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Can Bank Stocks Quadruple From Here?

History Would Argue That They Can

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THE KEY POINTS

In a recent interview, I was quoted as saying that bank stocks could quadruple in the next two years. The magnitude of the change predicted is correct. The time frame is not. It is expected to take a few years for this gain to materialize. To demonstrate why this might be the case this comment will explore a number of issues:

1. Why bank earnings had reached a plateau from 1980 to 1991?
2. What happened to make bank pretax earnings explode upwards by more 500% from 1991 to 1999?
3. The reasons why bank earnings will explode upward 10-fold in the next few years.
4. Bank stock performance from 1991 to 1998 compared to 2009 to the present.

Additionally, an attempt will be made to explain the two stage approach that investors should use in approaching bank stocks at present:

1. In Stage 1, the near term, the only consideration is whether loan losses are going to rise or fall.
2. Stage 2 requires an analysis of the industry longer term. This analysis explains why consumer finance is an unattractive sector lacking secular growth or high margins. Conversely, underwriting, trading, asset management, record keeping, and commercial lending are viewed as being very attractive.

In sum, it is believed that investing in bank stocks is likely to yield better performance than the markets, overall, near term. Investing in investment banks, wealth banks, and commercial lenders may yield superior results longer term. It is possible that in the next few years the value of these latter investments could rise by 400%.

REVIEWING THE INDUSTRY'S RECENT HISTORY

In this section, three periods are analyzed according to a set formula. The periods are:

- 1980-1991
- 1991-1999
- 2006-2009

The formula used is as follows:

- The size of earning assets times
- The net interest margins minus
- The loan loss provision plus
- Non-interest income minus
- Non-interest expense

This is the core approach that should be used when attempting to understand bank earnings. For those unwilling to wade through the dry statistics in the first section, they might look at the Stock Performance paragraph on page 8 to get some historical perspective and the Point of Interest and Stock Performance sections beginning on page 12.

Note: The tables in this report were prepared by Rochdale Securities. While they have been derived from sources believed to be accurate, accuracy cannot be guaranteed.

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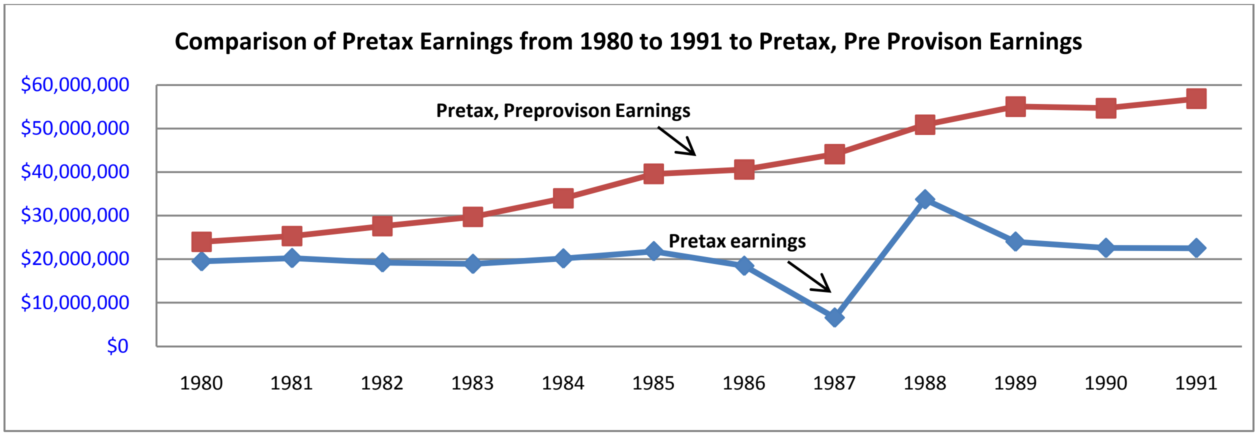
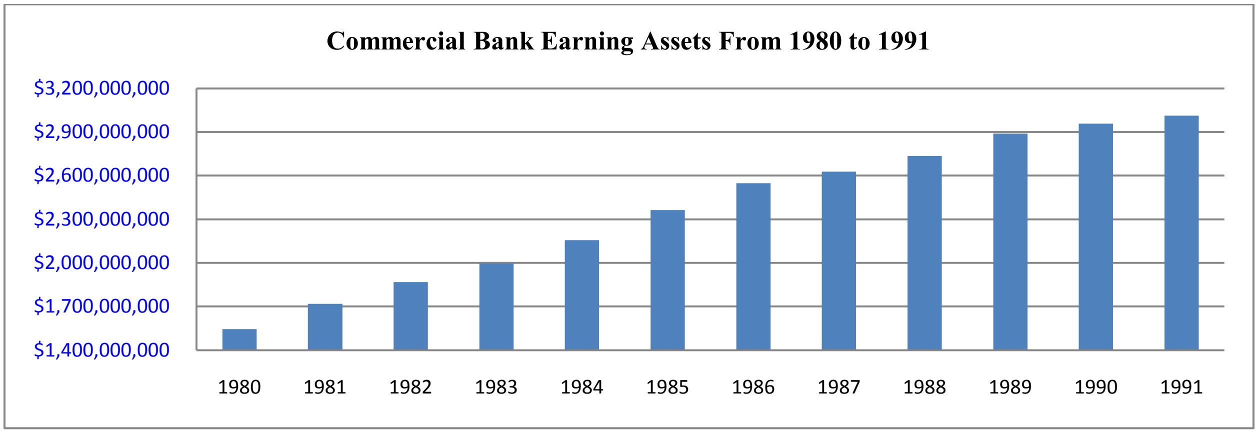
Banking Earnings from 1980 to 1991

Beginning in 1980 and up to 1991 the commercial banking industry had a problem (the industry is defined as commercial banks that are FDIC insured). In 1980, the industry had reached an earnings ceiling of $20 billion per year, plus or minus $2 billion. It was unable to pierce that barrier, meaningfully, for 11 years despite some Latin American influences, positive and negative, in 1987 and 1988.



Earning Assets

The 74 year record shows that earning asset growth in the commercial banking industry has averaged an estimated 8.1% per year. In the period from 1980 to 1991, earning asset growth was only 6.3% annually. In the last five years of this period, the annual growth averaged 3.4% while in 1991 earning assets only grew by 1.9%. Thus, the slowing growth in earning assets was a factor, but not the key factor, limiting the growth in bank earnings in this period.



The primary reason the growth in earning assets slowed was a government demand that banks increase their equity and reserves to deal with the financial crisis of the period. The ratio of reserves plus equity to assets was 6.34% in 1980 and 8.36% in 1991.

Net Interest Margins

The commercial banking industry's net interest margins actually rose in the period under study. They went from 3.64% to 4.05%. Both of these numbers were much higher than the estimated average net interest margin of the industry which was 3.22% from 1934 to 2009.

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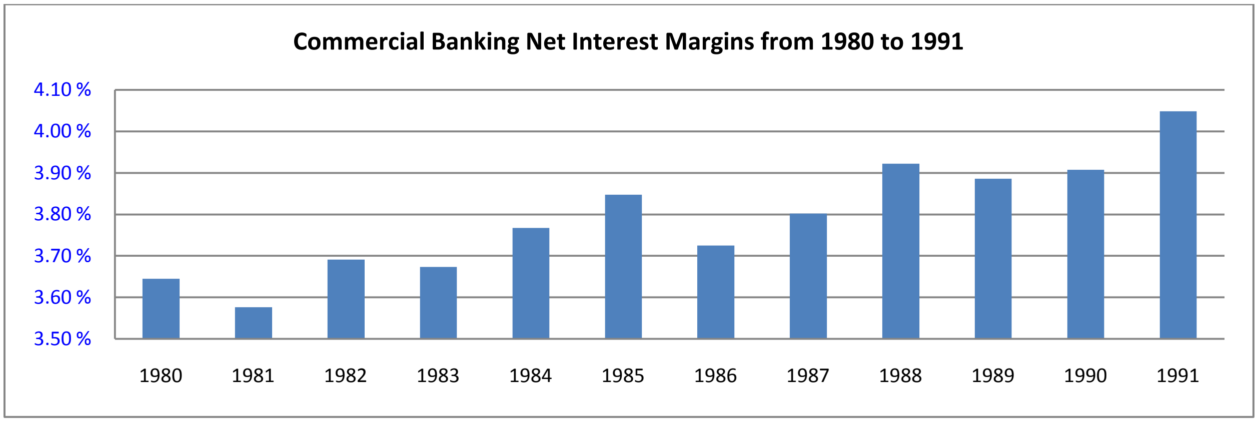


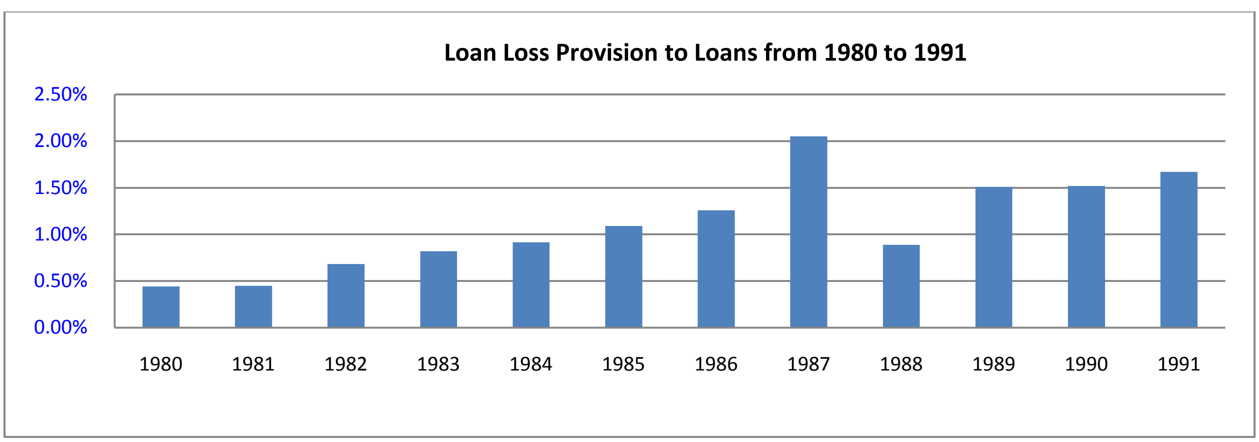
The reason for the relatively high margins despite growing loan problems and slowing earning asset growth was the dramatic decline in overall interest rates. The Federal Funds rate in January 1980 was 13.82%. It rose to 19.10% by June 1981; the highest at which this rate was ever recorded. By December 1991, the Federal Funds rate had subsided to 4.43%. The inflation rate had plunged through the 1980s.

Loan Loss Provision

The financial crisis of that period was precipitated by a number of factors:

- A law change in 1986 disallowed the use of depreciation on commercial real estate when filing personal income statements. This changed the cost of commercial real estate and it precipitated a collapse in the sector.
- The inflation in commodity prices which distinguished the 1970s ended due to stringent monetary policies in the United States and globally. Prices plunged.
- The leverage buyout craze that was driven, in part, by rising real estate and natural resource prices, buckled.
- The thrift industry which had been surviving on life support due to the Garn-St Germain Act of 1982 (the too small to fail legislation), finally failed. Thousands of these companies disappeared.

The ratio of loan loss provision to loans rose to 2.05% at one point in this period. The average of this ratio over the past 74 years of recorded data is 56 basis points.



Credit Income

Credit income is the result of multiplying earning assets by net interest margins and then subtracting loan loss provisions. Surprisingly, the rise in loan losses over this time frame were not large enough to cause credit income to decline.

