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AMERICA'S ECONOMIC ANEURYSMS?

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- A Restrained U.S. Recovery Showing Old Habits & Vulnerabilities
- Overextended Consumer Re-Leveraging & Saving Less
- Overextended Government Losing Debt Auction Audience
- Paradox: Strong Banking Sector Outlook

We have been very suspicious of the domestic U.S. economic recovery, doubting the sustainability of consumer spending and expecting a significant correction higher in Treasury bond rates. We have written frequently on our reasoning, but short-term indicators have pointed in the opposite direction for both.

1) Consumer spending levels continue to surprise us, particularly their acceleration in late fourth quarter through early 2011. Is this improvement fundamental and destined to be long-term, or is it artificial?

2) U.S. government long rates remain quite low, despite soaring deficits. Is this reasoned markets pricing risk or is it global fears driving liquidity flows into the safest currency in an unsafe world?

3) Financial stocks have neither led nor even paced the market since QE2 was announced last August. Is this a normal recovery pattern within equities, or are financials signaling that the broader market is ahead of itself?

We think it may be the latter answer in all three cases.

If so, financials may be counter intuitively a wiser sector to search for selected upside from here, as it has been the least influenced or overvalued by a sluggish recovery that supposedly has longer legs.

Two Economic Aneurysms?

The near doubling in the U.S. equity market over the last two years is understandably used as evidence that America's economy is more resilient than many believe. We agree with the premise. Resilient? Yes, but it's hardly robust, has been exceptionally reliant on government support, and is now showing premature signs of re-leverging.

Either the recovery suffers or interest rates must inevitably rise to support government support.

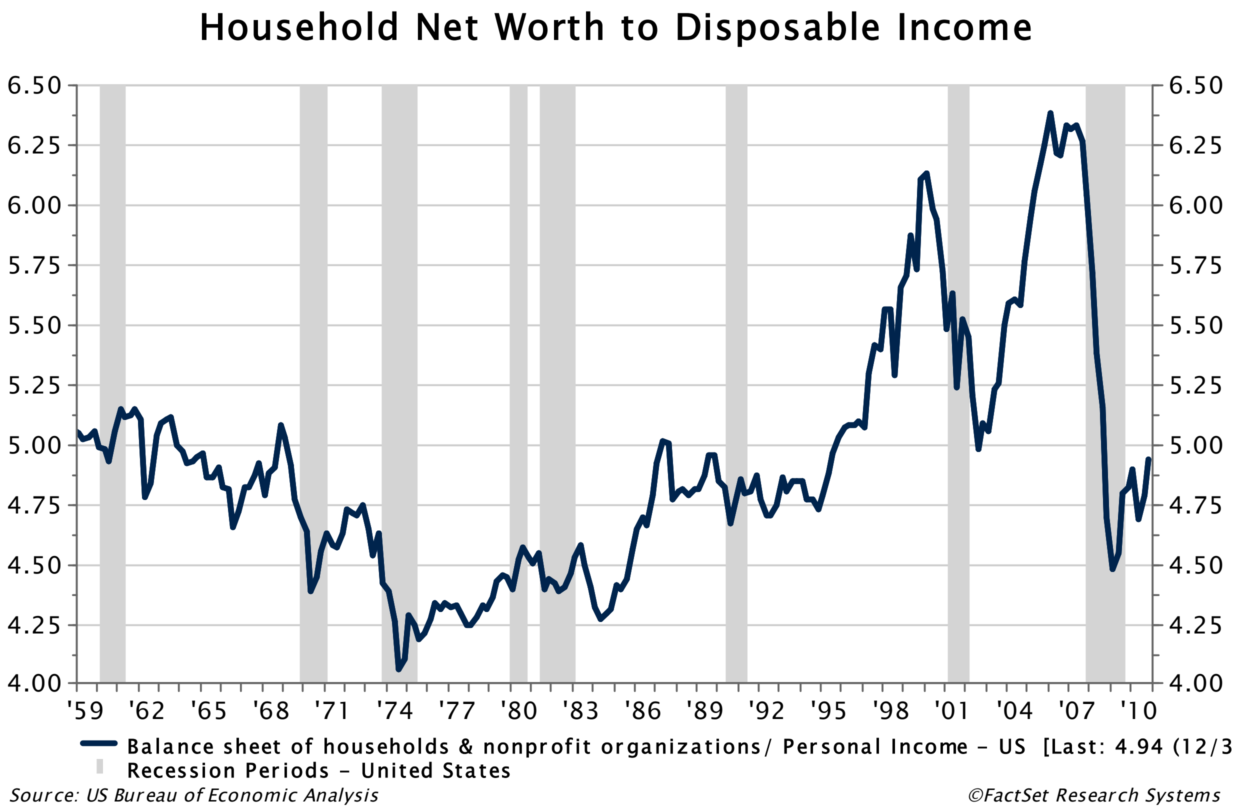
The U.S. economy as measured by GDP has risen, albeit modestly for a recovery, on the unrelenting back of consumer spending, while incomes remain severely constrained apart from government supplement. Meanwhile, the 10-year U.S. Treasury yield is unchanged from a year ago, while the U.S. deficit and debt projections are markedly higher. Financing terms for this support have never been easier.

These disparities are linked, exceptional and potentially unstable. The longer consumers spend more based on government largess or re-leveraging rather than a vigorous acceleration in private sector wages, the larger and more intransigent the government deficit. If GDP growth is sustained in 2011, it is increasingly likely that advancing Federal debt will trigger a period of rising interest rates.

