

Hysteria vs. Reality

Is the Unknown More Important Than the Known?

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Is The American Banking System About to Fail?

Since I am not in the office I do not have the data to support the statements being made here but the supporting information will be provided tomorrow. The dramatic decline in bank stock prices in the past few days and yesterday raises some issues that should be thought about.

First, the spreads in the Credit Default Swap (CDS) market and the prices of bank stocks in the equity markets suggest that the American banking industry is about to collapse. These banks have market capitalizations below the liquidation values of the companies even when the liquidation values are 100% cash. The CDS values suggest that the companies cannot raise funds in the open market again.

If the market valuations are correct, then the American banking industry must be nationalized. This must happen because according to the CDS values and the price to liquidation values these companies simply have no value. Is this correct, however? I personally do not think that it is even remotely true and that hysteria has taken hold of the markets and that reality is being ignored.

Reasons for View that Banks Will Fail

The reasons it is believed that the American banking system is about to collapse falls into four categories:

- Europe's financial system will fail and it will bring down the global financial system.
- The United States is in a recession and the government and the Federal Reserve are incapable of doing anything about it. Thus, employment will slide further and loan losses will increase dramatically.
- Housing prices are about to fall precipitously and this will create a new wave of foreclosures.
- The banking systems assets are overvalued so that no number being produced by the industry is valid and if truth be told there is no equity or liquidity in American banks.

These negative views are being reinforced by the government which is working hard to break the industry:

- The President has stated that banks created the past recession and the high level of unemployment. Yesterday, he reaffirmed his belief that price fixing on banking products is required. He is unremitting in his desire to harm the industry and he has whipped up public sentiment against the industry.
- Congress has passed the Dodd Frank Act and a series of other pieces of legislation targeted to break the banks. Recently Barney Frank (D. MA) expressed his satisfaction that big banks could fail in the United States.
- Banking regulators who keep tightening the rules under which banks operate.

The press is also convinced that the industry will fail and keeps producing reports to support this view. Certainly investors agree and the sale of these stocks and bonds keep occurring at a rapid pace. This concerted view that these companies must fail is thought to be a self-fulfilling prophecy so that companies and individuals will pull their funds out of the banks causing them to collapse.

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Why This View May Be Flawed

Some random thoughts:

- Banks do not fund themselves in either the CDS market or, now, the equity markets. They are funded primarily with deposits and deposits are rising.
- Bank balance sheets are stronger than they have been for decades when viewed from a capital and liquidity standpoint.
- There are a number of government and private auditors looking at these companies daily suggesting that their assets are being valued correctly.
- There are only 5 banks in the United States with meaningful exposure to Europe and these banks believe that they have reduced their risks through hedging over the past 18 months.
- While a recession is a distinct possibility banks have high reserves relative to history suggesting that the impact of the downturn will be less severe than what was experienced in 2008/2009.
- Housing values have been stabilizing in the past three months. Moreover, a house provides its user with a utilitarian value it is not just an investment.
- The vast majority of banks will report up earnings in the third and fourth quarters. The capital markets companies will not report losses.

The American banking industry is not going to fail or be nationalized. These stocks are representing hysteria not reality. They should be bought.

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