their failure posed significant systemic risks to the economy and the financial markets.

PIIGS Get Slaughtered

Across the Atlantic, governments are trying to muster billions to support ailing countries swamped with debt. At the centerstage of the EU debt problem is Greece (*A Greek Tragedy*, September 12, 2011). As the Greek government struggles to firm up austerity measures to calm its anxious bondholders, the leaders of EU countries continue to debate and disagree on how to provide bailout money to Greece. The risk of contagion to other PIIGS countries (Portugal, Ireland, Italy, Greece, Spain) increases as dysfunctional politics prevent a decisive EU action on the Greek sovereign debt problem.

Divided They Fall

What complicates the EU debt debacle is the fact that EU banks are among the biggest holders of PIIGS sovereign debt and loans. More specifically, the banks of the biggest EU economies – Germany and France – are among those with the biggest PIIGS exposure, as shown in Table 3. This is the main reason why Moody's recently downgraded the credit ratings of Credit Agricole and Societe Generale (2 of the 3 biggest French banks) while putting BNP Paribas (the biggest French bank and the biggest bank in the world) on review for a possible downgrade.

Table 3 - PIIGS Exposure (Sovereign Debt and Loans) and Effect of a 14.5% Drawdown

in billions of dollars	PIIGS Exposure	Total Bank Assets	Total Bank Capital	2010 GDP	14.5% Writedown on PIIGS	% of Total Bank Capital	% of GDP
Portugal	45	769	59	247	7	11.0%	2.7%
Italy	51	5,149	513	2,055	7	1.5%	0.4%
Ireland	32	1,856	149	165	5	3.1%	2.8%
Greece	1	679	63	310	0	0.3%	0.1%
Spain	127	4,797	438	1,370	18	4.2%	1.3%
France	646	10,530	664	2,113	94	14.1%	4.4%
Germany	533	10,646	528	3,306	77	14.6%	2.3%
Belgium	78	1,482	79	381	11	14.4%	3.0%
Netherlands	151	3,109	137	832	22	15.9%	2.6%
UK	347	12,249	1,028	2,250	50	4.9%	2.2%
US	147	12,551	1,554	14,527	21	1.4%	0.1%
Switzerland	56	3,063	191	528	8	4.3%	1.5%
Total	2,215	66,880	5,403	28,084	321	5.9%	1.1%

Sources: BIS, ECB, US Fed, SNB, Bloomberg, Wealth Securities

This table shows how a PIIGS contagion scenario, which may trigger writedowns on the PIIGS exposure of banks, can have detrimental effects to bank capital and the GDP of the 2 biggest and healthiest EU nations. Given this, it seems that the French and German leaders might be confronted with the bitter dilemma of choosing between fully participating in the bailout of ailing EU countries or directly supporting their titanic but vulnerable banks.

Resilient Philippine Banks

Amidst the carnage experienced by global banks, Philippine banks have been resilient and are trading within 15% of recent peaks, with some down only slightly for the year. Our banks would most likely have little or no exposure to EU sovereign debt and loans as Philippine banks focus their lending operations locally and their fixed income trading on Philippine bonds or US Treasuries.

Rising Middle Class is Key

Despite the strong performance of Philippine banks, we see room for further growth as bank lending continues to increase while credit penetration is still relatively low in our country. Bank lending grew 19% year-on-year in July 2011, as it continues to benefit from a strong Philippine economy and buoyant domestic consumption. This is supported by the strong contributions of OFW Remittances and BPO Revenues which contributed 9.4% and 4.5%, respectively, to our country's GDP. The increasing importance of these sectors drives the rise of a middle class that can sustain the growth of our domestic consumption. In our view, local banks would be major beneficiaries of this trend as consumer loans currently account for only ~5.3% of our country's GDP.

Considering these, we think that Philippine banks can withstand economic shocks and financial crises significantly better than their western counterparts. Further, our banks would be in a better position to grow their loan portfolios and earnings if and when the global economic recovery reaccelerates.

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