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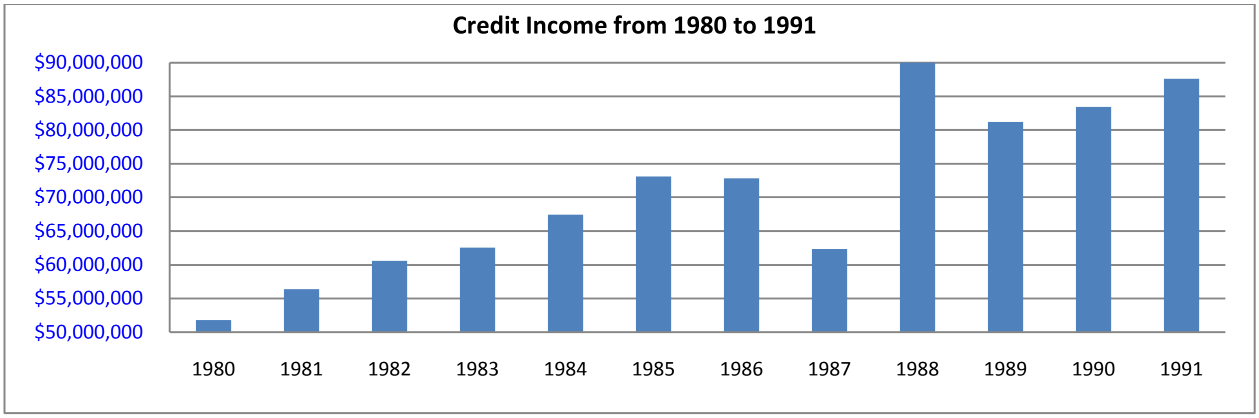
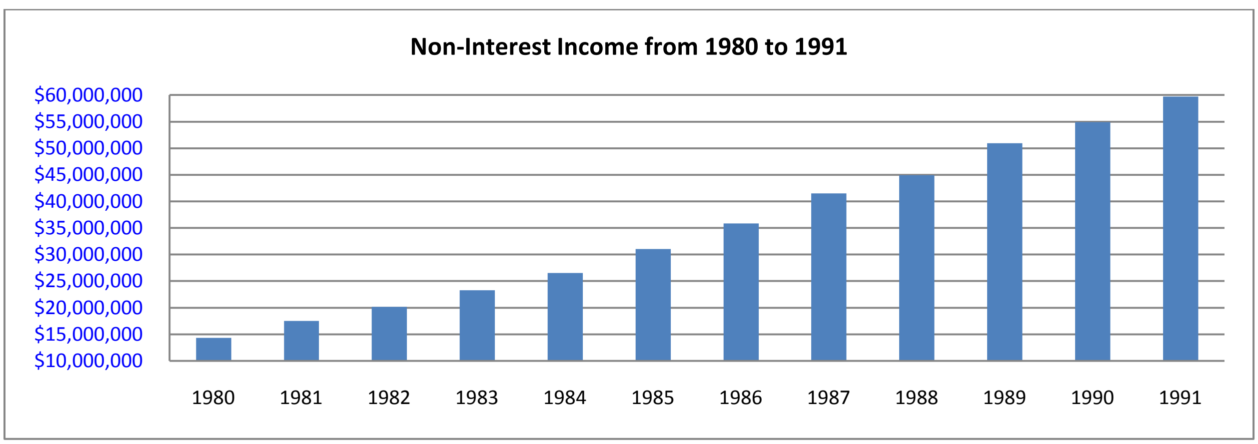
In the 1980 to 1991 period, earning assets rose albeit at a slower rate than normally. Net interest margins rose sharply based on what may have been the biggest gross drop ever experienced in interest rates in peacetime in the United States. These forces were more powerful than the rise in loan losses.

Credit income actually rose, although fitfully. Simplistically, the decline in interest rates more than offset the impact of higher loan losses.



Non-Interest Income

Non-interest income rose steadily through the studied period. Faced with a loan crisis banks raised fees across the board at an unusually high pace. They, also, changed their business models from originate to hold to originate to sell. The 74 year record shows that non-interest income rose an average of 8.8% per year. This is faster but consistent with the growth in earning assets (8.1%). From 1980 to 1991, the annual rate of non-interest income increase was 13.8%.



Non-Interest Expense

What then caused bank pretax earnings to plateau in the 11 year period from 1980 to 1991? Clearly revenues were rising. Operating income was up. Credit income was up. Credit income plus non-interest income was up. The reason for the earnings plateau is that non-interest expenses rose at a faster rate than all of the other metrics:

- Net interest income rose by 7.3% per year.
- Credit income rose by a slower rate due to the rising loan losses but it was up by 4.9% annually.
- Non-interest income rose fastest of all or by 13.8%
- Operating revenues were up by 9.0%.

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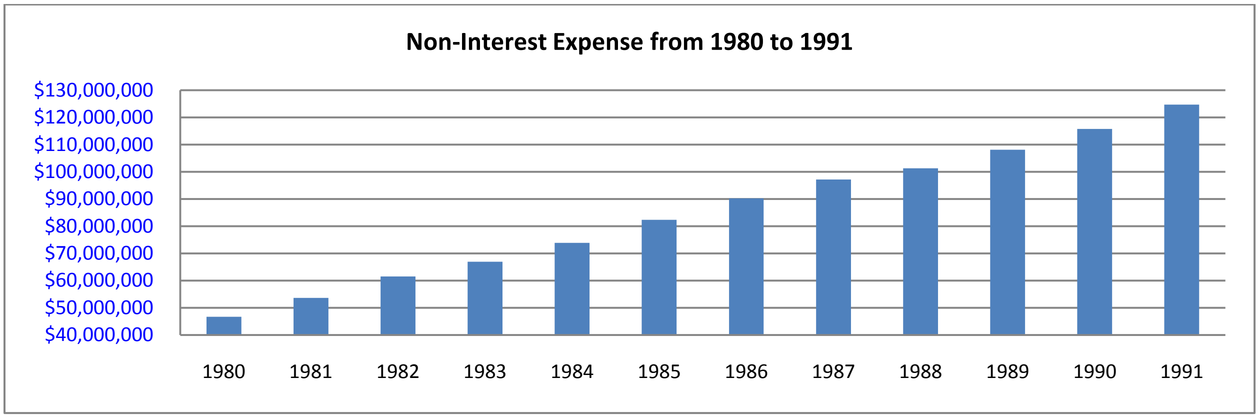
The industry simply did not have a revenue problem. Yet the annual growth rate in pretax income was only 1.3%. Clearly the problem was non-interest expenses. They rose by 9.4% annually. Banks were simply unable to downsize their businesses fast enough to meet the changes in the operating environment. Additionally, the costs of dealing with non-performing and foreclosed assets were significant.

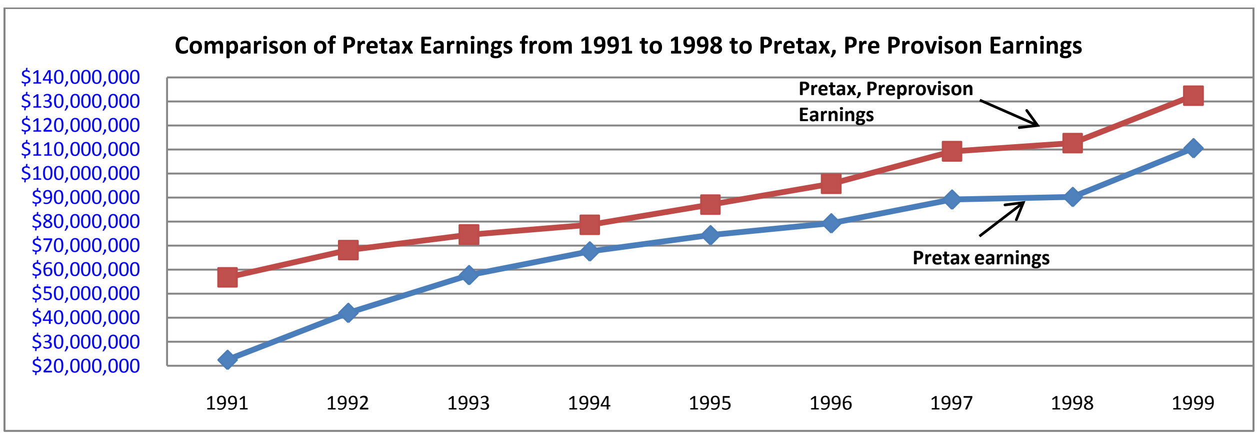


Initial Point of Interest

While loan losses presented a major problem to banks from 1980 to 1991, there was a powerful offset to the stress loan losses placed on earnings. Interest rates were tumbling from the high inflation 1970s to the low inflation 1990s and this pulled interest rates sharply lower. This offset the loan losses. The problem the banks were unable to combat in the 1980s was the rising costs of running their businesses.

The Recovery: 1991 to 1999

The formula utilized above to analyze the 1980 to 1991 period reveals the reasons for the explosive earnings advance of the following 7 years; a period when pretax earnings rose by more than 500%. Surprisingly, again, the decline in loan losses was not the primary driver of pretax earnings.



Earning Assets

The annual growth rate for earning assets rose but not dramatically. It went from 6.3% to 6.8%. It was still well below the long-term average of 8.1%.

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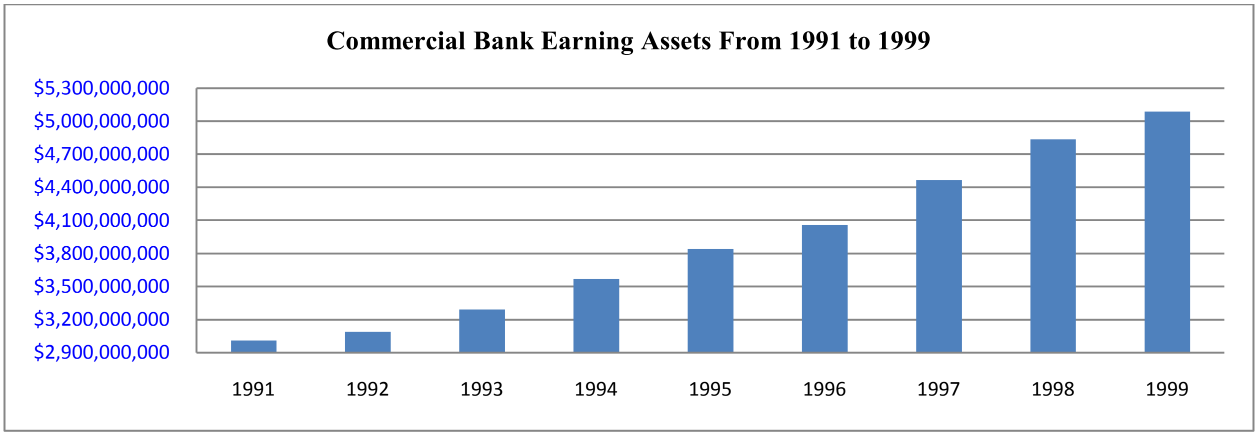
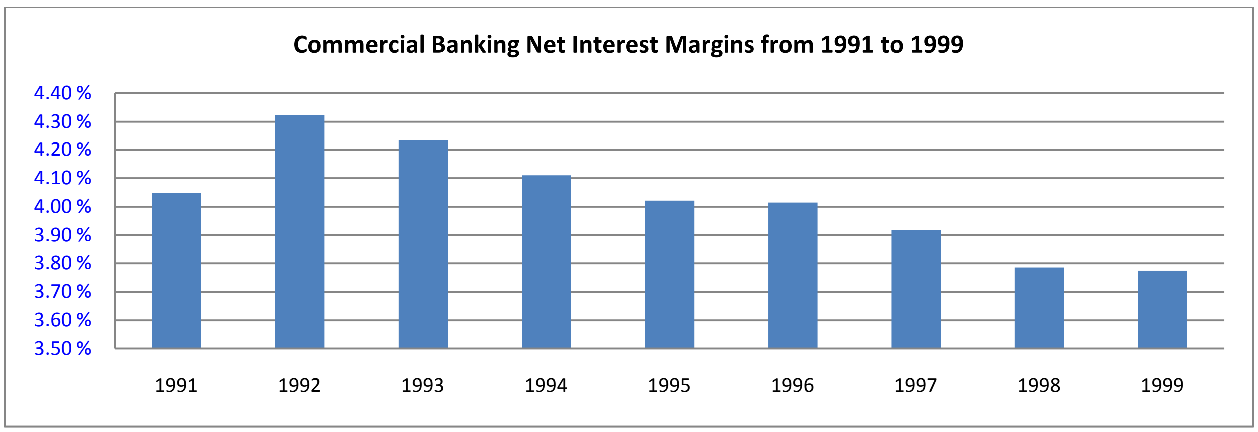


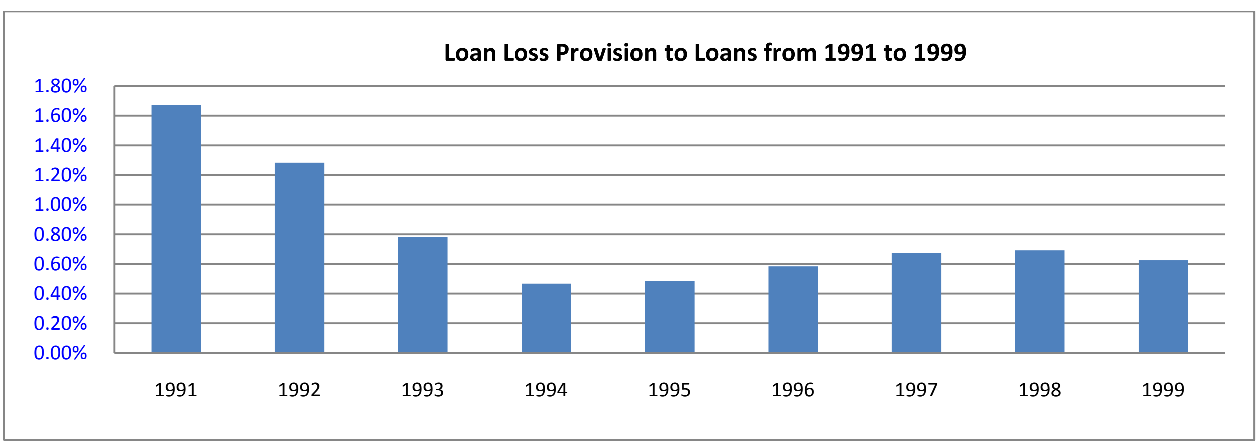
<u>Net Interest Margins</u>

Net interest margins actually fell continuously through the period. The Federal Funds rate which was 4.43% in December 1991 had risen to 5.30% by December 1999. Thus, the most powerful force to stabilize earnings in the earlier period was a non to negative factor in the 1991 to 1999 time frame. Net interest margins ended the period at 3.77% still above the long-term average of 3.22%.



