Zombie Banks
Mardjokic.com

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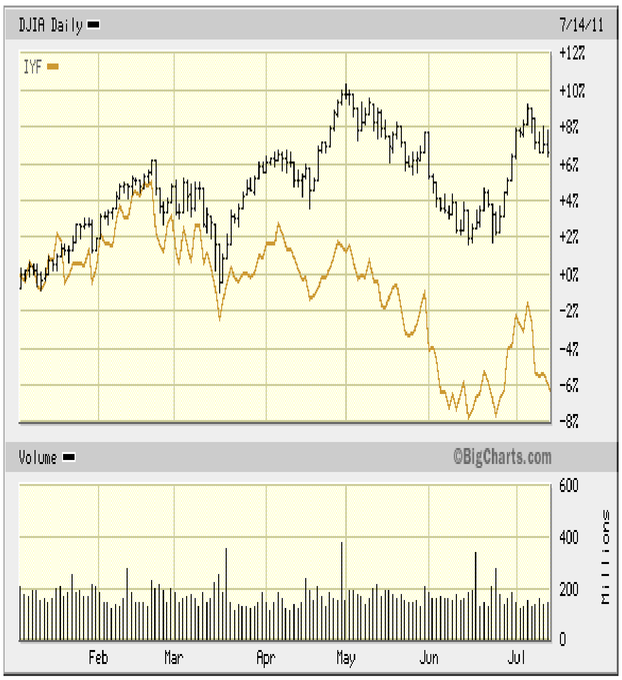
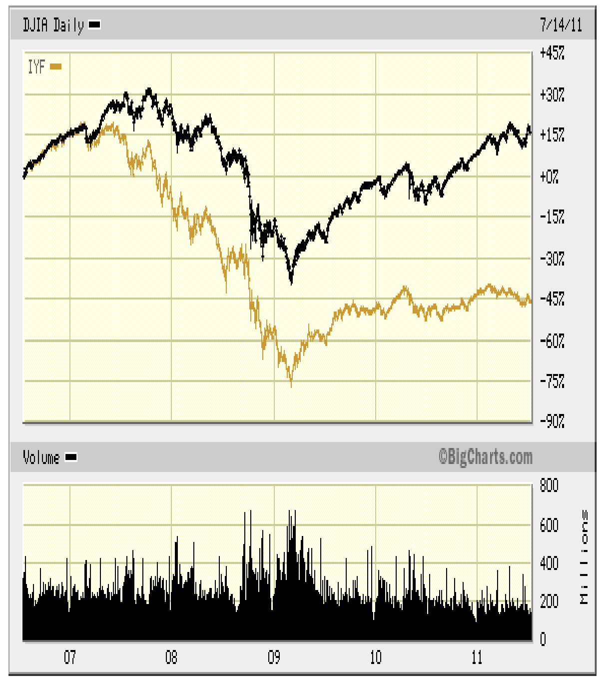
The financial sector has lagged the broader market throughout most of the recession and well into the recovery. Logically, this makes sense given the fact that they've been at the center of nearly every major market calamity over the past four years. It seems as if banks have a proverbial hole in their balance sheet that they just can't seem to fill. Quarter after quarter, we've seen write downs and bad press, and their stock prices have reflected this dismal performance.

YTD:



5 Year:



Source: Big Charts

Put the above chart in front of a contrarian and they might see 'opportunity': aren't we due for a 'correction'? After all, write off enough of a balance sheet and eventually you have a new one. But as much as I've tried to find the silver lining, I simply can't.

Short term, banks are dealing with the European debacle where contagion concerns and short CDS contracts seem to weigh heavily on their outlook. As if this wasn't enough, there are legacy loan books and continuing litigation claims that make valuing a bank's assets and ultimate liabilities very difficult. When markets don't know how to value an asset portfolio, they haircut it and move on. Better safe than sorry they'd say.

But what worries me the most are the longer term effects of increased public scrutiny and regulation. Already they've been forced to spin off their private investments, hedge funds, and their proprietary trading desks in the name of systemic risk. Layer onto this higher capital requirements, a subpar lending environment, and a mountain of new regulatory hurdles to overcome and I cannot help but wonder what ROE is going to look like going forward.

As regulation bears down on the banking sector I expect it to turn into a quasi-public institution, similar to a utility. A stable income base (bank deposits), heavy regulation, high entry barriers, and even lower leverage. For an industry predicated on levering up economic activity, the financial sector will be a shell of its former self (if regulators get their way).

That is not to say that bankers are incredible skillful at redeploying capital and finding innovative ways of making money and efficiently allocating capital. Already I have seen articles circulated that highlight the latest financial crazy: “commodity storage facilities”, principally metals storage. Instead of directly trading commodities, firms like Goldman Sachs, Morgan Stanley, and JPM have been buying up storage facilities to maintain some form of commodity beta. The alpha drivers of yesterday are not the alpha drivers of tomorrow.

Regulation will make certain of that. But when a regulator shuts one door, the bank always seems to find a window.