Investment Strategy Update

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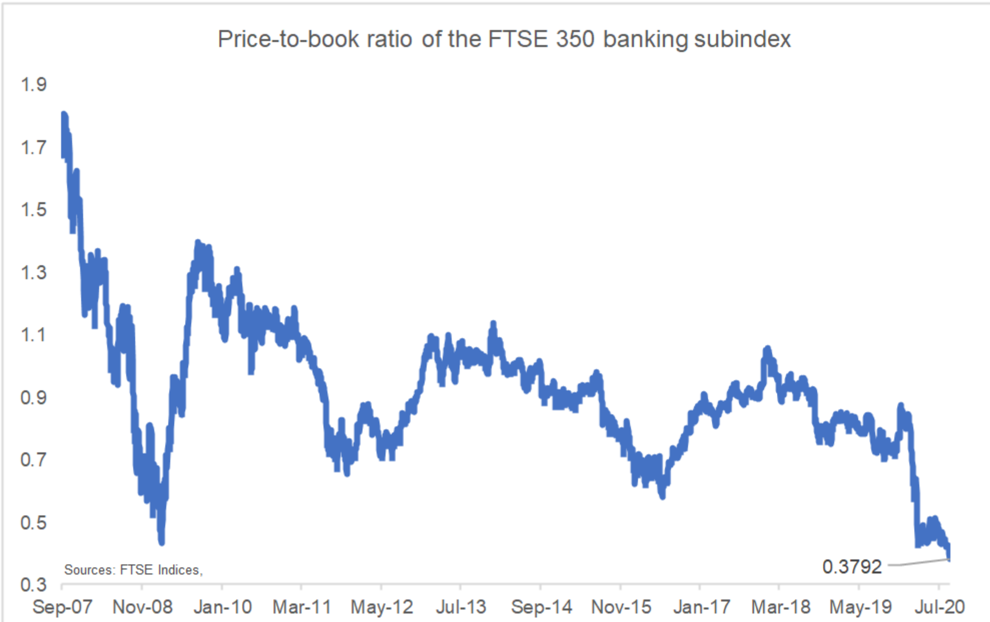
Bank balance sheets are mostly fine, but the sector is under fire

- **Bank stocks tank after news reports suggesting compliance issues at some of the largest financial institutions in the western world.**
- **Low-rate prospects add to the woes of the banking sector, as profit margins may be compressed.**
- **Lenders do not seem to have the same issues they faced during the 2008 -2009 financial crisis, but the sector is still one of the worst performers.**
- **Some of the world's largest financial institutions are being traded at a fraction of their book value.**
- **The FAB AAC remains underweight equities and overweight gold, though less so than in the second quarter.**



European and US banks still deal with the stigma of the 2008-2009 subprime crisis, when improper incentives to mortgage brokers in the US created a spiral that prompted one of the worst recessions in the modern history of the western world.

Since then, a lot has changed. Banks are required to hold much more equity against their loans, and a lot more liquid assets to avoid the chain of events that led to several large institutions failing in 2008. Yet, the sector is still being pummeled.

Today, the FTSE 350 banks subindex was down as much as 5.5% after a news report that suggested some large institutions had not curbed potential money-laundering activities fast enough. Curiously, the report is based on 'suspicious activity reports' obtained (illegally, according to the Financial Crimes Enforcement Network) by the journalists.

Such reports are actually an indication that these institutions were in fact acting on the suspicious activities, and informing regulators about them. It is part of a plethora of regulation to make banking safer implemented progressively starting in the late 1980s, after the savings and loans crisis in the US.

These facts are not enough to mitigate the sticker shock and the sell-off has been brutal. It also comes after a long period of underperformance. Financial stocks have only outperformed energy shares in the S&P 500, down 20.1% so far this year.

That can be partly explained by some fundamental reasoning. Banks are likely to suffer large losses from defaults and bankruptcies, though much of that has already been provisioned against and the latest estimates suggest default rates may not be as bad as initially assumed. Low rates also impact the profitability of lenders, as their profit margins drop.

The price-to-book ratio of the stocks in the FTSE 350 bank index is at the lowest ever

Some extreme values are appearing after today's sell-off and given the pummeling bank shares have received so far this year. Some of the biggest, most profitable banks in the world are trading at a fraction of the value of their assets. The average price-to-book ratio of the FTSE 350 banks subindex fell to 0.38 today, the lowest in the index's history. US banks are faring a bit better, with the same metric at 1.2 for the S&P 500 financials subindex.

Banks are not seeing their best days, but they are probably better placed to weather this recession than anytime in the past 50 years. Time will tell if that is the case and whether they were really so robust, but the current headlines and the reaction to them seem to be prompting extreme behavior.

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