<u>Loan Loss Provisions</u>

Loan loss provisions plummeted. They fell from 1.67% of loans in 1991 to 0.62% in 1999. This latter level was almost at the long-term average of 0.59%. In absolute dollars the annual provision fell by $10.3 billion or 32.1%.



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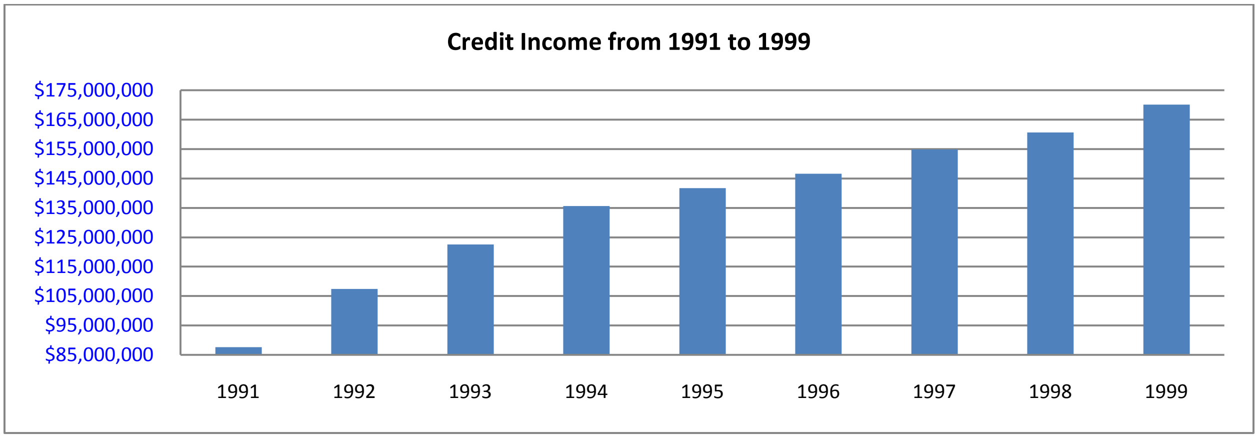
Credit Income

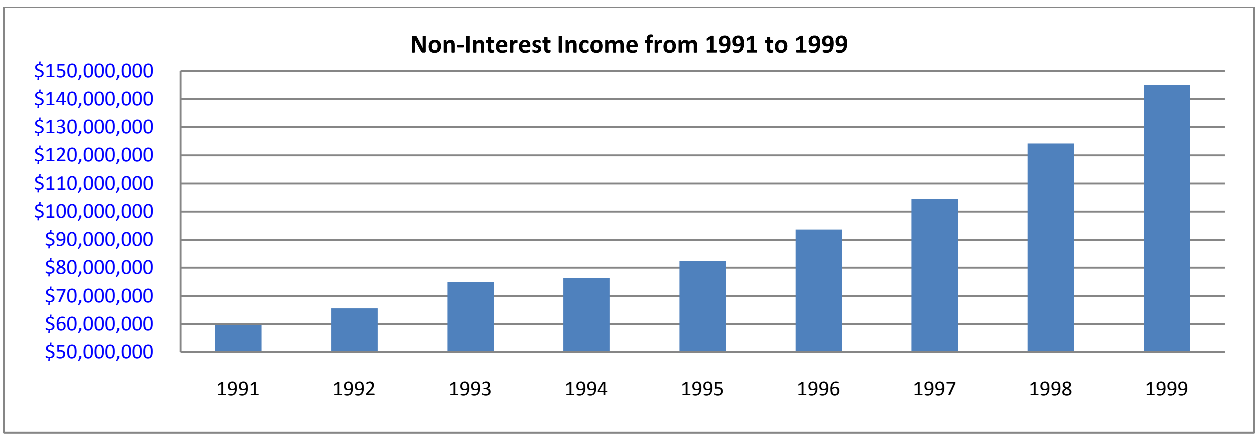
The deterioration in the net interest margin did not stop the growth in net interest income. Powered by continual growth in earning assets, net interest income grew by 5.8% per year from 1991 to 1999. Consequently, the decline in loan loss provisions had a significant impact on credit income. It rose by 8.7% annually.



Non-Interest Income

It will be noted that the increase in credit income in the period was 94.2% or meaningfully below the 500 plus percent growth in pretax income over the same time frame. For pretax income to expand at 500% plus, it required a major assist from non-interest factors. This, in fact, occurred. Non-interest income in the period rose by 11.7% annually.

In gross dollars the increase in non-interest income was $85.2 billion. Compare this to the $10.3 billion decline in the loan loss provision or the $82.6 billion increase in credit income. It immediately becomes evident that the more important factor in driving the increase in pretax in this period was non-interest income not earning asset growth, net interest margin expansion, or loan loss declines.



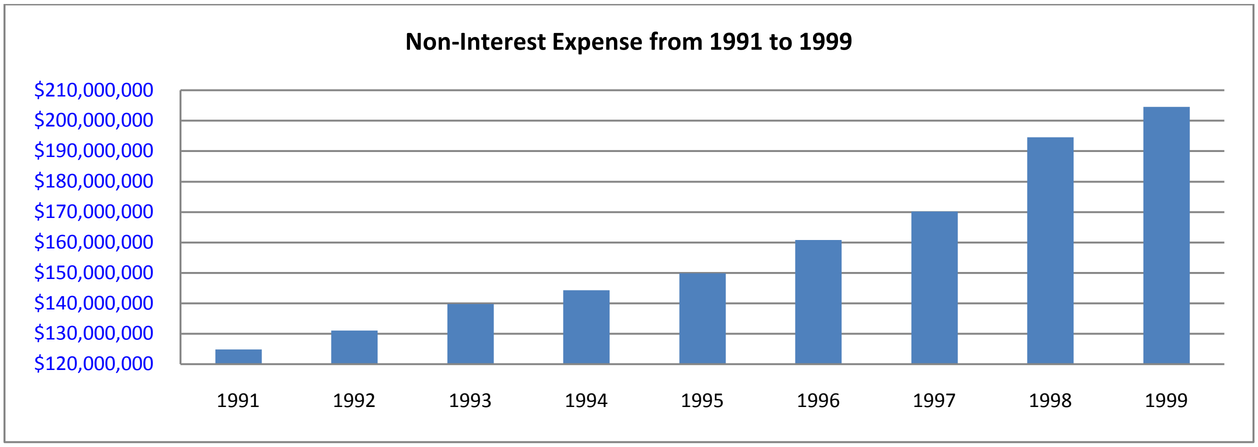
Non-Interest Expense

The banks had learned a great deal about controlling non-interest expenses in the 1991 to 1999 time frame following the debacle from 1980 to 1991. As stated, in the earlier period the lack of expense control was the biggest contributor to the inability of earnings to pierce the $20 billion ceiling, meaningfully. This changed in the later period. Consider the following:

- Net interest income rose by 5.8% per year.
- Credit income rose by a faster rate due to falling loan losses; it was up by 8.7% annually.

- Non-interest income rose fastest of all or by 11.7%
- Operating revenues were up by 8.0%.

Operating expenses were up by 6.4%. In absolute dollars, non-interest expenses rose by $79.7 billion. This was less than the $82.6 billion increase in credit income or the $85.2 billion increase in non-interest income. Non-interest expenses had faded as an industry problem. Non-interest income had gained primacy as the driver of revenues and pretax earnings.



Second Point of Interest

There is no question that shifts in loan losses have a dramatic impact on pretax earnings. They cause bank failures and financial crises. However, a close look at the industry indicates that it is not the income flowing from the loan portfolio that drives earnings the most.

- One reason for this may be that as banks are eliminated from the data base the loan loss impact is lessened.
- Another, more likely reason, is that as the largest banks gained market share, they caused a shift in bank revenues and earnings.

This could lead one to the conclusion that smaller banks that rely on credit income, and who lack large pools of non-interest income, are at greater risk of failing than large institutions with multiple revenue sources and greater operating controls. At any rate, while it is clear that for surviving institutions one key to their earnings are loan losses; it is also clear that a more important factor is shifts in non-interest income and expenses

Stock Performance

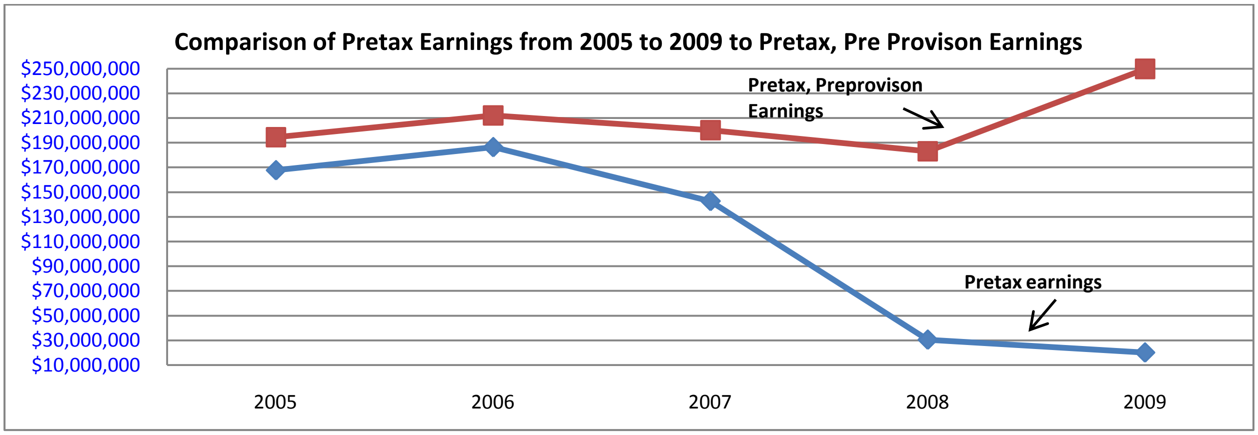
Using the Bloomberg data base it is possible to reconstruct the performance of 11 bank stocks from 1991 to 1999 compared to the S&P 500. These stocks literally exploded upwards when their earnings shifted far outperforming the S&P index:

- Universal Banks
  - Bank of America's stock price rose 405% from November 2, 1990, the trough of the downturn, to December 31, 1999.
  - Citigroup rose 2,479.9%
  - JPMorgan Chase: 1,236.6%
  - Wells Fargo: 872.9%
- Large Regionals
  - BB&T Corporation: 516.9%
  - PNC Financial: 408.6%
  - SunTrust: 605.8%
  - U.S. Bancorp: 1,107.1%
- Wealth Banks
  - BNY Mellon: 1,755.1%

- – Northern Trust: 1,147.1%
- – State Street Corporation: 1,013.3%
- S&P 500: 371.1%

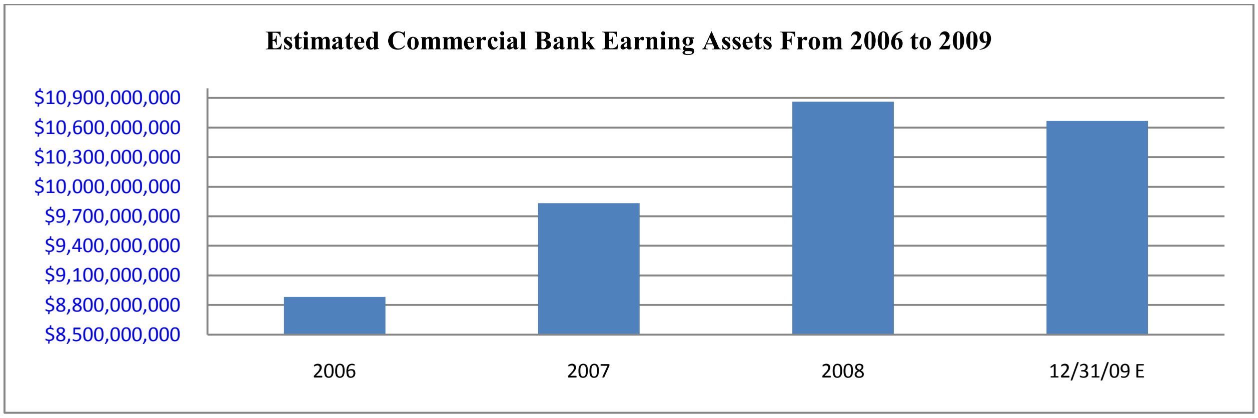
Current Position

Commercial bank pretax earnings peaked at $186.4 billion in 2006. They fell to $20.1 billion in 2009. It is relevant to apply the earnings formula to this three year period to explain what happened.