We think the best metaphor for these two imbalances is to characterize them as aneurysms – known and serious vulnerabilities with unknown timing and triggers.

We have been rigorously thematic that **consumer spending is imbalanced, confronting two unknowns**: 1) Consumer behavior addressing balance sheet repairs, including deleveraging, saving and rebuilding net worth, and 2) The eventual but unavoidable withdrawal of unprecedented income support from government. Components of fourth quarter GDP reveal repairs are actually reversing as government support finally begins to lessen.

Americans want to consume. Discipline has quickly waned. Yet massive net worth has been wiped out in residential housing. The consumer spending boom that took place in the 1990s through 2007 was artificially inflated and prolonged by a vaporous expansion in home equity net worth that has completely vanished. For consumer spending to grow well above the pre-recession level is very difficult to fathom or defend.



A brief look at the latest NIPA (BEA National Income and Product Accounts) data clearly exposes artificiality beneath the rise in consumer spending. The annual run rate for Disposable Personal Income (DPI) is actually up $886 billion, or an amazing 8.3%, from where it was just prior to the 2008-2009 recession.

This income base is hardly organic. Government transfer payments to individuals are up $572 billion and total taxes paid by individuals are down $266 billion over this same period, explaining 95% of the gain in DPI. Private sector wages and salaries are still down $106 billion, albeit rising at an anemic 2.5% annualized pace since the recession's end. Individual interest income is down $129 billion, largely due to the low-rate environment.

Yet consumer spending has risen $531 billion, or 5.3% above its pre-recession level. There are only two means by which consumer spending can hold current levels, let alone expand: 1) Government income support levels do not recede faster than private sector wages replace them, and/or 2) Consumer savings ebb and leverage rises.

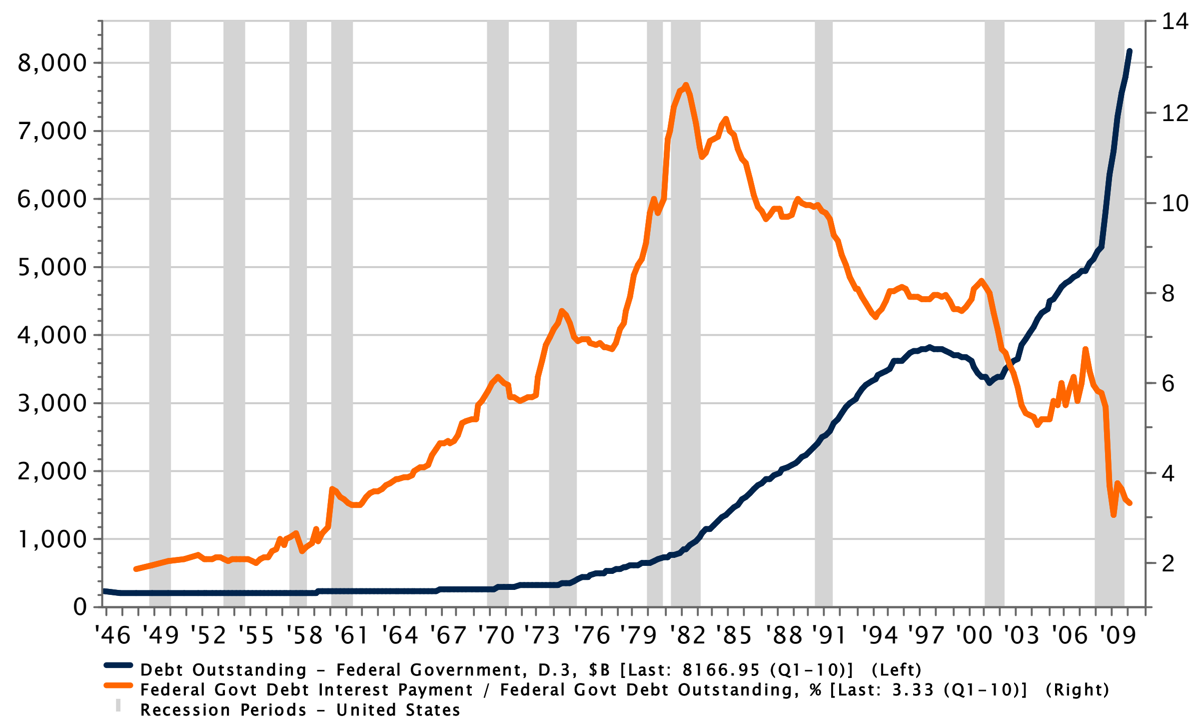
The latest surge in consumer spending unfortunately appears rooted in the latter. Fourth-quarter seasonally adjusted NIPA data reveals annualized Personal Consumption Expenditures

(PCE) were $154 billion higher than in the third quarter. Over the same sequential period, the latest seasonally adjusted Flow-of-Funds Accounts (Federal Reserve Z.1 release) indicate households have reduced their annualized savings by $56 billion while increasing their non-mortgage debt by $48 billion (only the second, but largest gain in over two years). Fourth-quarter government contribution to DPI through transfer payments and taxes was a negative $22 billion.

