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Bank Profits Means Stocks at 15% Discount to S&P 500 (Update1)
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(Adds futures in seventh paragraph.)

By Lynn Thomasson

Jan. 11 (Bloomberg) -- No U.S. industry has faster profit growth than banks and brokers, and no group is more hated by investors.

Analysts say earnings at financial companies rose 120 percent in the fourth quarter, accounting for all of the income increase in the Standard & Poor's 500 Index, and will triple by 2011, climbing four times as fast as the market. Should the estimates prove correct, the shares are trading at a 15 percent discount to the index, data compiled by Bloomberg show.

That's not enough for money managers burned by the 84 percent drop in the stocks from February 2007 through March and more than 160 U.S. bank failures in the past two years.

Financial companies are the least-favored equities, according to a Bank of America Corp. survey of investors with $617 billion in assets that showed 38 percent of 123 money managers are holding fewer shares than are in benchmark indexes.

"The stocks are clearly too cheap," said Mark Giambrone, a fund manager who bought PNC Financial Services Group Inc. and Bank of America stock for USAA Investment Management Co., which oversees about $74 billion in San Antonio. "There may be some bumps in the road ahead, but for the most part those are reflected in the valuations."

So far the analysts have proven right after the S&P 500 Financials Index gained 15 percent in 2009. Now, Jennifer Thompson, whose ratings for New York-based research firm Portales Partners LLC returned 31 percent in the past two years, eight times the gain for all the companies she follows, said PNC and Fifth Third Bancorp are poised to rally.

Most Bullish

Analysts are more bullish on bank stocks in the S&P 500 than any other industry based on their average share-price forecasts, which call for a 14 percent rally, according to data compiled by Bloomberg. That would extend the group's 145 percent rally since March that was spurred by better economic data and government rescues of companies from New York-based Citigroup Inc. to American International Group Inc.

The industry has risen the most of 10 in the S&P 500 during the past 10 months. The benchmark index itself gained 2.7 percent last week and closed at 1,144.98 on Jan. 8. Futures on the gauge added 0.4 percent to 1,146.10 as of 12:56 p.m. in New York.

The S&P 500 Financials Index of 78 banks, brokerages and insurers remains down 60 percent since peaking in February 2007.

The slump is twice the drop of the S&P 500, which has lost 27 percent from its October 2007 record, after the subprime mortgage market collapse caused $1.71 trillion in losses and writedowns for financial firms worldwide and led to the demise of New York-based Lehman Brothers Holdings Inc. and Bear Stearns Cos., data compiled by Bloomberg show.

Need Proof

Investors need more proof before buying banks, said Bob Doll, who helps oversee $3.2 trillion as vice chairman and chief investment officer for global equities at New York-based BlackRock Inc., the world's biggest asset manager. The default rate on commercial mortgages held by U.S. banks more than doubled to 3.4 percent in the third quarter, according to Real Estate Econometrics LLC, a research firm in New York.

"Are all the assets that are classified as performing going to perform?" Doll said in a Jan. 6 interview. "That is the concern. We would wait for some price pullback and have patience before buying."

Goldman Sachs Group Inc. and American Express Co., both based in New York, and 26 other S&P 500 financial firms are scheduled to release earnings by Jan. 22, according to data compiled by Bloomberg. The fourth-quarter reporting season starts today. New York-based Alcoa Inc., the largest U.S.
aluminum maker, is forecast to post profit of 6 cents a share, reversing a loss in the year-earlier period.

Biggest Jump

Analysts are counting on the financial industry to snap nine straight quarters of earnings declines for the S&P 500.
Without financial firms, income for companies in the index may fall 2.8 percent on average. With them, profit is forecast to jump 62 percent, the most in 21 years, data compiled by Bloomberg and S&P show.

Combined profit for banks, brokerages and insurers in the S&P 500 will rise to $19.51 a share in 2011, up threefold from 2009, Bloomberg data show. The companies trade for 10.5 times that forecast, the second-lowest multiple behind energy companies. The S&P 500 is priced at 12.4 times 2011 income, according to the data.

Banks and brokers may also be cheap relative to their assets minus liabilities. The industry is valued at 1.15 times book value, or 43 percent below the past decade's average, Bloomberg data show.

Bank of America is forecast to post the largest gain among the biggest U.S. banks, data compiled by Bloomberg show. Profit may climb to 93 cents a share in 2010 from a 20-cent loss last year, analysts say. It is rated "buy" by 25 of the 32 analysts with ratings on the stock, Bloomberg data show.

Economic Expansion

"What we're looking at is an improvement in the economy that will result in consistent declines in loan losses over the next two or three years, which will result in huge increases in bank earnings," Richard Bove, an analyst at Stamford, Connecticut-based Rochdale Securities LLC, said in a Jan. 7 interview on Bloomberg Radio. He recommends investors purchase Bank of America, based in Charlotte, North Carolina.

Profit at Pittsburgh-based PNC is forecast to climb 44 percent through 2011, giving the shares a price-earnings ratio of 11.9, Bloomberg data show. Cincinnati-based Fifth Third may post profit of 79 cents a share in 2011, reversing a loss of 67 cents last year and giving it an earnings multiple of 14.

“The bank group in general is still trading at a historically cheap level,” said Portales’s Thompson. “There’s the potential for significant price expansion once banks transition from trading on tangible book to projected earnings.”

Fed Stimulus

Financial companies are also benefiting as the Federal Reserve keeps interest rates near zero. The yield curve measuring the difference between 2- and 10-year Treasury yields reached a record 2.88 percentage points last month, allowing banks to profit from the difference.

Net interest margin, the difference between what banks earn from loans and pay to depositors, may widen to 3.54 percent in 2010, the highest level since 2003, according to forecasts for the 173 lenders followed by New York-based KBW Inc.

That may not last, according to Baring Asset Management Inc.’s Hayes Miller, who recommends holding fewer shares of U.S. banks before Fed Chairman Ben S. Bernanke winds down emergency programs to damp concern inflation will accelerate as the economy picks up.

Fed funds futures show a majority of traders are betting the central bank will boost its target rate for overnight loans between banks from the current range of zero to 0.25 percent by its August meeting.

‘More Difficult’

“It’s going to be more difficult to extract profits,” Miller, whose firm oversees $47.5 billion, said in an interview from Boston. “The expectations for banking profitability are predicated on a steeper-sloped yield curve than we think we’re going to have once the Fed begins to exit.”

Financial stocks posted the only declines among 10 industries in the S&P 500 between October and December, data compiled by Bloomberg show. While the benchmark index climbed 5.5 percent in the fourth quarter, banks, brokerages and insurers collectively fell 3.7 percent. The slump followed record quarterly gains of 25 percent and 35 percent.

The potential for more losses in mortgages and commercial real estate loans is already reflected in the price for most bank stocks, said Mark Bronzo, a fund manager for Security Global Investors in Irvington, New York.

“If I was leaning one way, it would be towards adding to our overweight in bank stocks,” said Bronzo, whose firm oversees $21 billion. “When a group is under-owned like this and the risks are known, the odds are that they have further upside.”

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