Earning Assets

Due to an estimated decline in 2009, it appears that earning assets grew by 6.3% annually in the period from 2006 to 2009. This was the same rate of growth as 1980 to 1991.



Net Interest Margins

Net interest margins rose in the period. They went from 3.21% to 3.37% ending above the long-term average of 3.22%. The Federal Funds rate was 4.21% in January 2006. It fell precipitously to 12 basis points by December 2009. On a percent change basis, the decline was much steeper than the fall in 1980 to 1991. So the initial numbers are similar to the metrics in 1980 to 1991. Earning assets rise slowly. The net interest margin also expands.

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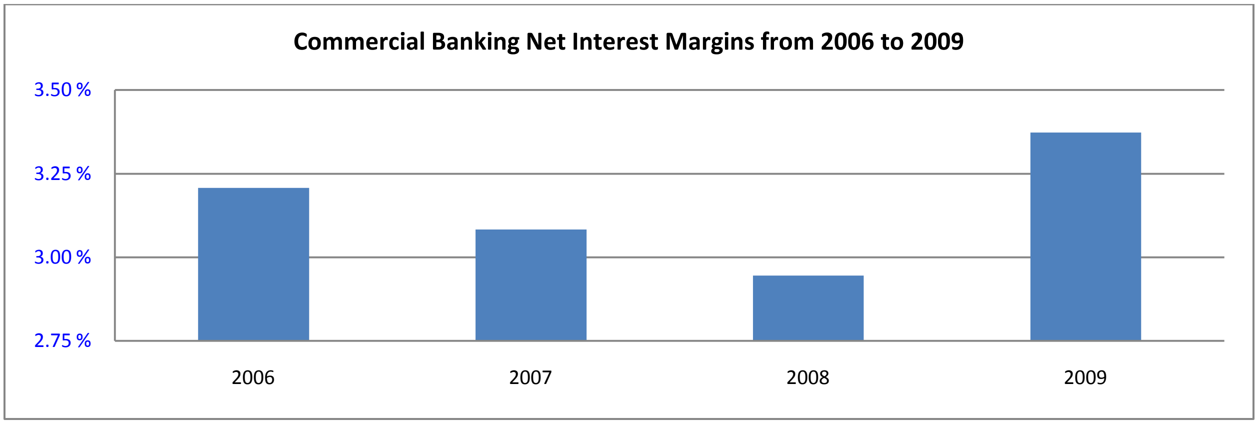
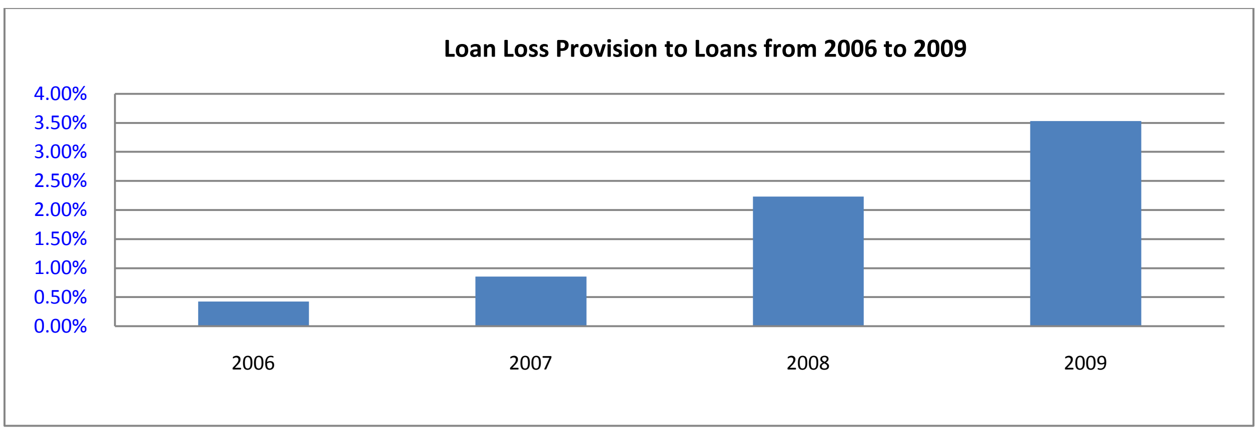


Loan Loss Provision

Another similarity between the earlier period and the 2006 to 2009 period is the rise in the loan loss provision. However, there is no comparison between the magnitudes of the increase in 2006 to 2009, to the increase in 1980 to 1991. The later timeframe experienced the biggest increase in loan loss provisions since the Great Depression. The provision to loans was 3.53%. This is the highest "loss" ratio in the recorded numbers exceeding the 3.42% posted in 1934.



Credit Income

The increase in the loan losses was so severe that it swamped the improvements in earning assets and the net interest margins. Net interest income actually increased at a healthy rate of 8.1% in the three year period. This is relatively close to the 74 year average increase of 8.4% annually.

However, due to the sharp increase in loan loss provisions in 2008 and 2009, credit income declined at a rate of 20.5% annually. This only happens in Depressions.

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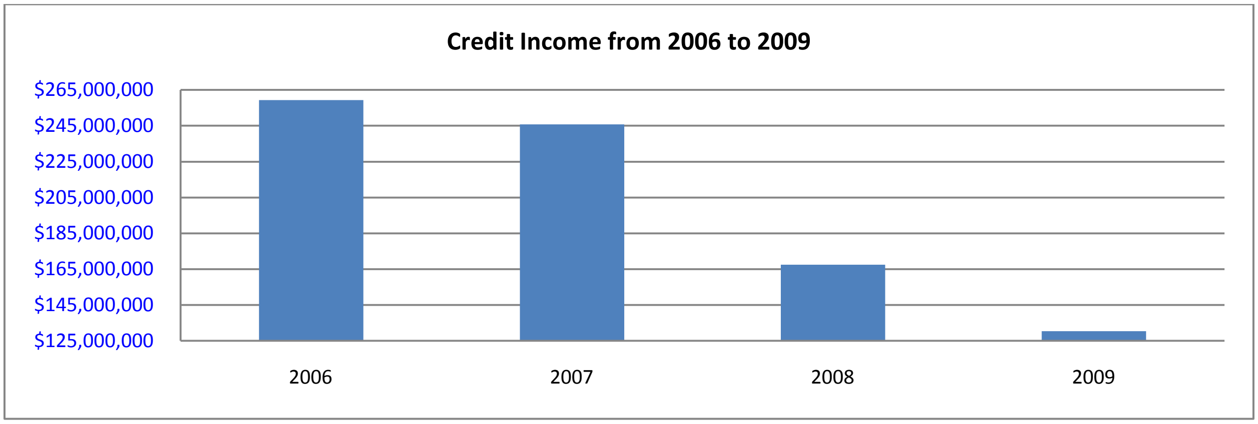
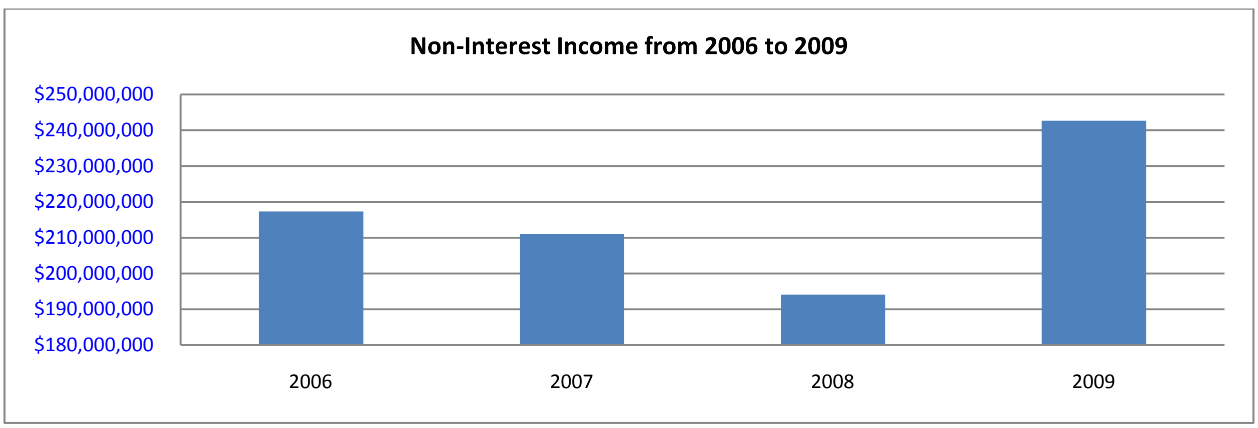


Non-Interest Income

In both the 1980 to 1991 period and the 1991 to 1999 periods, non-interest income showed above average gains. It rose 13.8% and 11.7%, respectively compared to a historical rate of gain of 8.8%. These increases reflected the shift in the nature of the banking business. It had become progressively less a balance sheet driven business and more of an "originate to sell" business. Thus, it was doubly surprising that loan losses were the core driver of the banking crisis since banks owned relatively less of the loans outstanding in the financial system.

However, the financial system collapsed for a variety of reasons (discussed in other comments) and some of the non-interest income business fell with it. Consequently, the growth in non-interest income was only 3.7% per year from 2006 to 2009. There would have been no growth had not the sector showed some recovery in 2009, itself.



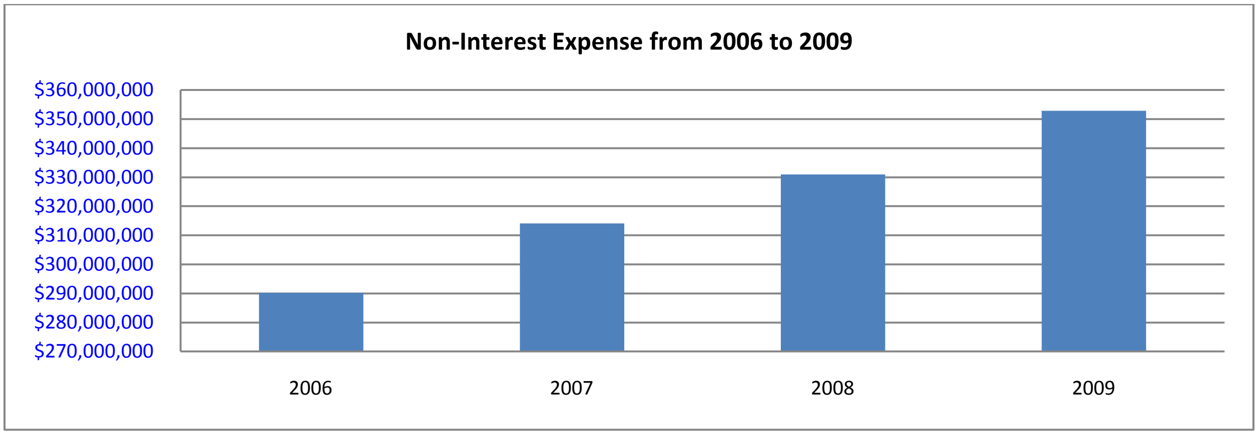
Non-Interest Expense

Non-interest expenses rose a bit faster in this period than in the 1991 to 1999 timeframe or by 6.7% not 6.4%. This would not have been a problem if revenue had not simply broken down in most areas:

- Net interest income rose by 8.1% per year (unlike other revenue indicators).
- Credit income declined by 20.5% per year; quite possibly a record fall.
- Non-interest income faltered, growing by 3.7%
- Operating revenues were up by 6.3%.