In summary, reduced savings and re-leveraging were equivalent to 68% of the quarterly spend rate gain in the latest quarter, replacing a gradual retreat in government support. Private sector wage growth was equivalent to only 35% of the rise in spending. Put another way, **for the U.S. recovery to maintain current momentum, let alone achieve "escape velocity," private wage growth would have to triple based on these trends.**

Switching to the other potential aneurysm, the 10-year Treasury yield has averaged just under 3.5% so far in 2011, well off its 2.4% October low but essentially unchanged from a year ago. Over the same period, the projected U.S. Government deficit for this year has risen by nearly 25% to $1.6 trillion, accompanied by the additional, massive round of QE2 quantitative easing. These two trends do not reconcile easily, and in fact such reconciliation has been virtually absent throughout the 30-year bull market for bonds, as falling rates have offset the actual interest service on the ever-expanding U.S. Government debt pool. This contradiction is vividly

Federal Govt Public Debt Outstanding vs Interest Payment



Source: Federal Reserve System *©FactSet Research Systems* apparent when we look at the blended interest servicing cost against the eightfold rise in Federal public debt over this period. In this sense, an aneurysm has been building for decades.

U.S. debt servicing cost confounded expectations again in 2010, and we think the best explanation for the ongoing disparity was the counterweight of comparative fear and strength as disturbing Euro sovereign risks emerged a year ago, and then re-emerged in recent months, arguably driving up the U.S. dollar's safe-haven appeal and therefore holding down the interest rate it must pay.

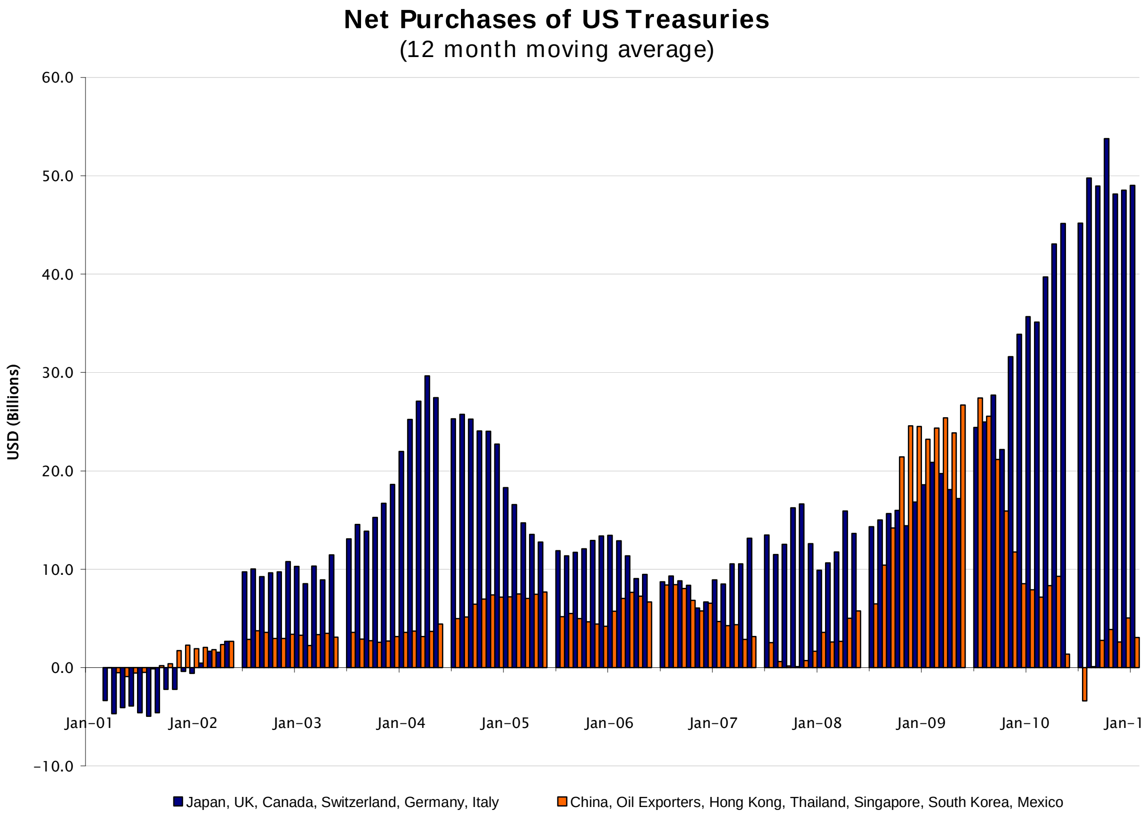
This helpful balm may finally be dissipating as neither the Middle Eastern crisis nor the Sendai earthquake have produced any noticeable influx of foreign buying. The opposite pendulum may be gathering speed as the U.S. dollar has been weakening, rather than strengthening as might have been expected.

Additionally, we still see an increasing shortage of final buyers for Treasuries at auction, particularly from sovereign offshore sources. This was already appearing from the emerging market (EM) sector in 2010, although gradually so. The tragic tsunami in Japan now seriously calls into question its ability or desire to buy more Treasuries. Japan, China and the U.K. have been the largest net buyers for some time.

In our November report, "Double Bubble," we argued that QE2 would do little for employment and could be easily offset by receding holdings of Treasuries by emerging markets as they increasingly focused on rapidly expanding domestic infrastructures. Over the last decade EMs became a dramatic force parking their hard currency reserves in the U.S. We have always cautioned that the incoming "global liquidity flood," as once termed by Chairman Bernanke, could and would eventually reverse. We highlighted China as the important bellwether, comprising half of all EM holdings and noted its net Treasury buying was sharply softening for much of last year.

