THE CARSON MEDLIN COMPANY
Investment Bankers

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BANK STOCKS: PERPETUAL BEARS OR EMERGING BULLS?

A Carson Medlin Research Whitepaper

EXECUTIVE SUMMARY

- Cycles in bank stock valuations are strongly correlated to general economic cycles
- Historical record: over the last 40 years, there have been:
  - Five major bank stock bear markets with lengths of 7 to 26 months, each of which began before, and in anticipation of, recessionary periods that followed
  - Five major periods of economic contraction (recessions) varying in length from 9 to 35 months
  - Four major bank stock bull markets varying in length from 5 to 9 years, each of which began before the end of the recession
- The early stages of every bull market was interrupted by a temporary "lull", lasting from 3 to 9 months with a 7-12% value correction, before the long-term bull market resumed
- Current trends:
  - The most recent recession of 19 months actually ended in June 2009
  - The last bank stock bear market ended and a new bank bull market began in February 2009
  - The new bull market went 14 months before experiencing a 6-month, 16% downturn from April to the present
- **Conclusion: the new bank stock bull market may have resumed a long-term, multi-year climb within the last 30 days**

INTRODUCTION

To talk to most bankers these days, one would probably conclude that the industry has been mortally wounded and that the shares of their companies are doomed to languish at dismally low, fire-sale level valuations permanently (or at least for the foreseeable future). Intuitively, our sense is that nothing in this world, including the financial markets, is permanent, so we decided to take a long-term, "multi-cycle" look at bank stocks by looking back at bull and bear markets over the last 40 years. We thought that by stepping out of the trees to view the forest from a long-term historical perspective, we might be able to better understand what has happened to the bank stock market during recent periods and get a glimpse of what might be coming next. In this paper we describe our methods for performing the analysis, reach some conclusions about the past, and speculate as to the future of the bank stock market and its implications for the banking industry.

The reader should note that the analysis that follows is strictly a technical one, dealing only with the correlation between national economic trends and movements in a general bank stock index. We have not, at this point, examined the fundamentals of bank performance (earnings, interest margins, asset quality, etc.) and correlated that with the economy. That is another analysis for another day. Besides, many others have written extensively on bank performance recently (ad nauseam). Frankly, our objective was to avoid that "sticky wicket" and simply infer investors' psychology from their historical trading patterns over a long period of time and a number of economic cycles.

Background & Method

The level of negativity and pessimism surrounding banks and their shares that began several years ago has been so intense that sometimes it feels as though it has always been this way. Those of us who are intimately involved with any particular industry on a day-to-day basis can become prone to believing that what has been going on recently represents permanent change in industry conditions, a belief that becomes more and more prevalent as negative markets drag on. However, as observers of bank stocks for several decades, we have noticed that the industry is notoriously, if not predictably, cyclical, much like the general economy. This has certainly been true since The Carson Medlin Company was founded almost twenty years ago in 1991. To make sure that the last twenty years is truly representative of the long-term, we extended our analysis of bank stock cycles back an additional twenty years to the early 1970s, the earliest date for which we were able to obtain consistently reliable indices that may be compared to current values.

Banks are a microcosm of the communities they serve, and their financial strength and performance generally reflects the economic well being of the customers who live there. In the last 40 years, the American economy has spent approximately 20% of the time in economic recession and about 80% in economic expansion. Over that time, there have been five significant periods of recession:

- November 1973 - March 1975 (16 months)
- January 1980 - September 1980 and March 1981 - November 1982 (35 total months)
- July 1990 - March 1991 (9 months)
- November 2000 - October 2001 (12 months)
- December 2007 - June 2009 (19 months)

In order to get a good visual representation of the overall economy and the business cycle, we measured quarterly change in real GDP. On the accompanying charts, GDP growth is represented by the green lines, and periods of negative GDP growth (recessionary periods) are shown as grey areas. Although it doesn't feel like it psychologically to many, the most recent economic recession technically ended more than a year ago when the American economy began to expand (or at least stopped contracting).

We also analyzed cycles in bank stock values over the 40-year study period. We chose to examine the behavior of the NASDAQ Bank Index, a measure that has been consistently computed since at least the early 1970s. Over the last 40 years, the NASDAQ Bank Index, measured on a monthly basis, declined approximately 39% of the time and increased in value 61% of the time.