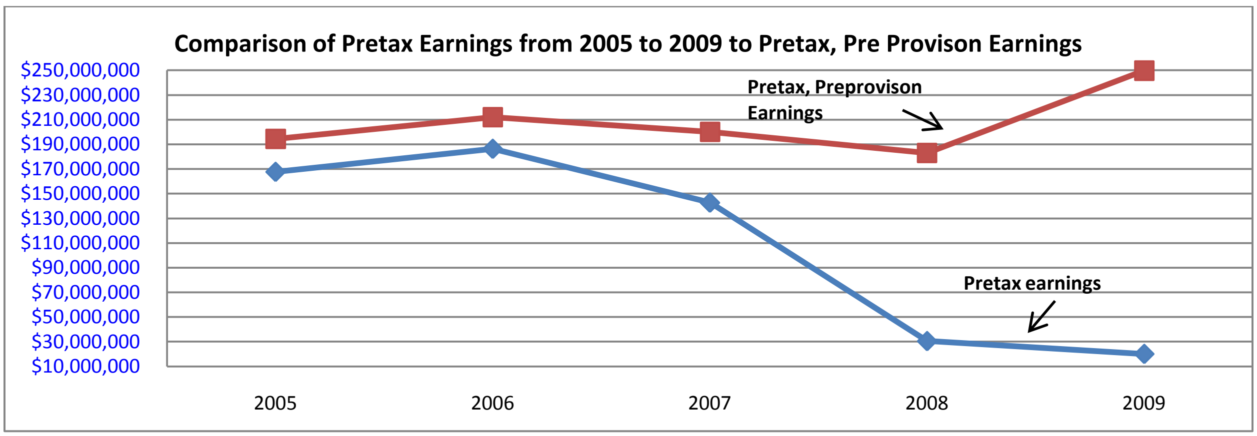
Thus, it would appear greater expense control would be helpful but that this is not the core problem. The core problem is that revenues did not grow as expected not that expenses were out of control.

Can Bank Stocks Quadruple From Here?

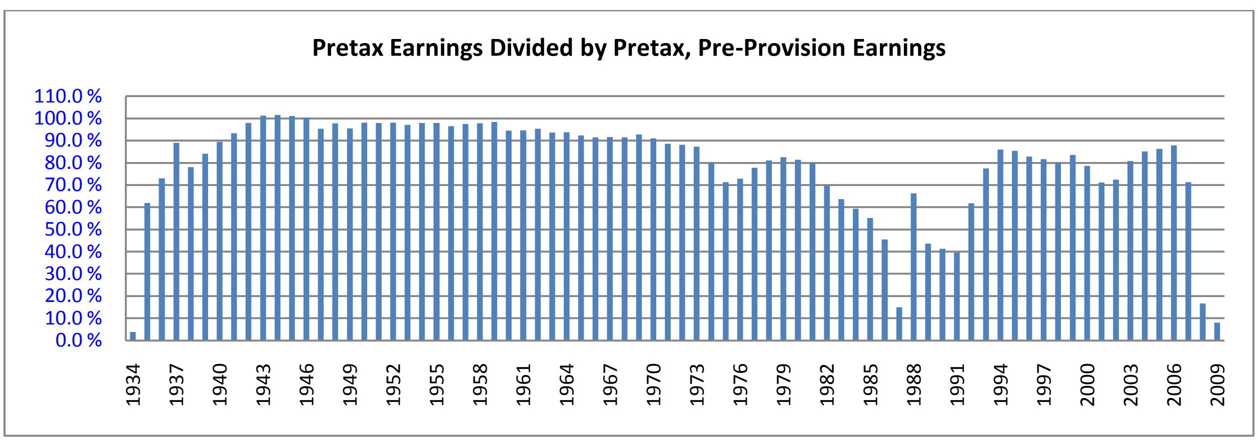


Third Point of Interest

It makes sense to take another look at the chart on page 9, as shown below.



Note the unusually wide gap between pretax earnings and pretax, pre-provision earnings. This is almost unprecedented. The last time it happened was 1934.



Pretax earnings in 2009 were 8.1% of the pretax, pre-provision earnings. The gap in absolute dollars is $229.6 billion dollars. The industry never earned $229.6 billion in pretax in its history. It only earned more than that amount once on a pretax, pre-provision basis. This was in 2009.

Can Bank Stocks Quadruple From Here?

One might argue that the banking industry is at all time record earnings if one deducts the loan loss provision from the total pretax, pre-provision number. Moreover, the probability is actually quite high that the bulk of the loan loss provision will be deducted from the total. In the 10 year period from 1997 to 2006, the average loan loss provision for the industry was $29.9 billion. If one deducts this number from the pretax, pre-provision number recorded in 2009, it might be argued that the industry's pretax earnings are roughly $200 billion, an all-time record.

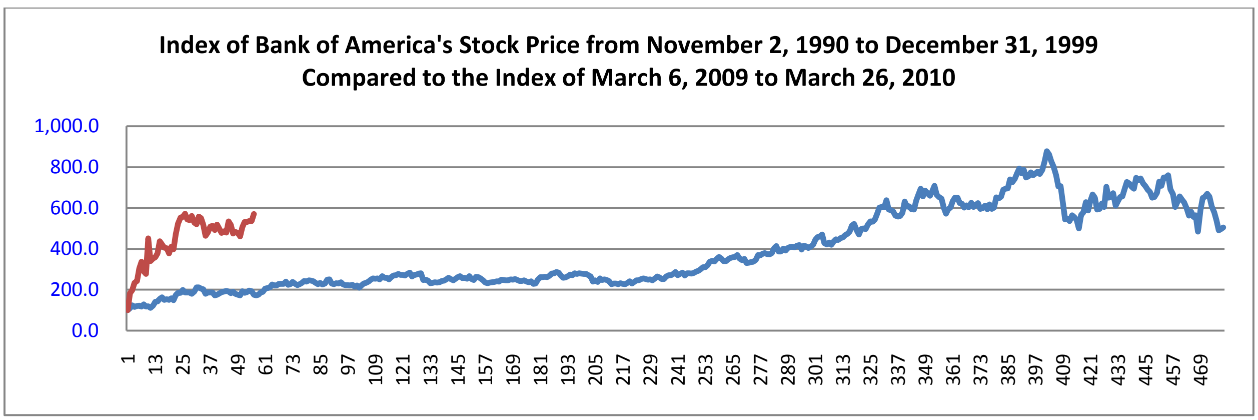
I believe strongly that this is the case. It is particularly true if the industry's recovery in non-interest income growth continues and the increases in non-interest expense costs remain muted. It should be noted that $200 billion in pretax earnings would be a tenfold increase from the $20 billion earned in 2009.

Stock Performance

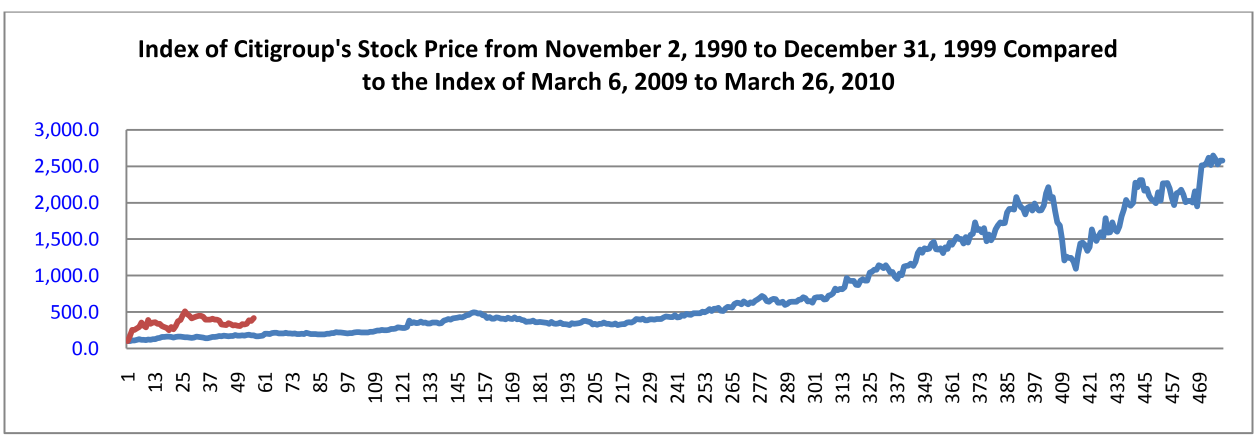
The following few pages show the performance of the 11 stocks highlighted above in 1991 to 1999 compared to 2009 to the present. All prices have been adjusted to a beginning base number of 100 for the comparison. These charts make it evident that investors have reacted more quickly this cycle to the expected change in bank earnings. However, it is also evident that these stocks have not reached their potential.

If history repeats, and I believe it will, these stocks could grow by 400% in value before this cycle ends. This will take more than two years but it is highly probable. The risk, of course, is a breakdown in either the economy or the financial system.

Bank of America



Citigroup



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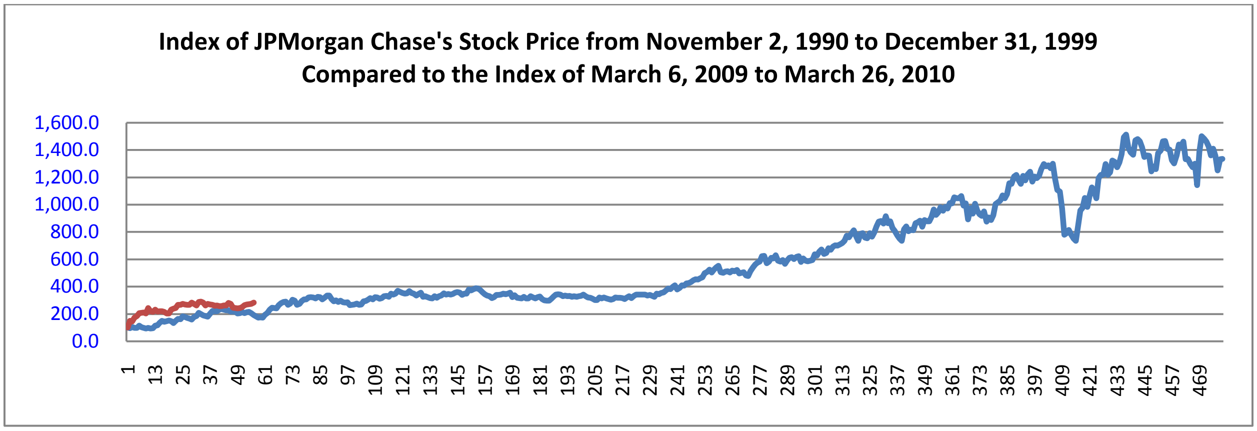
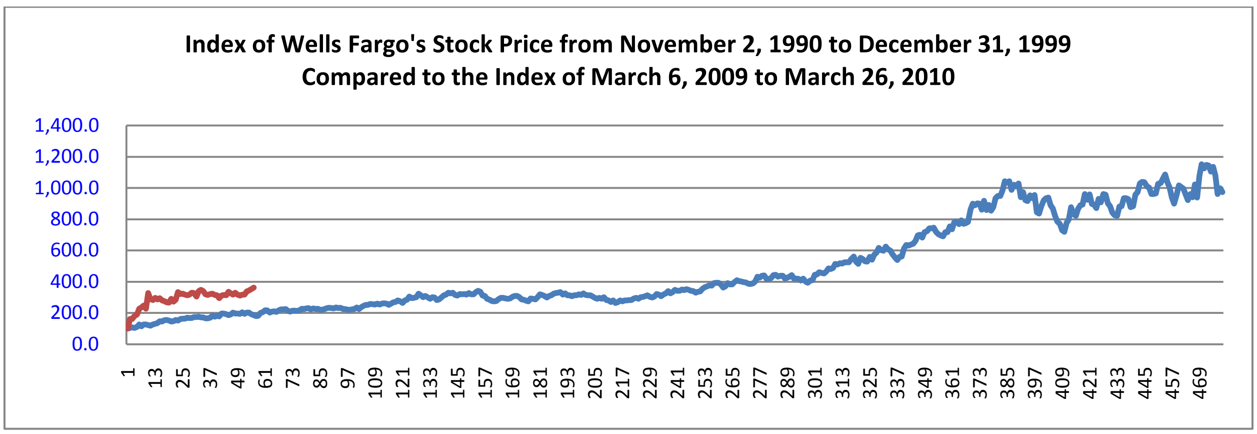
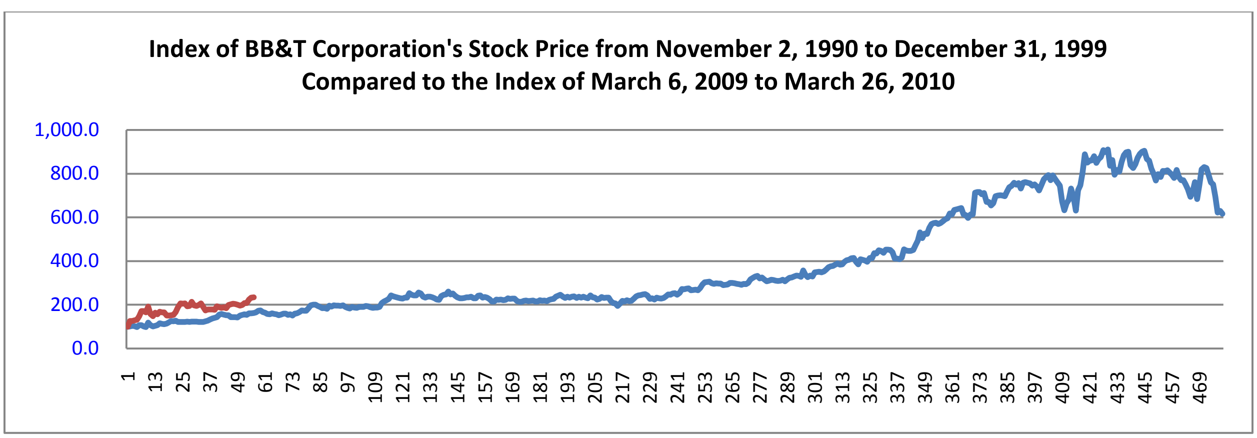
JPMorgan Chase