Since then the U.S. Treasury surprisingly disclosed a significantly larger estimate for China's holdings - presumed to have been acquired through U.K. financial markets. While China's net Treasury purchases have actually risen slightly to a net neutral since last fall, they remain over $30 billion per month below their 2009 peak.

This reduced appetite does not appear limited to China. We have attempted to capture the declining tendency of EM ownership more broadly, using monthly data supplied via Treasury International Capital (TIC) data. Although there is insufficient history to comprehensively show all EMs, and there are periodic recategorizations without lengthy historical restatements, the following exhibit is a reasonable rendition of EM net monthly buying in contrast to the developed world.



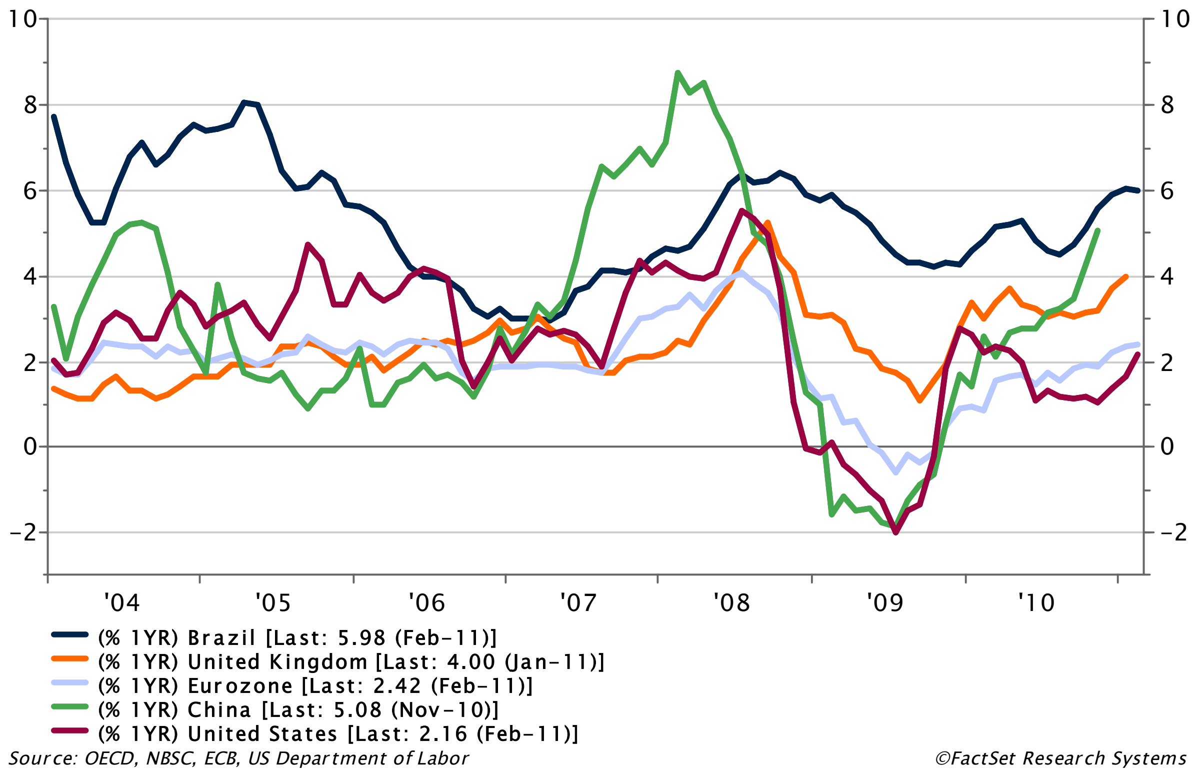
At first glance, investors may take solace that other foreign buying is supplanting the retreat of EMs, presumably taking some pressure off the Fed. However, this would miss the crucial point – foreign exchange reserve growth over the last decade has been predominantly created in emerging markets. They represent the new liquidity axe in town. Their emergence as serious Treasury holders was unprecedented, as was the trade surplus they generated with the developed world. **Their 2010 retreat suggests that the buyers generating the lion's share of global liquidity are, on the margin, losing interest in the U.S. dollar as a safe store of value.**

If so, it only seems logical that rates will have to rise simply to balance waning demand with ever expanding supply of our federal debt. This seems mostly a matter of time. Finally, inflation has its own, strong bearing on the course of interest rates. Price inflation is in the eye of the beholder, and the U.S. monetary authority has consistently excluded two, large price basket components – food and energy. In our November report, we only removed the shelter component, as it is derived by a theoretical calculation from rent rates, excluding home prices. This suggested an underlying 2% trend, not the 0.8% core reading from the Federal Reserve at the time. In February our version of core CPI rose to 3% while the Fed's version finally rose to 2%. Despite the disciplined and dull denial of authorities, the U.S. is hardly immune to, and is now experiencing the next inflation cycle.

Massachusetts Institute of Technology has developed its own price data for 11 countries, primarily based on retail goods, meant as a real-time daily predictor for official data released by a lag of one month or more. The sampling methodology is new, but in all but two of the countries tracked their price index closely follows the official CPI for that country. The two glaring exceptions are Columbia and the United States. In the U.S., MIT shows CPI moving noticeably above the official (BLS) CPI data in early 2009 and recently running at a level approximately 110 basis points higher than the official data. For mid-March, their sampling indicated 3.1% CPI (year-over-year). This makes more intuitive sense to us. With the February PPI (Producer Price Index) at 5.6%, substantially above its 3.8% average for the second half of last year, inflation momentum appears on the rise.

