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JPMorgan — the problem with warehouses

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Pacific Investment Management Co. LLC CEO Bill Gross put forth the investment thesis in early 2009 that investors should shake hands with their new partner, Uncle Sam. JPMorgan Chase & Co. did so in 2008 when it (a) acquired Bear Stearns with a $30 billion backstop from the Federal Reserve; (b) acquired Washington Mutual Bank from the FDIC for $1.9 billion; and (c) took $25 billion of TARP when it did not need the capital. The fallout continues today.

Wall Street does not seem alarmed about the size of the settlement talks between JPMorgan and the Justice Department for unspecified mortgage sins. Settlement discussions presently are around $11 billion. JPMorgan's shares are up 3.2% the past month through Sept.27, compared with a 1.1% increase for the SNL Bank Index. While most analysts may designate the outlay as non-recurring, I think there are several valuation implications for equity and debt investors that transcend the non-recurring nature of the matter.

The intersection of banking and national politics is not a new phenomenon. Until the balance of power shifted to governments and central banks in the 20th century, private banks were instrumental in financing kings' and governments' wars, business interests and other endeavors. Through the 19th century banks held the upper hand. While still wielding considerable power, the large banks are becoming a honey pot for politicians. Plus, central banks have assumed the role of government financing in the U.S., Japan and elsewhere.

Who knows how much of the pending fine JPMorgan will pay was because Jamie Dimon did not play nice with Washington in 2009 and 2010 when Dodd-Frank and the Volcker rule were being crafted. Washington may subtly demand a fresh start with JPMorgan, which may require a leadership transition as occurred at Bank of America Corp.

Along similar lines, JPMorgan's massive fine has the feel to me of a windfall profits tax in addition to political retribution. In 1980, Congress approved and President Carter signed the Crude Oil Windfall Profit Tax Act in an effort to tax "windfall" profits producers realized as a result of the spike in oil prices during the 1970s. As far as I know, Washington never considered taxing itself for its policies that probably contributed to the spike.

For JPMorgan and other Wall Street banks, the Federal Reserve's successful effort to inflate asset values has produced something akin to a windfall in that tens of billions in credit and market losses that would have been incurred were avoided. The Fed's policies also revived animal spirits on Wall Street, which especially benefited fixed income trading and underwriting. A massive mortgage fine extracts some of the lagniappe profits, though the biggest beneficiary of the Fed's zero (short) rate policy is the world's largest debtor, the U.S. government.

From an operational perspective, the pending fine points to the importance of due diligence. We do not know yet how much of the fine relates to mortgage activities conducted by JPMorgan versus contingent liabilities that were assumed with the acquisition of Bear Stearns and Washington Mutual Bank. Over a decade ago I heard banking attorney Rodgin Cohen comment that if M&A due diligence was an animal, it would be on the endangered species list as a result of a number of poorly executed deals in the late 1990s.

Today, investors in small and mid-cap banks are focused on M&A as a means to grow earnings in an environment where there is little revenue growth and credit leverage has run its course. It should not be lost on investors that M&A entails risks — especially when a transaction is structured as a stock purchase rather than an asset purchase. No doubt JPMorgan spent a lot of time in 2008 evaluating contingent liabilities; however, there probably was not much contemplation of the liability the government has alleged through a series of investigations. In its haste to construct a deal for Bear Stearns, attorneys may have overlooked exposure the company had in guaranteeing all Bear Stearns trades for a year. Bear Stearns used the oversight to increase the initial deal to $10 per share from $2 per share.

As for the $11 billion fine JPMorgan is facing, press reports imply that management may be willing to pay more if it can settle other investigations and lawsuits that are being brought by a bevy of federal agencies and state attorney generals. Quarterly pretax earnings have ranged between $7.0 billion and $9.3 billion the past five quarters. So maybe a settlement would amount to two quarters of pre-tax earnings. Perhaps that is a small cost to put a government liability in the rearview mirror.

But I think the Street will be off base in ignoring it just because it would represent a non-recurring charge or because the Street is focused on 2014 earnings and earning power. At the very least, the fine will slow the return of capital to shareholders. The company's Basel III leverage ratio was 4.7% at June 30, compared to the 5.0% "well capitalized" minimum. From an earning power perspective, the after-tax loss of $7 billion of equity translates to $700 million of annual earnings and $7 billion of market cap assuming 10:1 leverage, an ROA of 1% and a P/E of 10x.

Maybe that is not much in the context of a market cap of just under $200 billion and upwards of $25 billion of earning power that the Street and management have assigned to JPMorgan. But the mortgage issue and contingent liabilities more generally point to the opaqueness of bank earnings. Most surprises for banks tend to be negative — especially in the aftermath of M&A. Losses can be as high as 100% of a loan, but earnings are limited to a coupon less the cost to finance the loan.

Banking is in a period of retrenchment following 35 years of expansion and innovation that roughly coincided with Nixon's closing of the gold window in 1971, introduction of the cash management account by Merrill Lynch in 1977 and the subsequent explosion in the shadow banking system. P/Es are highly correlated with expected earnings growth. Issues like the Justice Department investigation, Dodd-Frank and Basel III that curtail profitability are not one-offs and have significant valuation implications.

As I have noted in the past, there is a warehouse element to bank earnings. If a gain is needed to offset a charge, management can send a forklift into the warehouse that is a bank's balance sheet to find a bond or other asset to sell whose market value is above its cost basis; or, excess reserves can be released if they exist. This financial leverage inherent in the banking model and weak growth prospects are the reasons I believe most banks, and especially large banks, should trade at a discount to the broader market other than when credit spreads are undergoing a period of sustained narrowing. And that is not to say bank shares cannot continue to be great investments, but investors have to buy the shares right as growth that drove earnings the past three decades will be harder to realize unless the environment changes.

On the other hand, the outlook for investors in bank debt from a credit quality perspective is very good, with the caveat that bank debt has experienced a huge rally the past four years. This is not because Inspector Clouseaus are being unleashed by regulators and compliance departments to rein in risk taking and profitability. Rather, banking is transitioning to a utility model with more capital and liquidity, especially at the parent company and non-depository subsidiaries.

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