Wells Fargo



BB&T Corporation



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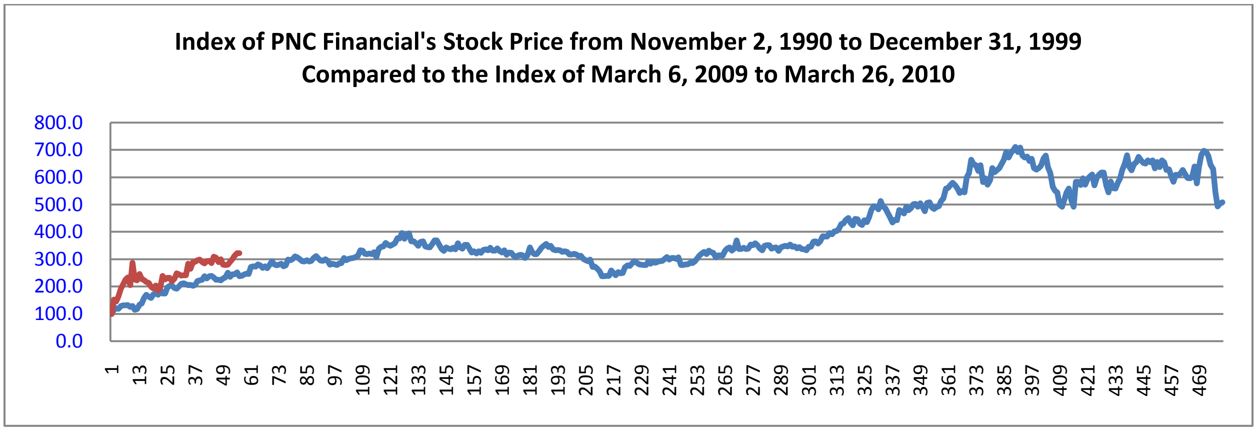
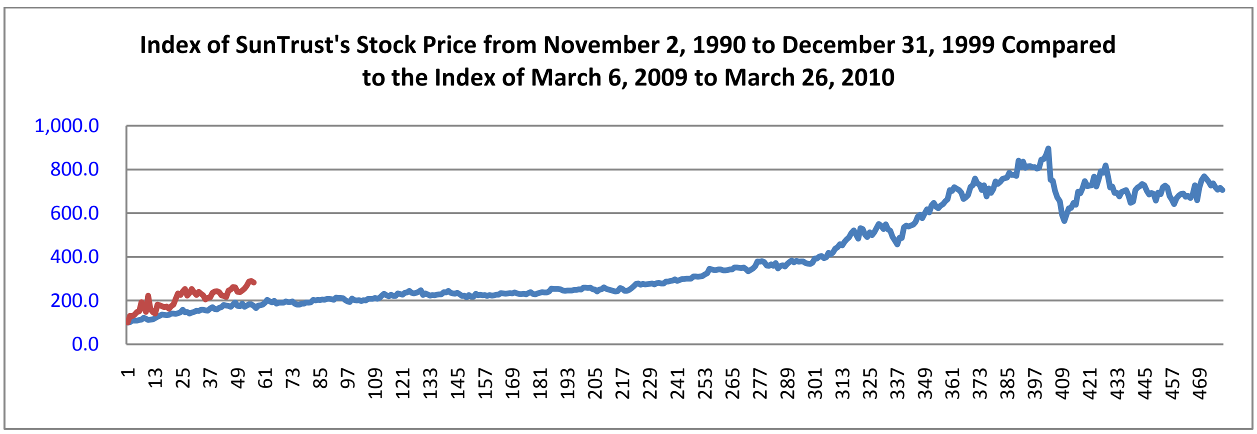
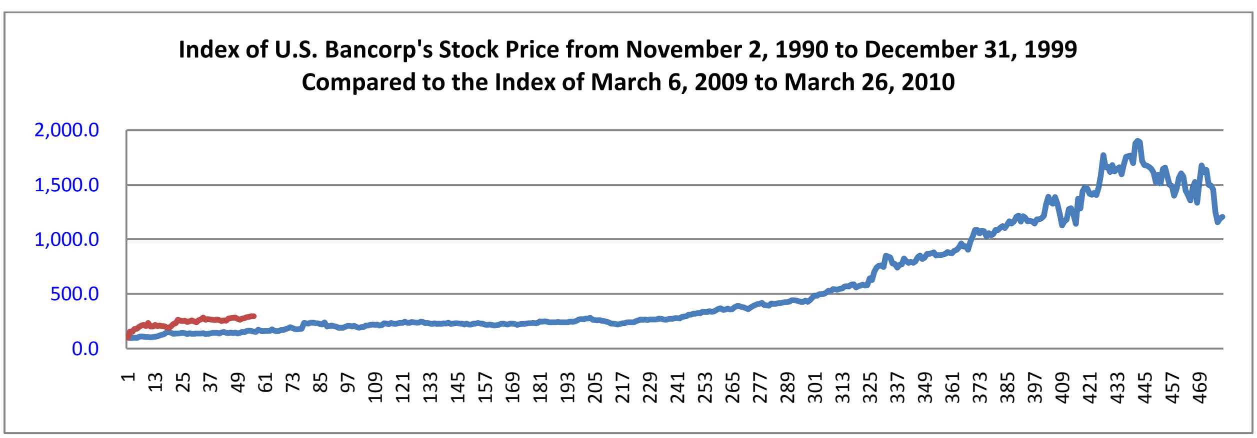
PNC Financial



SunTrust



U.S. Bancorp



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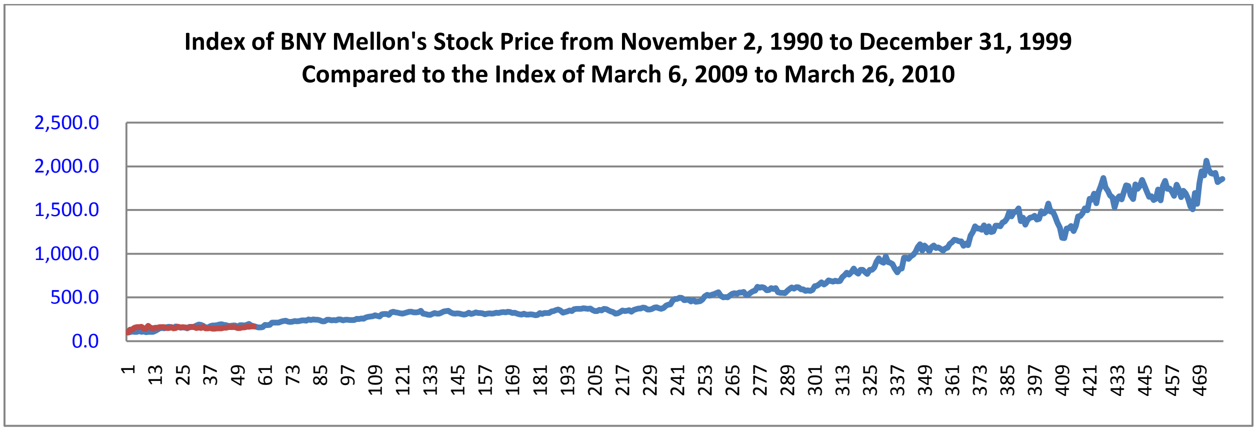
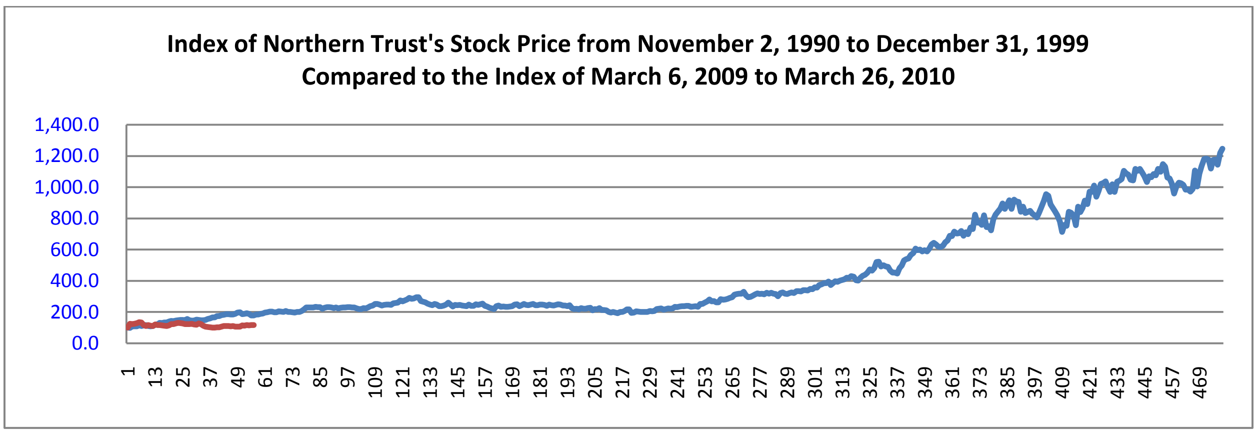
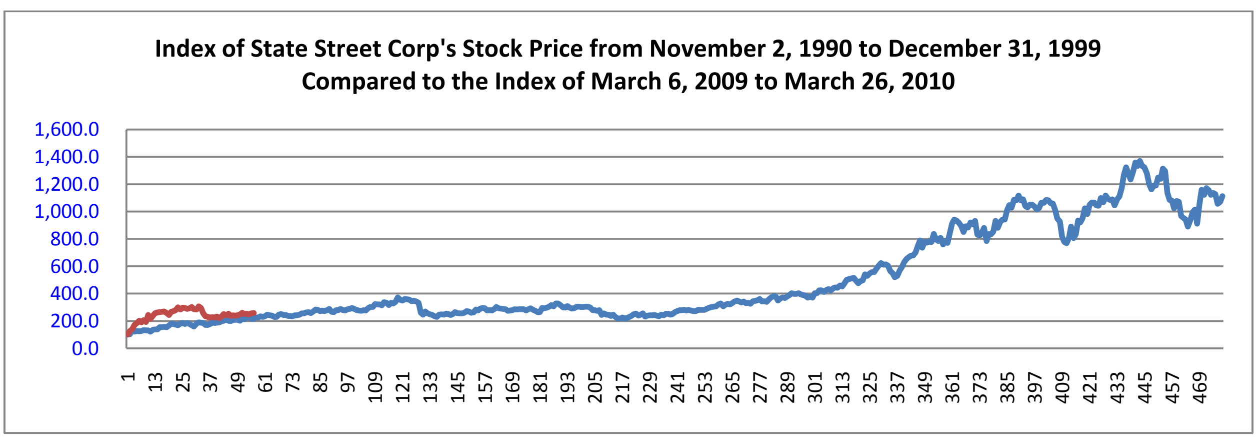
BNY Mellon



Northern Trust



State Street Corporation



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TWO PHASE INVESTMENT APPROACH

At the outset of this comment it was suggested that there is a two phase process underway in bank stock investing:

- Phase I is investing in the probable decline in the loan loss provision.
- Phase II is returning to traditional company analysis.