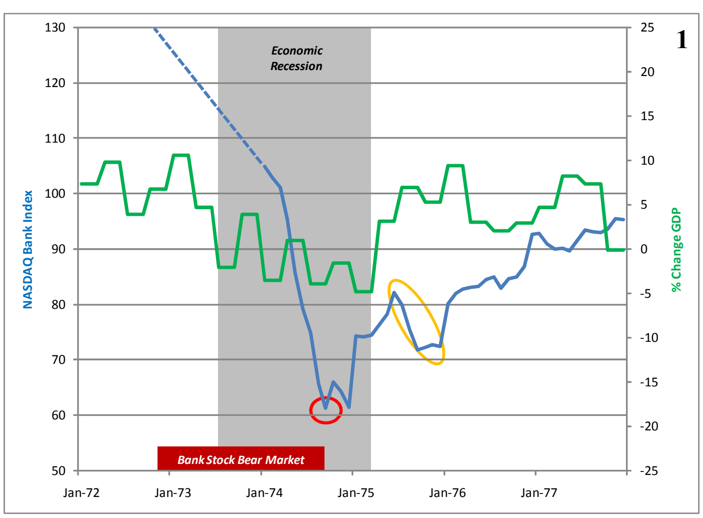
Over the 40 years, there have been five significant periods of extended decline in bank values (that is, "bear markets"):

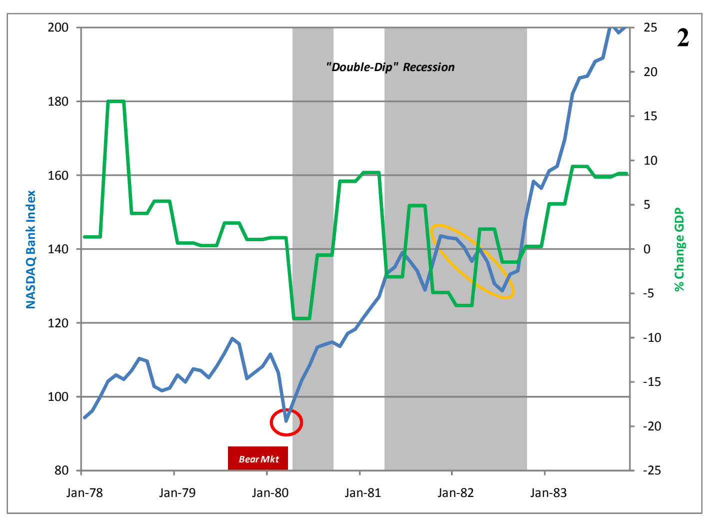
- January 1973 * – September 1974 (20 months)
  (Starting date estimated using previous indices such as the now defunct Salomon Brothers bank stock index)
- August 1979 – March 1980 (7 months)
- August 1989 – October 1990 (14 months)
- April 1998 – February 2000 (22 months)
- December 2006 – February 2009 (26 months)

Over the same period, there have been four significant periods of extended increases in bank stock prices ("bull markets"):

- September 1974 - August 1979 (59 months)
- March 1980 - August 1989 (113 months)
- October 1990 - April 1998 (90 months)
- February 2000 - December 2006 (82 months)

We begin the detailed analysis with a discussion of the historical business cycles in chronological order, followed with brief comparisons of various recessionary and expansionary periods, and then use those results to put recent events in a broader historical context. Finally, we give some thought to what this means for the future of bank stocks in both the short and long-term.





Detailed Examination of Five Historical Cycles

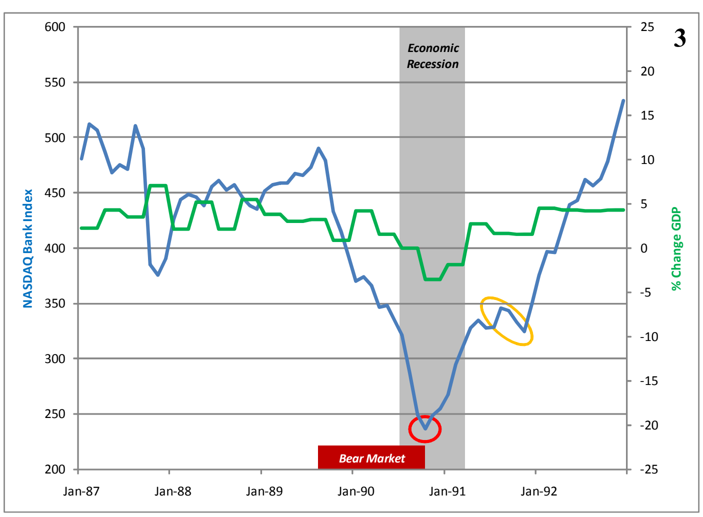
One: While we were only able to plot our bank stock index back to January 1974, we used other available information, such as an old, now defunct Salomon Brothers bank stock index, to extend the estimated trend back to January 1973 in order to compare bank stock trends to the recession of the early 1970s (See Chart 1). From January 1973 through September 1974, the NASDAQ Bank Index dropped from an estimated 130 to 61, or 53%. The period of extended negative GDP growth, or recession, began in the 3rd quarter of 1973 and ended in the 1st quarter of 1975. In this cycle, the bear market in bank stocks preceded the recession by approximately one year, and began to rebound 3-4 months before the end of the recessionary period. After hitting their low in 1974, during the recession, bank stocks experienced a **5-year bull market in which the index increased 90%**. We also note that **9-12 months into the recovery** and subsequent bull market, there was a **6-month lull** in bank stocks, where the index briefly **fell 12%** before resuming its climb.

