

## **LIVE BY THE BANKS, DIE BY THE BANKS?**

By: Jeff Link

January 2010

Readers familiar with scripture will recognize this quote taken from the metaphorical expression in the Gospel of Matthew that says, "Live by the sword, die by the sword." I believe it is possible that the fate of the stock market could be in the hands of the banking sector. Why? Allow me to explain.

As all investors know, the year 2009 brought a tremendous stock market rally after the devastating losses that came in 2008. But what they may not know is that the rally that began in March of 2009 may have been a "manufactured" rally initiated in the banking sector. It was in March that the Financial Accounting Standards Board (FASB) caved in to political pressure to allow banks to mark their toxic assets to "mark-to-model" instead of "mark-to-market" values. In essence, if the bank had a loan that was not performing (the borrower was delinquent or even in default), the FASB allowed the bank to mark up the value of the loan to whatever the bank "believed" they would eventually receive in the future when the loan matured. As a result, the bank stocks rallied strongly on accounting adjustments - not due to improved business results. As most investors know, you don't make money from accounting adjustments. So where exactly did the money come from to pay the bonuses that resulted from these gains due to these accounting adjustments? The answer of course is likely from the government bailout and TARP. But that is a story for another day.

The bank stocks led this rally from March 2009 through September 2009, but since then their ascent has stalled. This could be due to any number of reasons, including simple consolidation due to the gains, or investor fears of the future impact on earnings due to the current administration's newly advocated policies. But what is of most importance is that the value of the assets on the books of many banks is not what is being reported. For example, Horizon Bank of Bellingham, Washington was the first bank failure of 2010. According to the FDIC, they had \$1.1 billion in deposits at the bank, and \$1.3 billion in assets, representing a difference of approximately \$200 million. Yet the estimated cost to the FDIC to close the bank is \$539 million. Come again? How can the difference between deposits and assets be \$200 million but it will cost the FDIC \$539 million to close the bank? This (along with every bank failure reported since) shows that the banks are far more insolvent than what the investing public is being led to believe. (Please note this does not necessarily mean deposits are at risk.)

Why should this interest you? First, what is being reported in the media is far different from reality. Every investor needs to recognize what they are told through TV and other media channels is not gospel. Second, consider lessons from history. In the "Roaring 20s," the auto industry was the leading sector that drove the economy for ten years leading up to the great crash. Once that sector stopped rising and rolled over, it wasn't long before the rest of the sectors of the economy followed in kind. While ten months of rally is a far shorter time period than ten years, the lesson should not be dismissed. A case can be made that if the banks are topping out, so may the rest of the market. Caution is warranted.

*Jeff Link, Vice President/Investments, can be reached at the Raleigh, North Carolina office of Stifel Nicolaus at (888) 825-6400. Stifel, Nicolaus & Company, Incorporated, is a member of the SIPC and New York Stock Exchange.*

*Past performance is not indicative of future results.*