Phase I – The Loan Loss Provision

For the past two years there has only been one variable in deciding whether to buy or sell bank stocks. This has been the direction of early stage delinquencies. Hypothetically, investors have been waiting outside the door of the FDIC. As Call Reports come in from the various banks, they have looked at only one line. That line relates to the 30 to 89 day delinquencies of the institution. It is the so-called early stage delinquencies.

If these delinquencies are rising, the stocks are aggressively shorted. If the delinquencies show signs of topping out, the stocks are purchased. Given the size of loan losses in this past cycle this approach to investing made sense. This is because the direction of troubled loans is the key to the future success and possible literal failure of a bank. However, implicit in this form of investing is that nothing else matters:

- The government's actions toward the industry are not worth considering.
- The direction of loan volume is immaterial.
- Near term earnings have no meaning.
- The capital concepts being mulled over interminably by the regulators are eyewash (I agree with that one).
- Plus, any other fundamental factors related to revenues and earnings simply are not important.

A quick look back at the same chart shown on both pages 9 and 12 indicates why this view actually makes sense. Pretax, pre-provision earnings are not declining. They are actually rising. The key to turning earnings around at some future date is shifting the mix away from the provision to pretax. This is likely if, as expected, the economy does recover on a sustainable basis.

Phase II – Return to the Fundamentals

However, at some point, the industry's fundamentals will matter. The actions being taken by the government will have to be assessed. The importance of non-interest income and non-interest expenses will have to be assessed

<u>Balance Sheet</u>

One of the key government influences on the industry is the reshaping of the industry balance sheet. It was recognized in the fourth quarter of 2008, that the banks who failed did so because they had:

- Large amounts of short-term debt that could not be easily rolled over in a crisis.
- Little or no liquidity on their balance sheets to meet runs on either debt or deposits.
- Large amounts of assets dedicated to high risk lending, which was vulnerable to revaluation in an economic or financial downturn.

Funding

The solution to the first problem was relatively simple. Eliminate as much short-term debt as possible. Replace it with common equity and deposits. This was done with a vengeance. Note the increase in common equity and deposits as a percent of assets on the next page. Also note the decline in borrowings on a relative basis in the charts below.

Note: The tables above were derived from the FDIC reports and related to commercial banks alone. The tables below have also been prepared from FDIC data but they relate to all FDIC insured institutions. There are 6,839 commercial banking entities insured by the FDIC and 8,012 total institutions insured by the agency.

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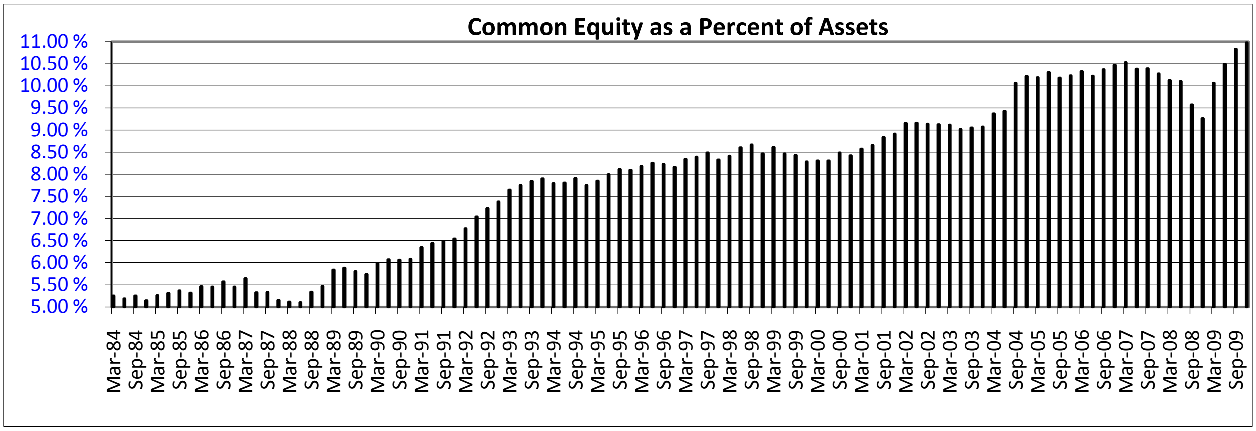

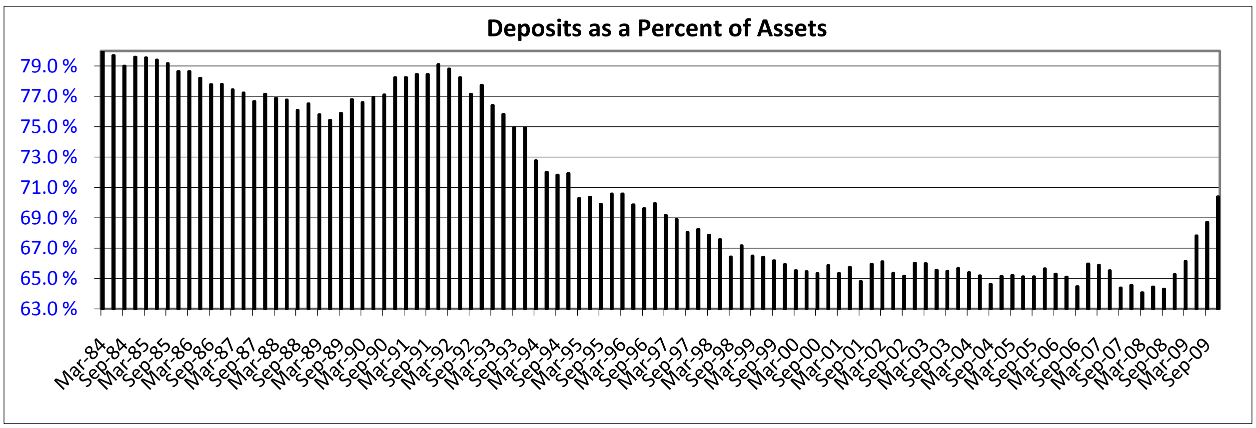

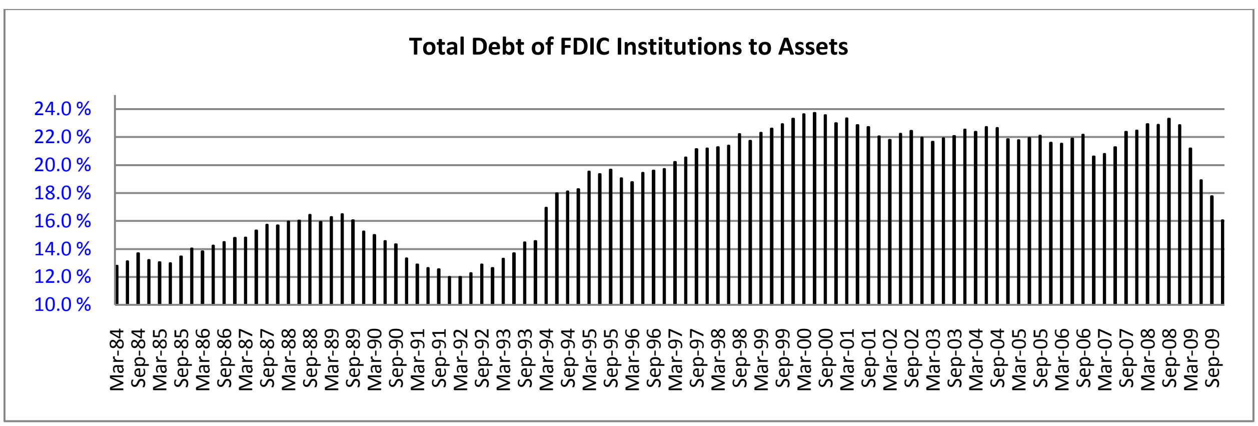

Liquidity

The banks have also acted quickly to increase their liquidity. This is a multi stage process. On one hand, they must increase their cash holdings. On the other, they must increase their holdings of securities. This latter effort was made difficult by the fact that the banks had to rid themselves of privately insured, or guaranteed, asset-backed securities, and the banks had to replace these weaker instruments with government backed securities. They achieved these goals.

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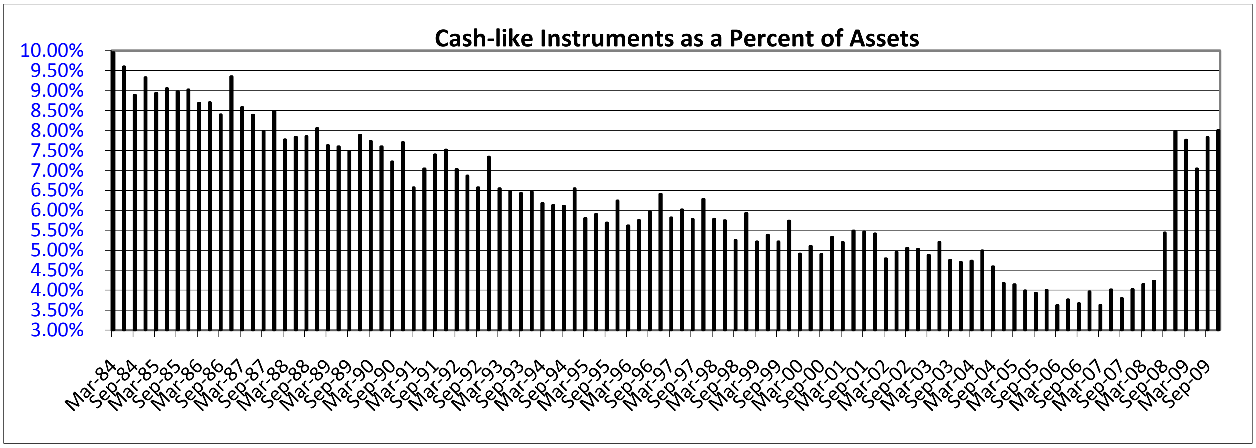
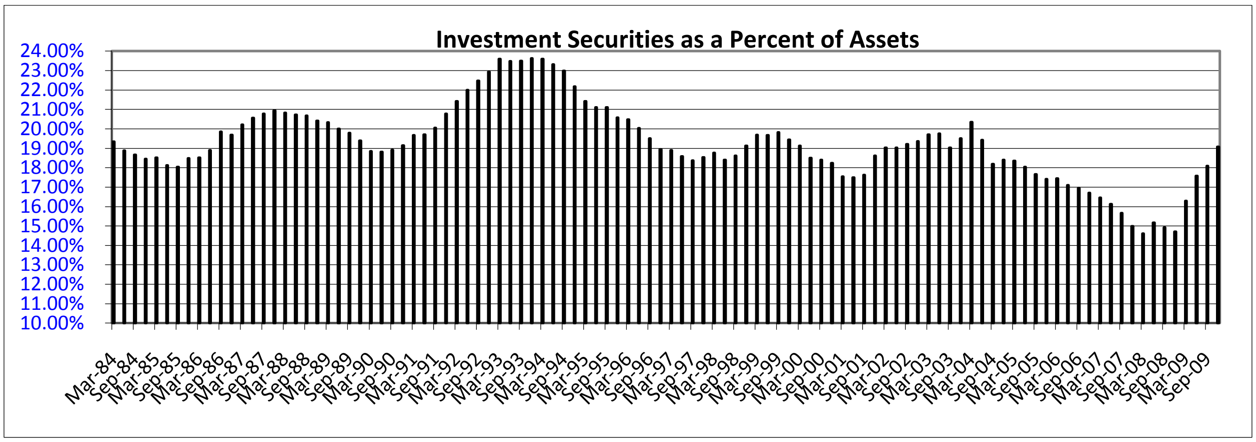
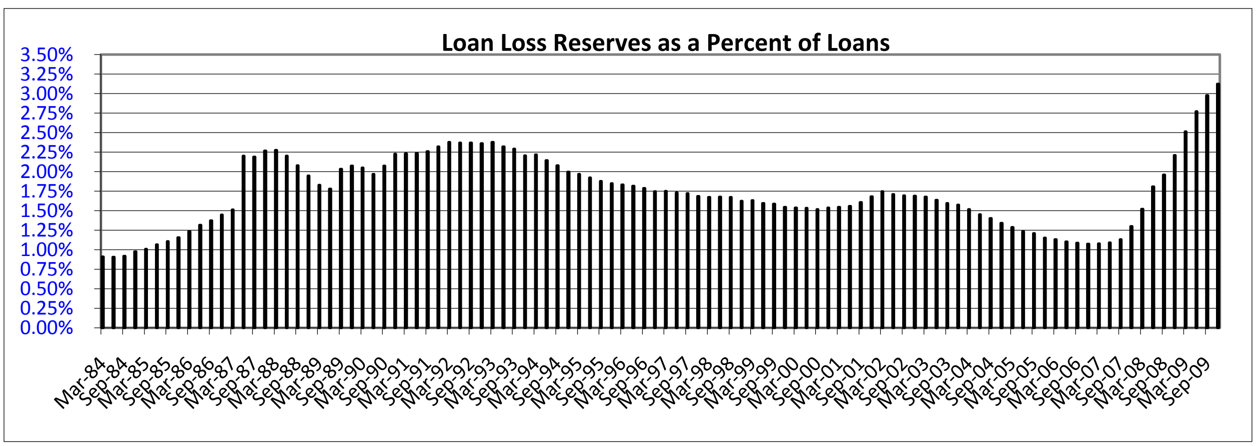




Asset Quality

The improvement of asset quality is a longer process. It requires write-offs of problem credits; mark downs of foreclosed assets; and the creation of sizable reserves against the remaining portfolio. This is also being accomplished. Reserves have increased dramatically as a percent of loans outstanding – although in this case I might argue they should be higher still.