A rather striking disparity can be seen when comparing inflation trends globally. The official U.S. inflation trend appears almost detached from rising prices worldwide, whether compared to developed or emerging economies. Despite the recent run-up, we are the only country showing inflation below its 2009 post-recovery peak.

Global Inflation Patterns



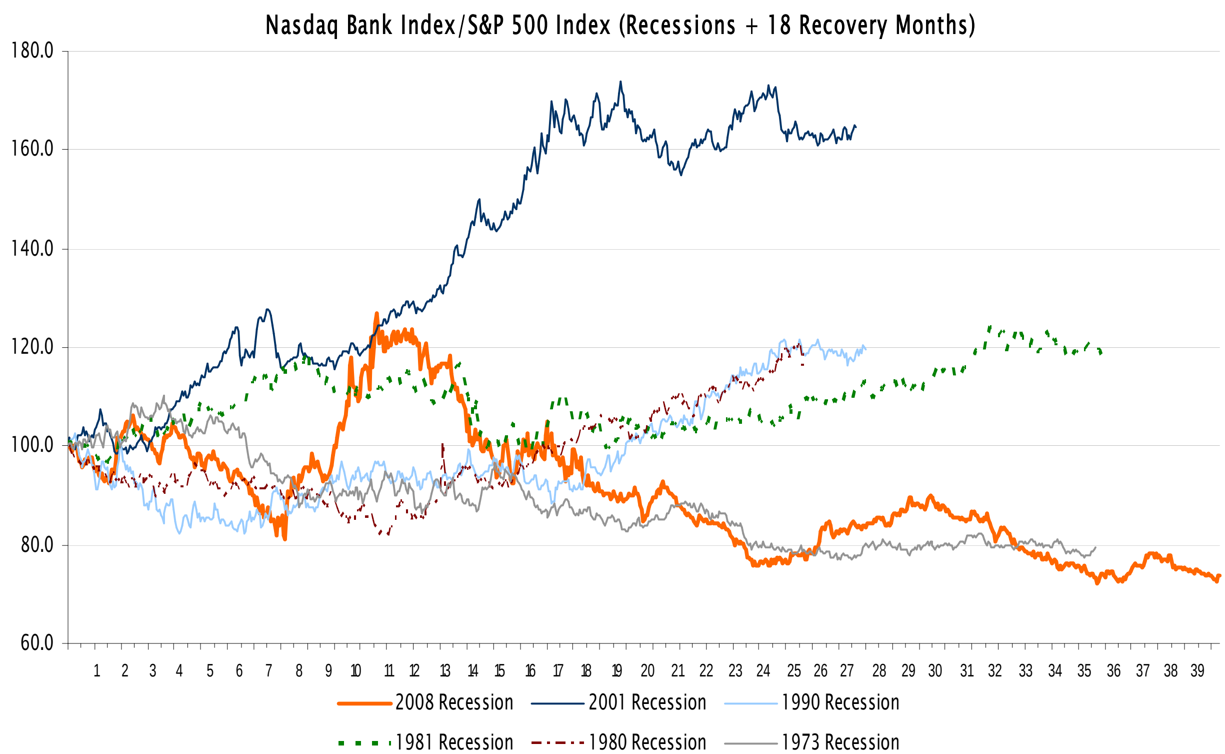
We can only conclude the risk of higher rates is steadily increasing with combined pressure from rising government debt supply, declining foreign appetite and fundamental inflationary undercurrents – all despite lukewarm domestic economic momentum.

Oddly, while none of these monetary risks ever seem fully discounted in the market, they are rarely contested. Only their timing is actively debated. The contentious arguments are around when they will eventually impact U.S. interest rates. That is why we think "aneurysm" may be the appropriate metaphor.

Counterintuitive Financials

With such uncertainty, particularly surrounding interest rates and economic momentum, why revisit or consider a return to financials? For the longer-term banking sector, we see four reasons: 1) Prolonged underperformance; 2) Potential re-intermediation; 3) Massive, albeit not universal balance sheet improvement; and 4) A long-held misunderstanding surrounding the impact of interest rates.

The underperformance has been remarkable. Viewed in comparison with past recessions, the banking sector gave up its leading indication of confidence and conviction early in 2009 and,



more surprisingly, never recovered it since. This is rare, post-recession behavior. While an argument can be made that the damage was worse than prior cycles, the continued slide is puzzling. The immediate rationalization is that the sector faces a lower valuation and slower revenue recovery from lending. But this was generally assumed a year ago.

Another, perhaps cynical, bias is that investors have been "crowded-into" equities by a Fed removing yield compensation and debasing the currency. Equities are among the few, remaining open doors. But financials are levered equity models, and probably a stretch too far when playing chicken with the Fed.

