Philequity Corner (December 3, 2007)
By Valentino Sy

Changing Tides, Changing Fortunes

Last week, our article "Will History Repeat Itself?" presented a table of the similarities between the 1990 Savings & Loans meltdown and the present sub-prime crisis. True enough, the repeat of history continues. The Middle East comes again to the rescue of Citigroup & the Fed is poised to cut the fed funds rate on December 11. This, in turn, will turn the tides of the sagging fortunes of Citigroup and the US financial markets.

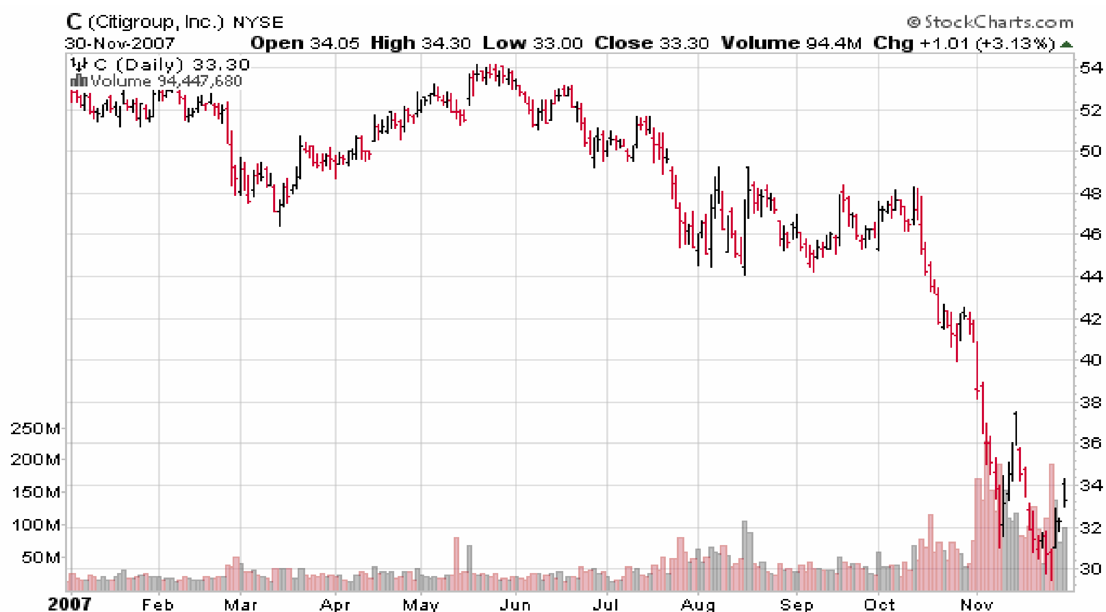
History, indeed, repeats istelf

In 1991 Prince Alwaleed Bin Talal came to the aid of Citigroup with $590 million when the bank was in dire need of cash due to losses in Latin America and the collapse of US real estate prices during the Savings & Loans crisis.

Fast-forward 2007, Citigroup again is facing huge erosion in capital due to losses in sub-prime mortgages. Its CEO, Chuck Prince, has resigned after the bank announced write-offs amounting to $8 billion to $11 billion. The stock has also fallen as much as 46 percent since the start of the year.

This time, however, it is Abu Dhabi Investment Authority (ADIA) who is coming to the rescue with a $7.5 billion cash infusion. ADIA will purchase convertible preferred shares yielding 11 percent a year which is higher than the average junk bond yield of 9.5 percent, underscoring the bank's immediate need for cash. In addition, the investment can be swapped to as many as 235.6 million Citigroup common shares (or equivalent to a 4.9 percent stake in the bank) starting March 2010 to September 2011 at prices ranging from $31.83 to $37.24. After conversion, ADIA will become Citigroup's largest shareholder, ahead of Prince Alwaleed's current 4.4 percent stake.

ADIA's investment should help stabilize Citigroup which has lost around $124 billion in market capitalization since the start of the year (see chart below). It will also help the bank reach its goal of returning to its target capital ratios by 2008.



Interestingly, both bailouts of Citicorp came from Arab funding at a time when oil prices was surging to record highs. In both instances, the US was reeling from a real estate collapse, plummeting bank shares and threats of bank failures. History, indeed, repeats itself.

The cat is out of the bag

Meanwhile, remember what we said last week that "we are sure that the Fed will continue to cut rates until a recession is averted." Well it looks like the cat is out of the bag. Three Fed officials, in separate statements last week, signaled a rate cut in the coming Fed meeting on December 11.

Fed Chairman Ben Bernanke reinforced our view when he said in a speech that the economic outlook has become more uncertain, requiring the central bank to be "exceptionally alert and flexible." Vice Chairman Donald Kohn added that the degree of deterioration over the last couple of weeks "is not something that I personally anticipated." Meanwhile, St. Louis Fed President William Poole said on Friday that he would not let concerns about "moral hazard" prevent him from advocating further rate cuts.

From their statements alone, it is almost certain that Fed will cut its fed funds rate by 25 basis points. Moreover, based on market expectations on fed funds futures, there is also an increasing chance that they may cut the benchmark rate by half a percentage point.

A contrarian view – buy the banks

During the US Savings & Loans crisis, banks saw their shares under severe pressure, many went bankrupt and even Citibank was thought to be a candidate for failure. However, the height of that crisis which also coincided with aggressive cuts by the Fed would have been the ideal time to buy shares of strong banks just as Prince Alwaleed did. Not only did it make billions in profits for Alwaleed but moreover, it marked the beginning of the great US bull market of the 1990s.

Lessons can be extrapolated from that time to the present day. Most investment banks have recommended an underweight or a sell on US banks because of their deteriorating assets, further equity write-downs and a dim outlook on their 2008 earnings. However, we have a contrarian view. Looking at the chart below, if one is to hold two to three years or even longer, now is probably the best time to buy.

Citigroup Weekly Chart (1987 to present)

Source: www.bigcharts.com

One should buy when everything looks bleak and not when everything is rosy. We would recommend buying into banks like Citigroup, Bank of America, Wells Fargo, JP Morgan. In fact, Warren Buffet has been buying Bank of America, Wells Fargo and US Bank. Buying at these levels now would be buying at even cheaper prices than Warren Buffet paid for.

In the Philippine context and if one is constrained in buying only Philippine stocks, we recommend buying into blue chip Philippine banks with high trading liquidity like Metrobank, Bank of Phil. Islands and Banco de Oro and RCBC.

Thursday's panic – a buying opportunity

The panic in the markets because of the Peninsula incident last Thursday should be viewed as an excellent buying opportunity. We were poised to buy following the 331 point rally in the Dow Jones Industrial Average on Wednesday. Luckily, the incident gave us a chance to buy at cheaper levels.

We have always contended that political events (while they may cause knee-jerk reactions in the market) tend to be filtered out in the long-term. What's more important to us are economic fundamentals, i.e. the Fed moves to avert a US economic slowdown, the Philippine GDP figures, and the country's budget and current account balances.

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