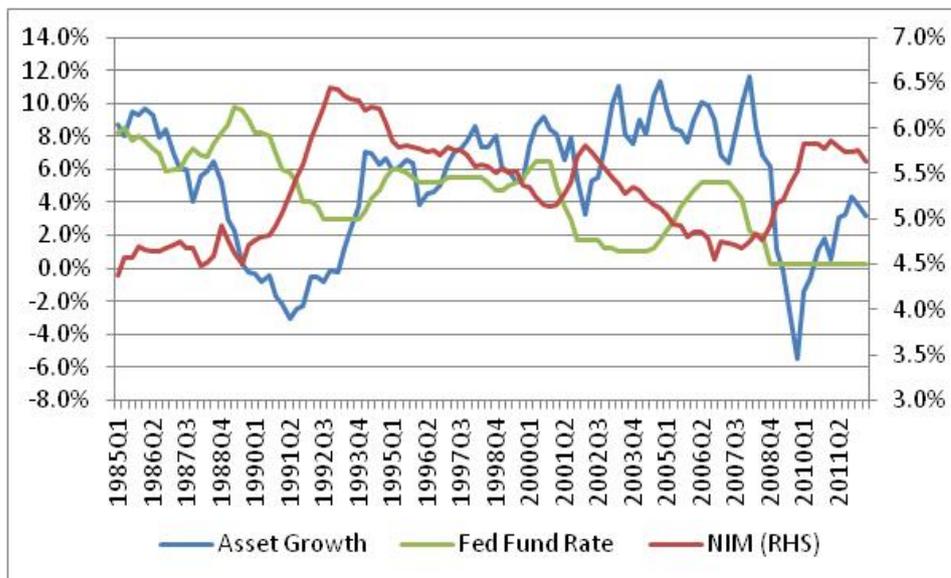


THE PROBLEM WITH US BANKS



Recent data from the US has been encouraging, with levels of home sales increasing and share prices of homebuilders performing very well recently. Typically such moves would lead investors to expect domestically focused banks to do well, as an improving housing market leads to reduced loan losses and increased loan growth. Unfortunately, data from the FDIC paints a different story.

Banks make most of their money through charging a spread. To put it simply, they take in deposits at a low rate, and then lend it out at a higher rate. The spread they earn between deposits cover their operating costs and should also be used to generate capital to cover any future losses on loans.



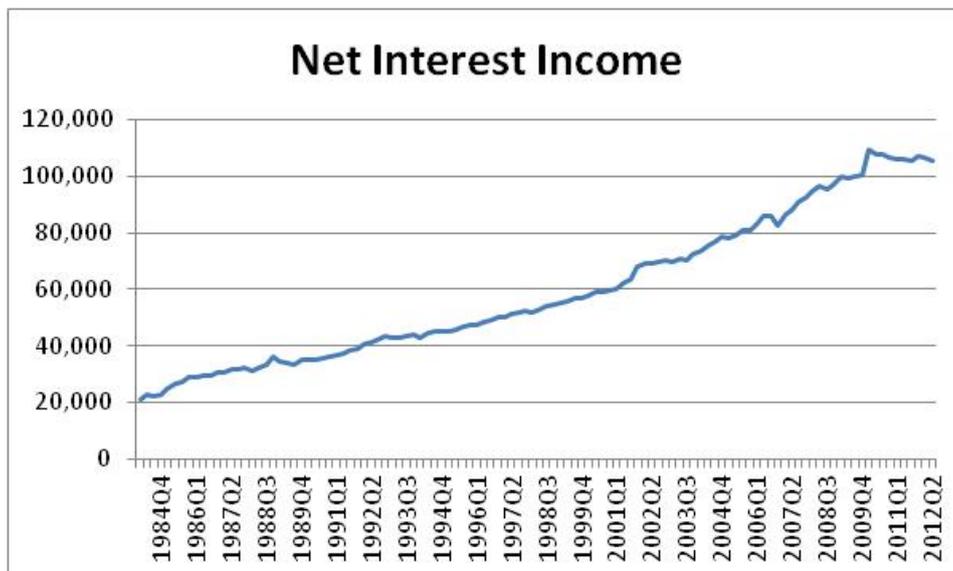
Typically, in a recession, asset growth goes negative for banks, but net interest margins rise as the Federal Reserve slashes rates, and banks are very quick to pass on lower interest rates to deposit holders, but are tardy to cut lending rates. As loan growth returns, net interest margins are reduced as the Federal Reserve normalizes rates.

