Banking sector: to buy or not to buy?

Many market commentators are saying now is the time to buy into banking stocks. Michael Hewson from CMC Markets believes the charts do not support this 'buy' message and urges investors to consider the uncertainty that will remain in the banking sector moving forward.

Banking sector set to remain risky

If concerns about Europe and exposure to the amount of bad debt on European banks balance sheets weren't enough for the banking sector to think about, the current furore surrounding the Libor fixing scandal isn't likely to change public perception of mistrust with respect to the problems facing a sector that has endured a torrid five years.

In mid-2007 the UK banking sector had a combined market value of over 11,000. It now trades at a mere 33% of that at 3,800.

Since the lows seen in 2009 at 1,877 the sector managed to recover to highs of 5,400 in 2010 and the beginning of 2011, however since then the sector has remained under pressure largely as a result of events in Europe and the sectors exposure to potential sovereign insolvencies and insolvent banks in Europe.

Banking sector, 5 year chart (Source: Digital Look)

Public perception about the banking sector had already been fairly low after the events of the last few years, which in turn has prompted calls for much tougher regulation of the banking industry and the 'too big to fail' culture.

Certainly there has been a lot of criticism of the **Vickers Report** on banking with the watering down of some of the more controversial aspects of the report, including the separation of the investment banking and retail arms.

Regulatory spotlight

Recent events with respect to the behaviour of banks in the UK over PPI mis-selling, interest rate swap mis-selling and now LIBOR fixing is likely to increase calls for much more regulatory oversight from regulators not only here in the UK but also worldwide as public anger demands action from politicians anxious not to be seen to be pandering to banks vested interests and big business.

If you add to that, the controversy over the JP Morgan 'London Whale' trading losses which are expected to exceed $5bn, then you have a very toxic operating environment for banks in general.

This increases the risks of the sector being used as a political football by politicians anxious to deflect attention from their own shortcomings, inadequacies and policy failings.

You only have to look at Europe's politicians and the proposed implementation of a financial transaction tax to see how much in denial these policymakers are with respect to their roles in the current crisis in Europe.

Today's resignation of Barclay's CEO Bob Diamond, while likely to draw a line under his role in the Libor fixing saga, is unlikely to be the end of the story for the banking sector.

There also remains the question of how much central bankers knew of what was going on and whether a blind eye was turned to the practice.

Regulators globally are now likely to focus their attention to the involvement of other banks and the likelihood of litigation as a result of any findings is likely to increase.

Any increased regulatory oversight is likely to increase the costs to the business models of banks and could also prompt much tougher steps to separate the business units of bigger banks, and even break some business units up altogether.

Barclays stock price: where to from here?

Barclays share price has certainly shown some resilience after its sharp falls last week and while some analysts are starting to break cover and tip the shares to move higher, the charts don't support that view in the short term.

Barclays, 1 year chart (Source: CMC Markets)

Since April, the price action has been firmly to the downside and while it remains in the downward channel from the March highs as well as the 200 day MA, the trend remains lower. A move back above the 200p level could well stabilise in the short term.

As for the nationalised banks of **Royal Bank of Scotland** and **Lloyds Banking Group** the risk remains that they too become embroiled in the Libor scandal with all the risks that entails for further share price gains. The ironic thing is that any fines, if levied, will end up being paid for by the UK tax payer.

Royal Bank of Scotland, 2 year chart (Source: CMC Markets)

Future profitability of the banks

The main downside to all of this is that any future profitability of these banks is likely to be mitigated by stronger regulation as the banks riskier activities get pared back.

It therefore seems unlikely that, given the current environment, tax payers will see any return on their investment in either of these banks.

Royal Bank of Scotland's share price needs to get back to 550p to even get close to break even, which is more than double its current value of 218p. A break above the 300p level would certainly help in stabilising the share price, but for now the range seems to be 175p, the 2011 lows, and the multiple highs this year around 299p.

HSBC, 1 year chart (Source: CMC Markets)

Even **HSBC,** which has found itself fairly insulated from the travails of the banking sector over the past few months, has struggled to make much in the way of gains above the highs seen this year at 588p.

If the current enquiries into other banks activities see the bank dragged into the Libor enquiry, further share price volatility in the sector seems likely.

The upshot is that the banking sector is likely to remain a fairly high risk sector going forward; with the likelihood of further regulation, possible litigation and further write downs of bad debt as economic conditions deteriorate in Europe.

According to BIS data, as of the end of 2011, UK bank exposure to Spain and Italy is estimated to be in the region of **£90bn.**

This raises the likelihood of significant losses especially if there is a restructuring of the Spanish banking sector further down the line, if economic conditions in the country continue to deteriorate.

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