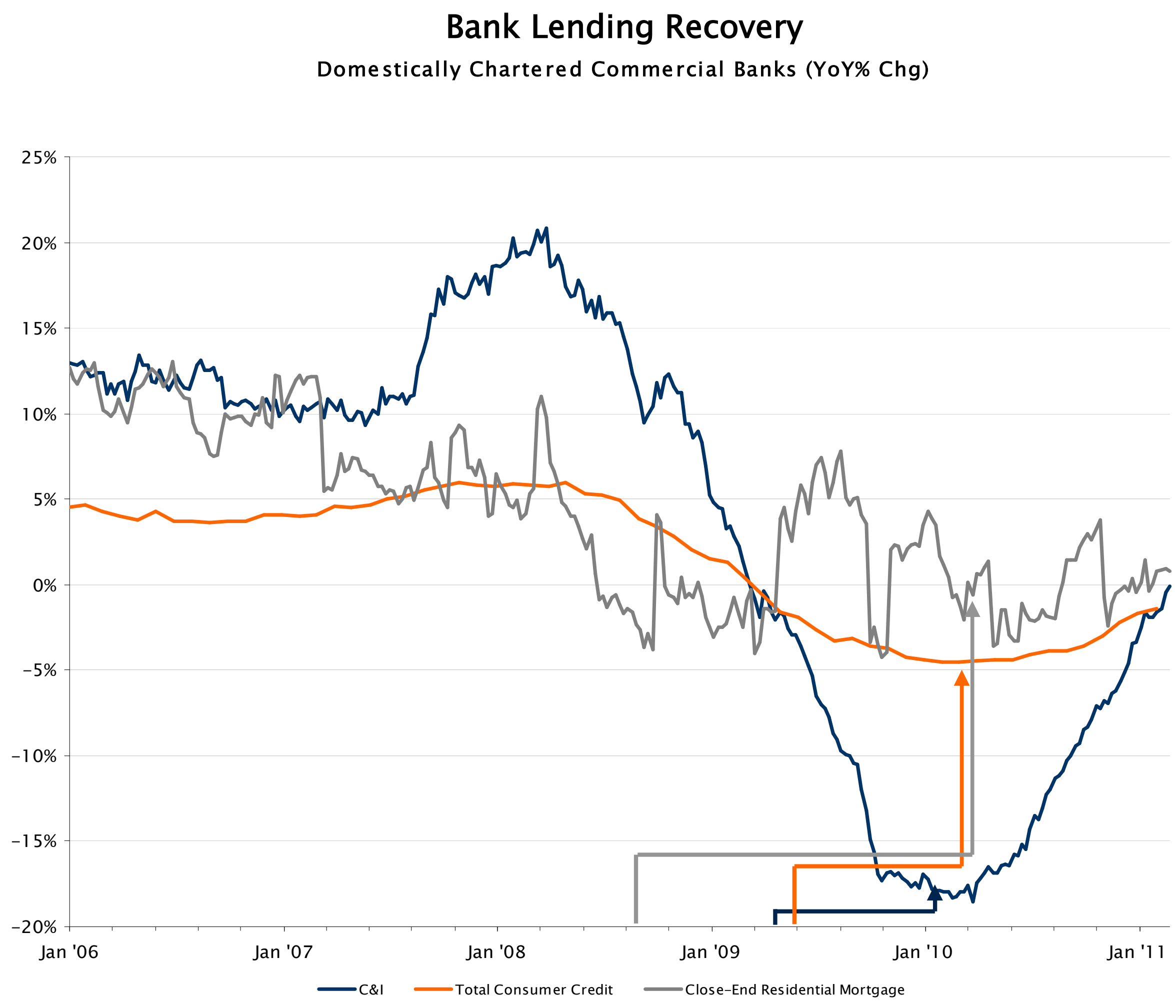
Our take is split between an overly pessimistic view on loan demand and a sector that is highly sensitive to uncertainties. **While the broader market seems willing to flirt with and defy the economic aneurysms and almost inconceivable course of world events, financial stock investors clearly hesitate.**

We have previously discussed at some length the loan asset growth potential if banks are re-intermediated to partially replace the "shadow banking" market. In distilled numbers, the private side of the shadow banking market has dramatically shrunk, with the asset-backed issuance and mortgage pool markets now a startling $5.3 trillion smaller than they were before the recession. In comparison, loans outstanding at U.S. commercial banks are virtually unchanged, totaling $6.1 trillion today, about where they were just before the recession. While the Fed and the GSEs initially had to accommodate this massive credit shrinkage, the replacement opportunity for bank balance sheet lending is clearly vast. The banking system is barely larger than the non-bank shrinkage!

Moreover, bank lending is rather clearly in the early stages of a normal credit demand recovery cycle. This recovery currently mirrors the economic recovery - a bit meager. This can be seen in the year-over-year comparisons for several sectors of bank loans. One must keep in mind that bank lending has never led economic growth, which the political class has never recognized.

Additionally, the lag factors have been reasonably consistent over past cycles. Our analysis indicates that, on average, consumer borrowing follows consumer spending by about five months, business borrowing lags fixed investment by about nine months, and residential mortgages lag new home sales by approximately 17 months.

As shown below, the business lending inflection point has already been verified and is on schedule. Consumer credit is running about four months late, but is also recovering with consumption spending. Mortgage outstandings are harder to visualize due to their volatility, but also seem to have hit a noisy, saucer-like bottom.



- C&I Loans Lag Real Fixed Investment Recovery by 9.1 months:
  Due Date was January 2010 – ON TIME
- Consumer Credit Lag Personal Consumption Recovery by 5 months:
  Due Date was November 2009 – 4 MONTHS LATE
- Home Mortgages Lag New Home Sales Recovery by 17.4 months:
  Due Date of March 2010 – ON TIME ? SLUGGISH

Balance sheets for American banks have been largely transformed. The largest issued massive common equity early in the crisis. Since 2008, those 19 in the original SCAP (Supervisory Capital Assessment Program) stress test have cumulatively raised $127 billion. Another 207 regional and community bank offerings have raised an additional $35 billion over the same period. While the FDIC problem bank list has risen to 884 banks, their combined assets are down to only 2.6% of total insured banks and their average asset size is under $500 million.