As we can see from above the graph, the recent recession saw a brutal contraction in asset growth with only tepid growth since then. Due to the low growth, the Fed Fund rate has stayed at zero, but intriguingly we are beginning to see a gradual contraction in the net interest margin (see the red line in the graph above).

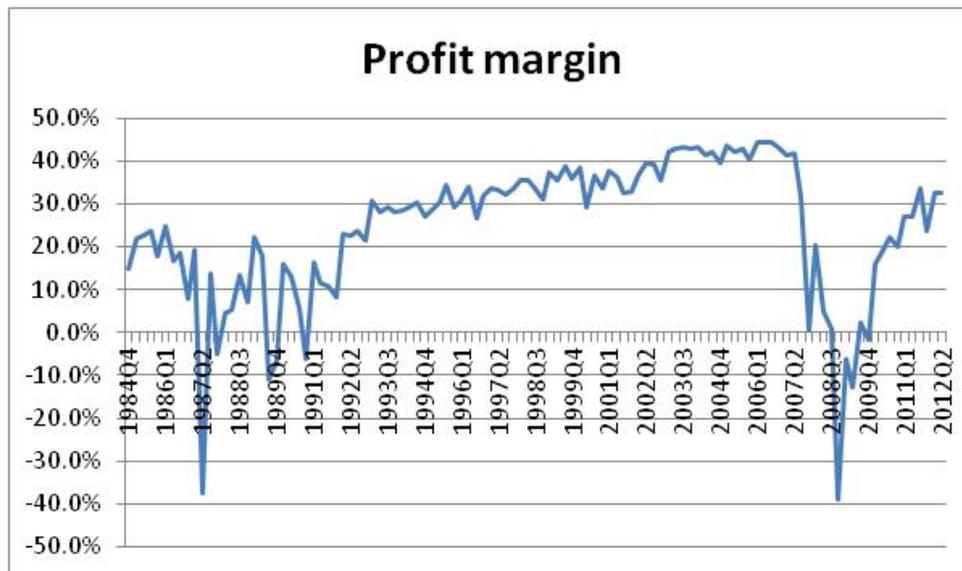


One way to see the problems of the US banking system more clearly is to take the net interest income of the banking sector and divide it by total assets to calculate the asset base yield for banks. As we can see here it has been steadily declining for years and generally follows the yield on the US 10 year treasury. Given the recent move lower in 10 year bond yields, we should expect the asset base yield on US banks to move lower.