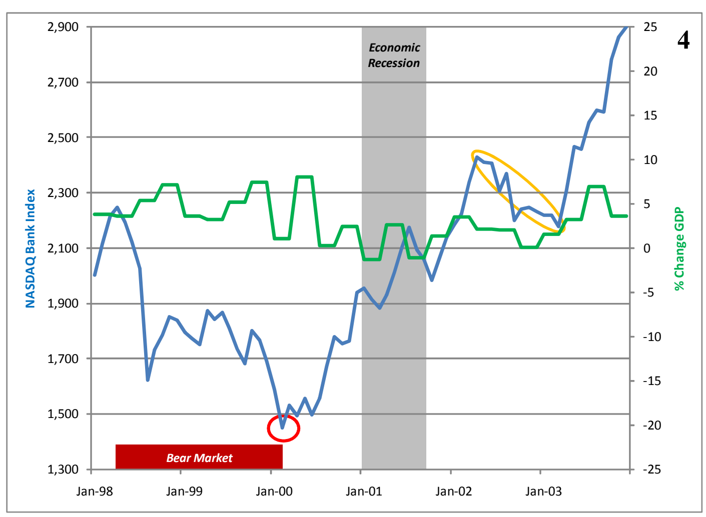
Two: The next major shift in the direction of bank stocks was a 19% decline from August 1979-March 1980 (see Chart 2). This event, the first meaningful decline of this size since before the previous recession, also preceded the next significant recession, or rather pair of recessions, otherwise known as the "double-dip" or "W-shaped" recession of the early 1980s. Even in this more unique case of the double-dip recession, we see a similar pattern of bank stocks beginning their decline before the first recessionary quarter (approximately 7 months before, in this case) and beginning their recovery before the end of the recession. After the March 1980 low point in bank stocks, the index began an extended, 9-year long bull market. We note that about 18 **months** into the rapidly recovering bank stock market, the index again experienced a statistically significant lull, in this case a **10% decline** that lasted approximately **8 months**, before the bull market resumed. Throughout the 1980s, bank stocks enjoyed **a nearly decade long bull market** (the longest during our 40-year study period), where the index **rose 281%**. This figure is even more impressive considering the time period was marred by Black Monday (October 19th, 1987), which led to a 21% decline in the bank index during that month alone.

Three: Notwithstanding the events of Black Monday (which did not coincide with economic recession), the next significant, long-term shift in the overall direction of the bank index occurred from August 1989-October 1990 (see Chart 3). During this 14-month period, bank stocks declined 52%. Approximately one year after the beginning of the decline in bank stocks, the US economy experienced its next recession, this one lasting from July 1990-March 1991. Once again, bank stocks hit their low point before the end of the recession (in this case five months before), and then began another sustained bull market, this one being the most dramatic of any we have seen. **Over the next 7 years, the bank index skyrocketed 848%.** Importantly, even in this roaring bull market, we see again that about **9 months into recovery**/bull market, there is a **3-month lull** where the index temporarily **declined 6.5%.**

Four: After the great bank bull market of the 1990s, the next significant decline in bank stocks was from April 1998-February 2000, when the bank index fell 35%. As in the all of the previous bear markets we have so far discussed, the bank decline preceded the next economic recession in 2001 (this time by over two years) and the subsequent recovery and next long-term bull market also began prior to the end of the recession (see Chart 4). Once again, we noticed the recurring trend of a significant lull in the index relatively early in the bull market, this time a little more than **two years in,** when the **index dipped 10%** over **9 months,** before resuming its climb. This subsequent bull market, beginning with the low in early 2000, was destined to become the third consecutive one to last at least 7 years. **Over this period, the index increased 136% and reached its all time record high in December 2006.**

Five: December 2006 also began the next, and most recent bank stock bear market, which has been the steepest during the 40-year study period. From the beginning of 2007 through February 2009, the index plummeted 59% (see Chart 5). The familiar pattern of recession trailing the beginning of





the bank bear market recurred once again, with the onset of recession lagging the bank's decline by exactly one year.