Core capital has advanced 19% in the system over this same period with loss reserves up 33%. Since 2007, banking system equity as reported by the FDIC is up $166 billion and loss reserves are up $128 billion, all after absorbing cumulative net charge-offs of $465 billion. **These add up to slightly more than $750 billion in actions addressing problem assets.**

Charge-offs are in a convincing decline spanning several quarters, as are nonperforming assets. We began tracking system-wide charge-offs and loss provisioning since 2007 against a theoretical, embedded, life-of-loan loss by loan category. We generally based our cumulative loss ratios on worst-case periods in history, similar to the SCAP methodology, and periodically modified the targeted losses based on data and experience from several banks that disclosed expansive quarterly detail. A hybrid of history and refinements left us in the vicinity of just under $900 billion for total loan losses embedded in the portfolio of loans held by U.S. banks as of 2007 ending balances on a reasonable, worst-case estimate.

The following exhibit summarizes our tracking through the fourth quarter of 2010, and the embedded loan loss assumptions. In the box we measure "loss completion," which is the degree to which actual write-offs have been absorbed across nine loan categories. In aggregate, about 61% of our estimated life-of-loan losses have been absorbed to date. Adding net additions to the reserve, it can be said that **79% of the embedded loan risk in the banking system has been addressed.**

The three loan categories least absorbed are, perhaps unsurprisingly, residential mortgages, home equity loans and commercial real estate (CRE). The absorption ratios shown can only be taken as a modeling exercise, and excess reserves suggest we are in the eighth inning overall, but only in the fourth or fifth in these three categories. Of the three, the most interesting and worrisome one to us is the first. We assigned an 11% ultimate loss ratio for residential mortgages based on separate allocations by mortgage type - ranging from 42% on subprime, to 20% on Alt-A and down to 5% on prime. Considering that prime began as two-thirds of the single family mortgage portfolio on bank balance sheets, the aggregate loss was projected at $78 billion against $85 billion for the subprime category - roughly equivalent in absolute loss size. Prime loans were seven times the size of subprime, explaining this barbell-like loss distribution. We assume that, within the mortgage spectrum, subprime and most Alt-A losses have largely been absorbed by now, while prime mortgages perhaps have longer to play out - at least on bank balance sheets. The overall lag in mortgage loss recognition is undoubtedly influenced by restraint and legal friction in the foreclosure process.

We conclude that, after three years of capital raising and heavy provisioning, **the endangered balance sheet narrative is ending. Investors are shifting their sights toward future revenue growth, organic and otherwise.** As this will most likely be accompanied by rising rates, we must now re-examine the sector's supposed vulnerability to such an environment.

Cumulative Losses Absorbed Using SOP Embedded Loss Projection	
40%	1-4 Family Less HE
51%	NonRes (CRE)
56%	Const & Dev (C&D)
42%	Home Equity
61%	Multifamily Resi
76%	Commercial & Indl
74%	Noncard Individuals
111%	Credit Cards
60%	Other
61%	Total Embedded
Losses Absorbed + Loss Reserve Addition	
79%	Total Embedded

	2007 Loans $MM	Mix	SOP Cumulative Loss Projection	$MM	SCAP 2-Year Assumption	Actual 1990-95 Cumulative Loss History
1-4 Family Less HE	2,241	28%	11%	237	9%	1%
NonRes (CRE)	969	12%	5%	51	9%	5%
Const & Dev (C&D)	629	8%	20%	126	18%	6%
Home Equity	611	8%	20%	122	18%	1%
Multifamily Resi	203	3%	5%	10	11%	4%
Commercial & Indl	1,439	18%	7%	101	8%	5%
Noncard Individuals	637	8%	12%	76	12%	4%
Credit Cards	422	5%	30%	127	20%	21%
Other	629	8%	4%	25	2%	
Total Loans	7,909	100%	11%	882	10%	5%

We wrote extensively on this subject back in 2003, and our Research Department recently published a thoughtful retrospective as well. Most investors have been trained in the belief that rising interest rates hurt most financials – particularly bank stocks. Yield curve compression is thought to be another major and companion negative. Due to this widely-held view by traders, **when interest rates do begin to rise, bank stocks will invariably dip – but this has historically been shown to be temporary and without fundamental merit.**

This will likely be an important buying opportunity, because rising interest rates usually accompany accelerating credit demand, which tends to easily overwhelm any yield curve compression. This may be hard to foresee while rates stay low and loan demand stays soft, but earnings propulsion has quickly followed in the past.