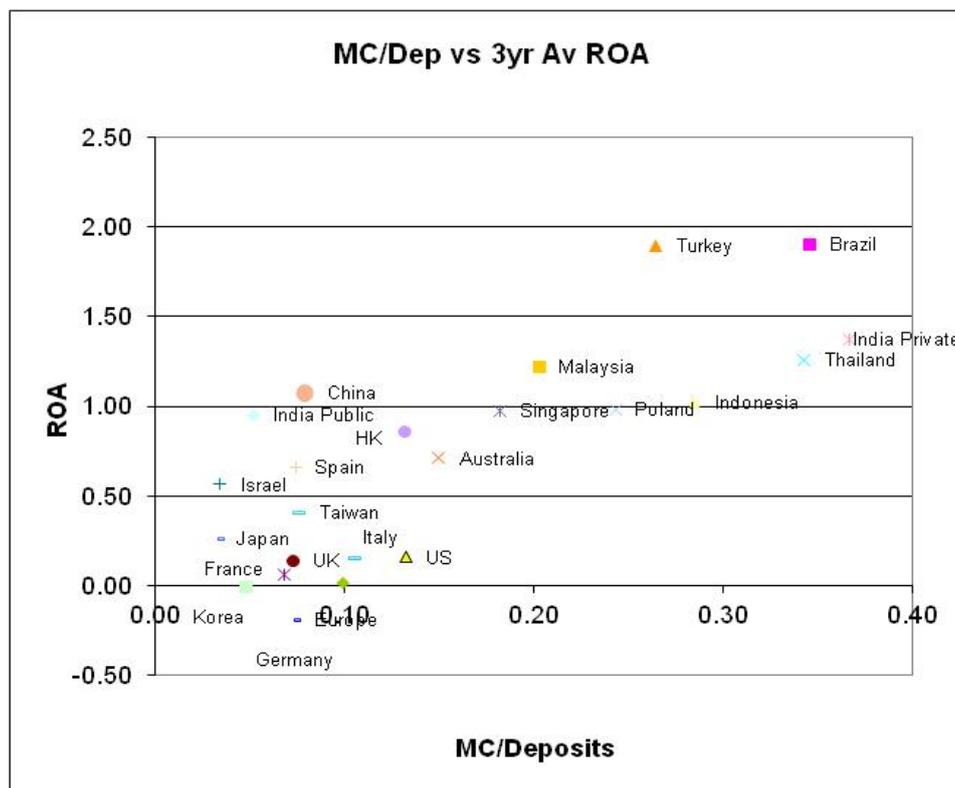
In concrete terms, lower yields and low loan growth mean that interest income accruing to US bank industry is not growing.



As can be seen above, total net interest income to US banks is beginning to decline. Unless we see a change in the interest rate environment or an increase in loan demand, stagnant net interest income would be the best possible outcome for US banks, with the chance we might see net interest income decline.



Banks in the US could continue to post profit growth if margins continue to increase. On an aggregate basis I like to look at net margin as a percentage of net interest income. While it does potentially oversimplify banks earnings, it does provide a fairly good idea of whether we are closer to a top or bottom in bank profitability. In my view it looks like we are closer to a top than a low.



As can be seen above, bank industries tend to have a market cap to deposit ratio that is closely related to its return on assets. Current ratios for US banks (at around 13%) put it on a par with countries that have faster asset growth and higher interest rates. In other words, the markets seem to be pricing a brighter outlook than what current bond yields imply. To me US banks offer a good risk reward as a short.

INFORMATION

Issue Date: September 2012
Source: Bloomberg, unless otherwise stated
Investor Relations: Samantha Dunn
Email: info@russellclarkim.com
Telephone: +44 (0)20 7838 7580
Website: www.russellclarkim.com

Business and registered address: Russell Clark Investment Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

DISCLAIMER

This Market View has been prepared and issued by Russell Clark Investment Management Ltd (the "Firm") authorised and regulated by the Financial Conduct Authority. It has been approved as a financial promotion by the Firm and as such is intended **for professional clients and eligible counterparties only and is not intended for retail client use**. It is not intended for distribution to any country where such distribution or use would be contrary to local law or regulation.

This Market View is provided for information purposes only and should not be regarded as an offer to buy or sell any investments or related services that may be referenced herein. No guarantee is made as to the accuracy of the information provided which has been obtained from sources believed to be reliable. The view expressed in this Market View are the views of the portfolio manager at time of publication and may change over time. Nothing in this Market View constitutes investment, legal tax or other advice nor is it to be relied upon in making an investment decision. No recommendation is made positive or otherwise regarding individual securities mentioned herein. Past performance is not indicative of future performance. The price of investments can go up as well as down and can be affected by changes in the rates of exchange. The information contained in this document is strictly confidential and is intended only for the use of the person who has been provided the Market View by the Firm. No part of this Market View may be divulged to any person, distributed, resold and or reproduced without the prior written permission of the Firm.

Where "forward looking" information, including estimates, projections and subjective analysis and judgement are provided no representation as to the accuracy of such projections or estimates or that they may be realised. Certain assumptions used in formulating such "forward looking" information may differ materially from actual events or conditions.