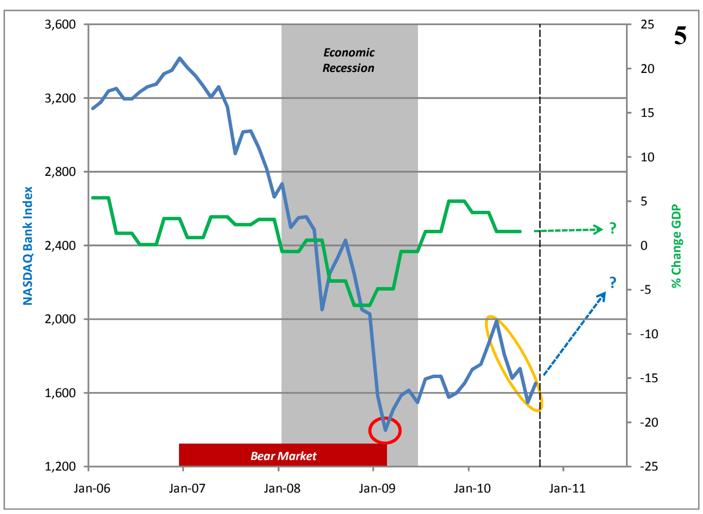
This brings us to the most recent performance of bank stocks, which we will discuss in a moment. First, lets briefly summarize what we've just analyzed regarding the relationship between bank stocks and economic recession. Since 1970:

A. Bank stock bear markets have preceded every economic recession
B. Every bank stock bear market was then followed by economic recession
C. Bank stock bear markets have consistently begun their recovery and subsequent bull market before the end of the recessionary period
D. The bank stock bull markets that follow tend to be extended, with the shortest lasting approximately 5 years and three out of the four lasting 7 years or more
E. All previous bank stock bull markets have experienced some sort of statistically significant, but temporary, dip early in the cycle, averaging approximately a 10% decline and lasting around 6 months

The Current Cycle

After reaching a low point in February 2009 (four months before the end of the recession), bank stocks began to recover considerably, increasing 42% over the next 14 months. Most recently, the index has experienced a 6-month downturn, having declined approximately 16% since April.

This is where we are now: (i) in a significant 6-month lull in bank stocks (ii) after 1-2 years of rapid recovery (iii) following an economic recession (iv) that was preceded by a bank stock bear market. Does this pattern sound familiar? It should, because it is the same sequence we have seen in every economic cycle since 1970.



What happens now? Well, in every historical case we examined, **while post recession bank stock recoveries all tend to temporarily falter early on, they have always resumed as long-term significant bull markets.** To be plain, we are saying that, unless the current environment is so unique as to suggest that comparisons to previous business cycles, no matter how statistically similar, are irrelevant, then **we are already in the next bank stock bull market, and it began in 2009.** To those who would say "yeah, but this time its different", we would ask "*what's* different?" While all bull and bear markets have unique triggers/catalysts, and all business cycles have unique economic and political environments, they are exactly that, ***cycles.*** To those who would say the sheer scale of the most recent downturn renders historical comparisons meaningless, we'd point out that during the two recessions most statistically similar to the recent Great Recession, namely the recessions of the early 70s and the early 90s, the associated bear markets saw bank stocks decline 53%, and 52%, respectively, vs. 59% in the most recent bear market. So, **while the recent bear market was unquestionably severe, it was hardly unique.**

Conclusion: Where We Are Headed

When can we expect the current bull market to resume? It may already have. While the length of the early bull market lulls has varied somewhat, they have averaged approximately 6 months, and we are currently 6 months into this one, which would suggest that the resumption should be imminent.

We feel obligated to point out that in the increasingly unlikely event that the US economy falls back into recession (a "double-dip"), the historical trends we have analyzed here would suggest that bank stocks would be in for another round of considerable declines, and as the bank stocks lead the recessions, we would expect to start seeing that very soon.

However, in finishing this piece, we can't help but notice that since the end of August, the NASDAQ Bank Index is up a whopping 8%… so, here's to the end of the early bull market lull and the resumption of a strong, upward movement in bank stock valuations that may last for many years! Does that mean that we are saying bank stocks will go up tomorrow? Of course not (although as we have learned they do better than 60% of the time), but if we were betting men, and everyone is in our industry, unless we're in for a double-dip, this would certainly be the time to consider doubling down. Optimistic? Perhaps… but if there is one thing we have learned from studying bank stocks and the business cycle for decades, it is that history has this stubborn habit of repeating itself.

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