

## Credit Losses:

# Daylight at the End of the Tunnel? Or an Oncoming Train?

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We're now well into the second straight year of underperformance for U.S. financial stocks, and the question on every investor's mind is, when is this all going to end? Memories of huge appreciation opportunities coming out of prior credit cycles have helped generate keen interest in this question. While it's difficult to answer it with any precision, we thought a look at recent history might provide clues as to how the timeline might unfold from here.

Historically, it has been difficult for financial stocks to outperform in the heart of a credit crisis: worsening credit losses tend to outweigh other factors when it comes to earnings results. This raises two pertinent questions:

- When might we expect losses to peak in this cycle?
- When might the markets anticipate the peak and begin to bid up credit-sensitive financial stocks in advance?

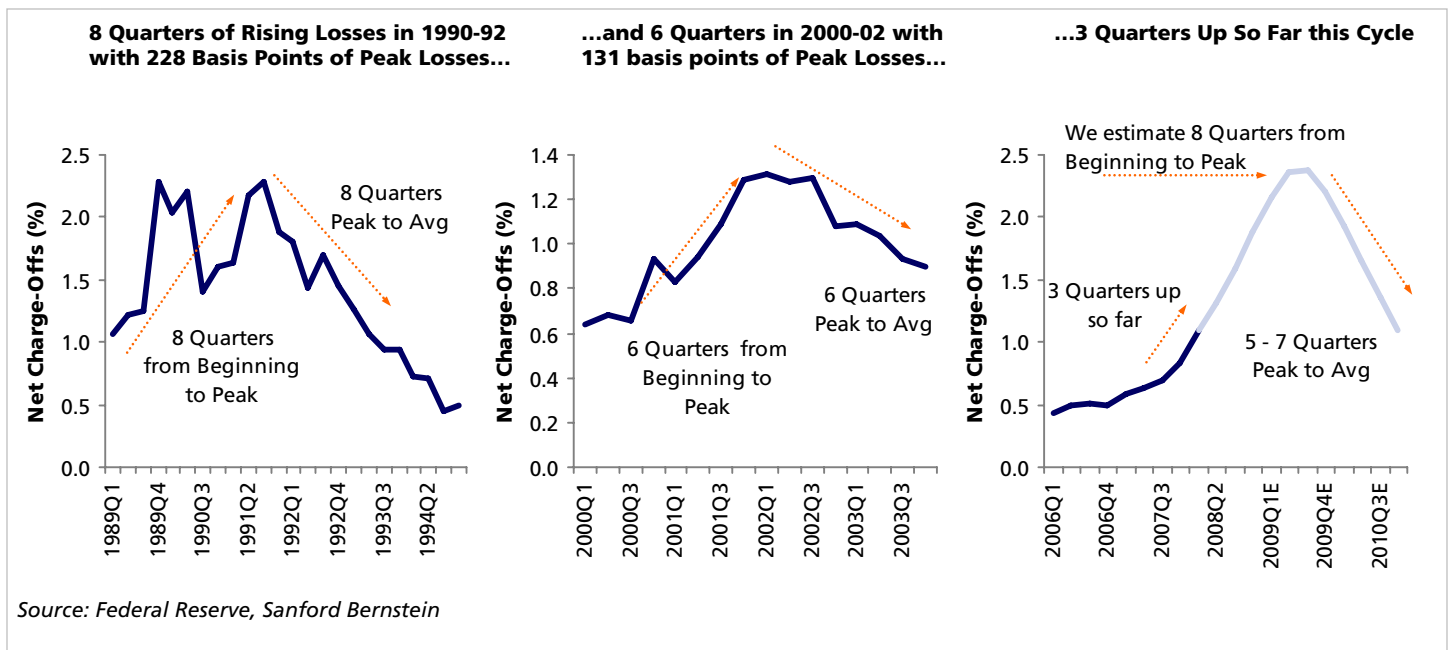
The last two major credit cycles were 1990-92 (a significant recession) and 2000-02 (post 9/11), with the former period being the more severe. What we observe in these cycles is roughly six to eight quarters of deterioration, measured in terms of rising bank loan losses (i.e. net charge-offs, or NCOs), and 12 to 16 quarters for the full cycle to run its course. This is illustrated in the first two graphs below, which are based on Federal Reserve bank data compiled by Sanford Bernstein.

As we are now three quarters into the credit deterioration, past cycles would indicate it could take another three to five quarters before we reach a peak in losses. We think the current cycle will be more like the longer contraction of 1990-92, given similarities in severity, the stress on bank capital ratios, and the major role played by declining real estate values.

Also supporting the idea that this will be a longer cycle is the fact that most credit losses so far this cycle have stemmed from a combination of poor underwriting and sharp declines in residential real estate, whereas the broader deterioration in credit that typically results from slowing economic conditions has only just begun. Thus we'd expect another five quarters, if not perhaps more, until peak losses are reached, which would put us into the second half of 2009.

So we move to the second question: when might the market start to anticipate the credit turn?

Unfortunately, the recent historical guidance here is less clear. In the cycle of the early 1990s, bank stocks bottomed and began recovering well *before* credit losses peaked, beginning to rise steadily a full year before the peak in credit losses. If this period were our model for the present, we would be led to conclude that the July rally in bank stocks was in fact the beginning of a move that might sustain itself (albeit in fits and starts) for the next few quarters at the very least.



However, the 2000-02 example is quite contradictory: rather than leading the peak in credit losses by a year as in the earlier cycle, bank stocks didn't bottom and begin to recover until credit losses peaked (i.e., just before the quarter when banks reported a decline in credit losses). If this period is our model, well... that would imply that bank stocks (and probably most financials) will continue to lag, or at best tread water, well into 2009 before a sustained rally could commence.

Which path will the stocks follow this time around? Our view is that credit-sensitive financial stocks will anticipate the peak in credit losses and bottom before that milestone is reached, especially given how well the "short financials/long energy" trade has worked. However, since valuations are not currently

as low as they were in 1990-92, we don't think the bottom in these stocks is likely to occur as far ahead of the credit peak as was the case in that cycle.

Given our view that a peak in credit losses in the second half of 2009 seems most likely, we believe any sustained move in the financials will likely be delayed until early – or perhaps mid – 2009.

The magnitude of broader credit deterioration in non-residential lending areas, which will depend largely on the severity of the current economic downturn, will be a key wildcard that could extend the credit cycle and push out the ultimate recovery. Given this uncertainty and our assessment of how the timeline might unfold, we are still exercising caution on credit-sensitive financials. ■