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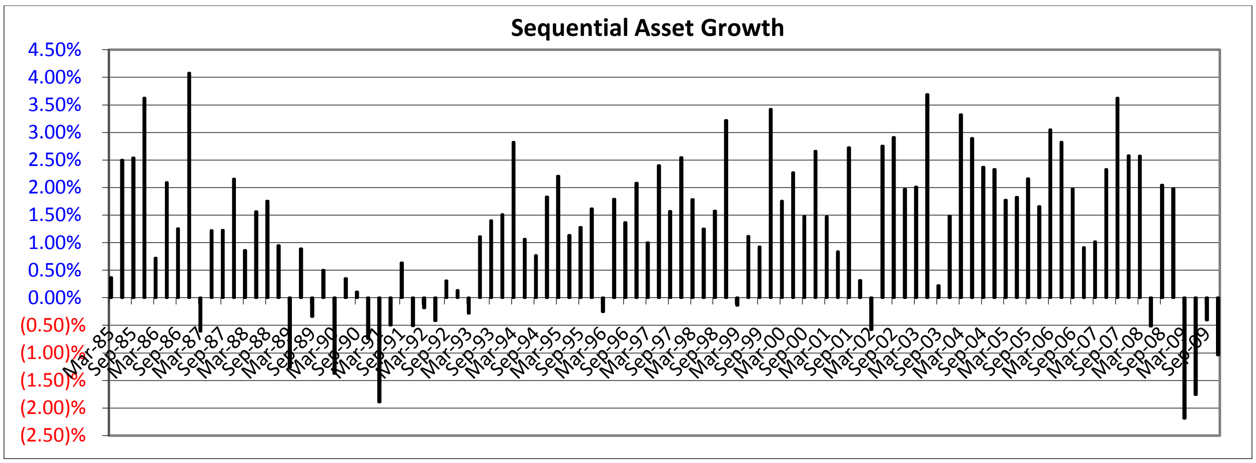
The Cost of Safety and Soundness

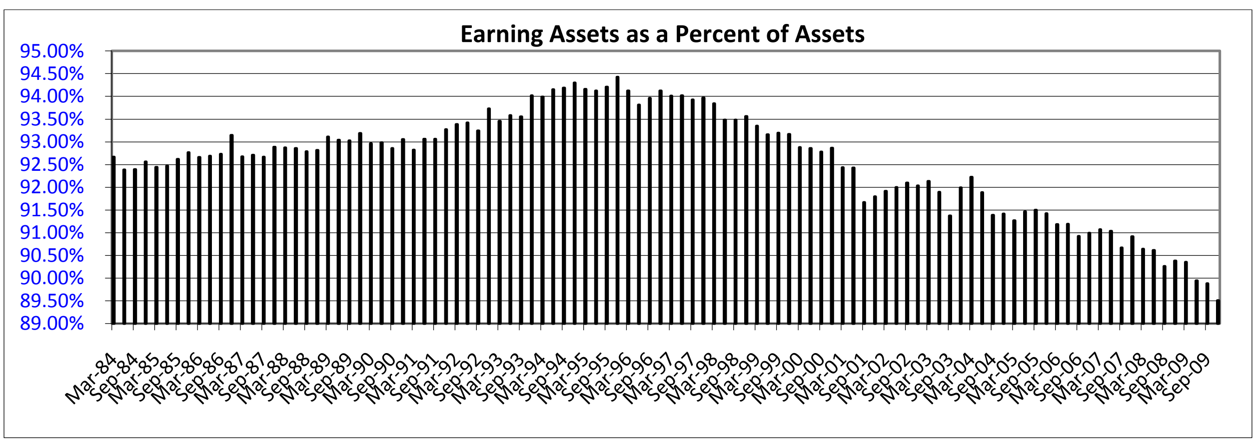
These actions have definitely increased the safety and soundness of the banking industry. They will hasten the return to a more normal loan loss write-off strategy. They, however, come at a high cost to the banking system. First, it is evident that if banks are to fund themselves primarily with capital and deposits they will have shut off access to the fastest growing funding source – i.e., the wholesale money markets. This will slow the growth of bank balance sheets.

If the government continues to seek even more capital in the system than there is today, and, at the same time, disallows a portion of existing capital, the banks will actually be forced to shrink their balance sheets. It is now believed that the standard of 8, 10, and 12 may be put in place by yearend. This means demanding 8% Tier 1 Common Capital, 10% Tier 1 Capital, and 12% Total Capital. The calculation of these ratios eliminates capital backed by intangible assets, which is foolhardy, since, as shown above, the non-interest income businesses of these banks, the acquisition of which generated the intangible capital, grows faster than the so-called tangible assets like loans.

Moreover, in these shrinking balance sheets, the banks must use more of the available funding to support liquidity. This means less money for loans. Going one step further, if the loans to be made are "plain vanilla" then these loans will offer lower yields.

All of these factors are showing up in bank balance sheets. Assets are shrinking. Earning assets are shrinking faster than assets and loans are shrinking fastest of all.





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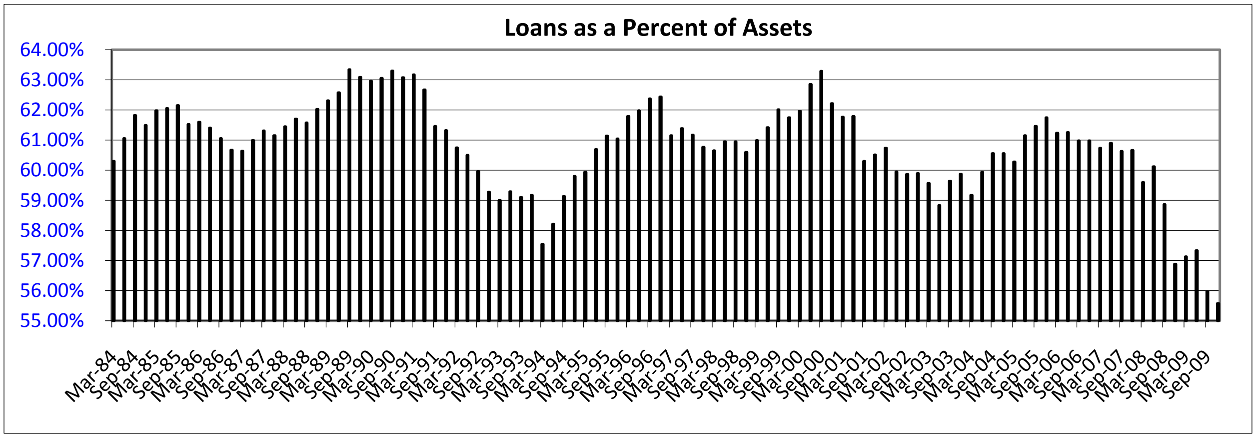

<u>Reduced Revenues and Distortions in the Market</u>

Government programs are distorting the markets; lowering banking revenues; and increasing the cost of running a banking institution.

Non-Interest Income

It was demonstrated above that the growth of non-interest income prior to the period from 2006 to 2009 had accelerated meaningfully. The conventional wisdom is that this growth was not stimulated by real demand but rather it reflected fraud, greed, and general dishonesty on the part of bankers. Therefore, measures have been taken, and are being contemplated, to prevent the bankers from becoming involved in these activities in the future.

- A bill reducing the flexibility in pricing in the credit card industry has been passed.
- Regulation E of the Federal Reserve has been adjusted to reduce bankers controls over pricing portions of their deposit business.
- It is contemplated that a new Consumer Finance Protection Agency will be put in place that may promulgate multiple rules to control banking activities.
- There are a series of proposals to reduce or eliminate proprietary trading.
- There is a desire to eliminate the private equity activities of the banks.

These actions are certain to reduce both the revenues and the profits of banking institutions. There is even the specter that some type of Regulation Q will be revived giving the government control over the rates banks charge for their services.

Non-Interest Expenses

While there are proposals in place, and being considered, which will reduce revenue generation by both shrinking bank balance sheets, and placing limitations on the revenues that can be earned from normal banking activities, other proposals are in place that will increase the cost of running a bank.

Forced programs to demand banks forgive bad loans are not only distorting the markets but they are causing banks to lose money. Additionally, simply the reporting requirements that are constantly being imposed on the industry will lower profits. The Bank Secrecy Act is a good example of how costly new government regulations can be.

Market Distortions

The government's actions in the mortgage markets are an example of how badly the markets are being distorted. Take for example the idea that banks reduce the size of loans on houses that are in default or have values less than the mortgages on these units. By reducing the outstanding loan, the government is explicitly indicating that those who may have cheated on their loan applications have a right to homes by paying less than the household down the street who is paying full value. This has the following anticipated impacts:

- It sets a double standard incenting people who own homes to default so that they can take advantage of the benefits of being a non-payer.
- It maintains housing pricing at higher levels than otherwise would be the case so that everyone who buys a different home must pay more than if the free market drove the prices to where real demand would be.

At some point, this problem gets unwound creating more losses and fewer opportunities for the banking system.

Business Lines

Based on these thrusts and looking at the overall markets, one can begin to separate those business lines that are unattractive, since they offer limited growth, from those that will be very attractive going forward. Basically, all consumer businesses are unattractive while all capital markets and commercially oriented programs are likely to be successful:

- Consumer Finance
  - The credit card business is saturated. It is rampant with price discounting to incentivize use. It is overlaid with government regulations that limit pricing flexibility.
  - The mortgage industry is now so subsidized by the government that no one can tell what real demands and real pricing are in this sector. This problem extends to housing which is in over supply, and heavily subsidized.
  - The home equity sector has shrunk by at least 30% as housing prices have tumbled.
  - The auto finance industry is likely to be co-opted once again by the auto companies once these companies regain their health.
  - The deposit sector is being hampered by Regulation E which is likely to eliminate the profits on a large number of bank accounts.
- Commercial banking
  - Inventory building and capital expenditures will increase as the economy recovers.
  - The need for payment services grows as the complexity of the markets increase.
- Capital Markets
  - Money supply continues to grow stimulating the growth of the shadow banking markets.
  - Underwriting activities will be stimulated by this growth.
  - The need for liquidity will stimulate trading.
  - The assets being created must be held somewhere.
- Record Keeping
  - The need to account for every transaction will increase the need for the services provided by the so-called wealth banks.
  - The increased sophistication of the markets will give the technologically advanced companies an edge in the markets.

Reshaping the Markets

Banking markets will change most dramatically in the consumer sector. The following is likely:

- Millions of bank accounts will be closed as bankers rid themselves of unprofitable accounts.
- Branches will be closed across the country and hours of operation will be cut back.
- Service will fall off as full-time employees are replaced by part-time workers.
- The price of all banking services, not specifically limited by the government, will rise appreciably – e.g., expect free checking to be replaced with monthly charges of $10 or more to maintain a bank account.
- Banks are likely to divest numbers of activities that are no longer deemed to have secular growth opportunities.

The capital markets sector will benefit in numerous fashions:

- As banks shrink the capital market companies will pick up their business.
- The opportunities internationally will dwarf those domestically and capital markets companies can gain these benefits.

- The overwhelming growth in money supply will provide myriad opportunities.
- The shadow banking market will return bigger and stronger than ever.

SUMMING UP

A review of the recent history of banking suggests that bank earnings could move sharply higher in the near term. This could drive all bank stocks higher in price. Longer term the industry will be reshaped by outside forces. Those companies that are allied to consumer finance are facing a difficult future. Those companies associated with the capital markets and commercial lending sectors are expected to do quite well.

Not mentioned above is the likelihood that the industry will return to a policy of paying out 40% in dividends. This will allow dividends to grow faster than earnings. It will return a segment of the industry to being public utilities with high yields.

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