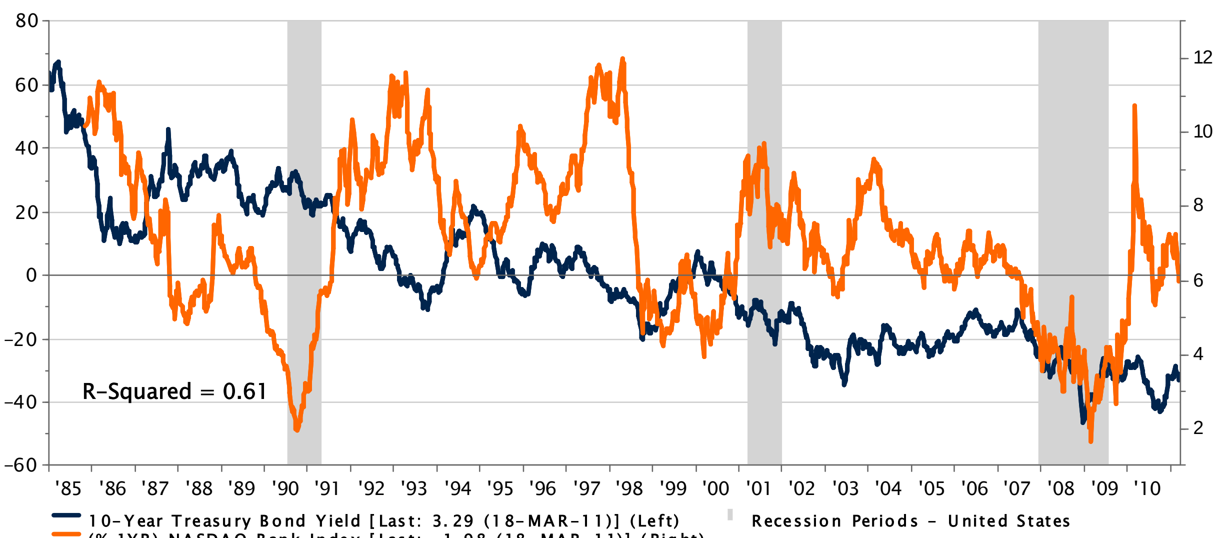
The inner dynamics to all these factors can be best simplified by observing that bank assets are generally divided between two earning asset categories – securities and loans. Intrinsically, the profitability on loans is much higher and the loan base is easily double the investment securities base. Most of all, it is only within the investment portfolio where "borrowed short, lent long" is truly a common and correct depiction of balance sheet sensitivity to rates.

The loan portfolio tends to be the opposite, simply because borrowers seek to lower their cost by leaning toward shorter maturities while depositors seek to raise their returns by leaning toward longer maturities. The long-term fixed-rate single-family mortgage has been the only serious exception, which is why it has been forced off balance sheets. This was a financial product proposed and promoted outside the private sector, and will perhaps be remembered as a glaring example of government policy falling to unintended consequences.

Therefore, as rates rise, the short-funded securities portfolio does suffer margin compression, while the far larger and wider loan portfolio margin experiences expansion as well as growth. This is ultimately seen in longer-term regressions and analysis of bank stock performance versus rate trends and yield curve changes.

We present two such versions here, among the many that are available. The first is a direct regression analysis of the NASDAQ Bank Index against the 10-year bond rate. The 0.61 R-squared indicates that 61% of the Bank Index movement over the last 35 years can be explained by the 10-year rate, a reasonable, though not overwhelming correlation.

Nasdaq Bank Index vs 10-Year Treasury Yield



Source: Federal Reserve System

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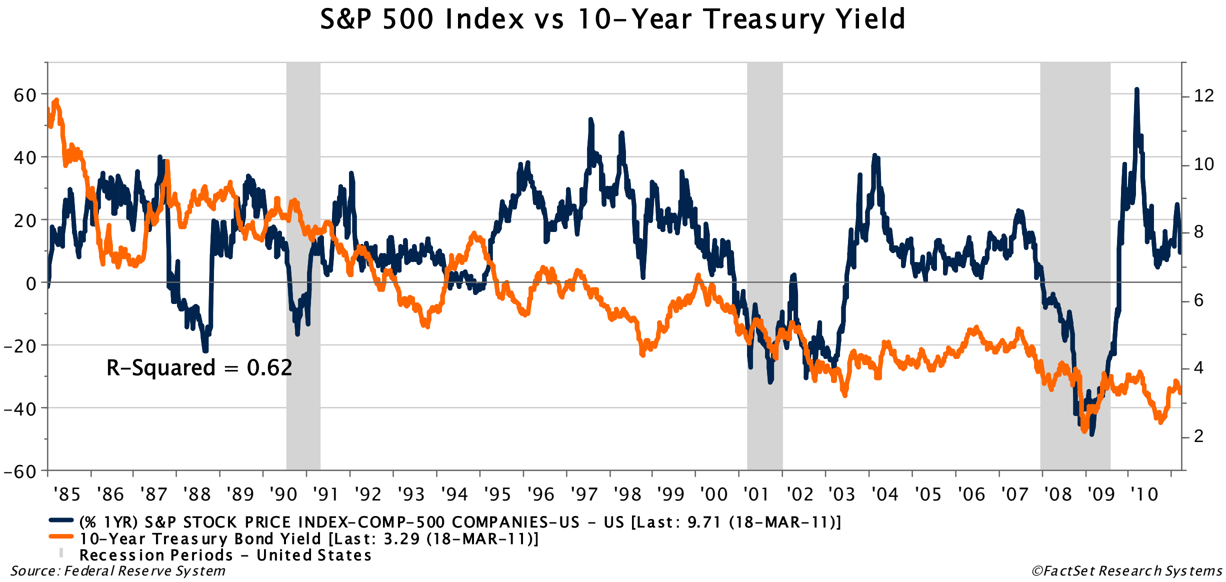
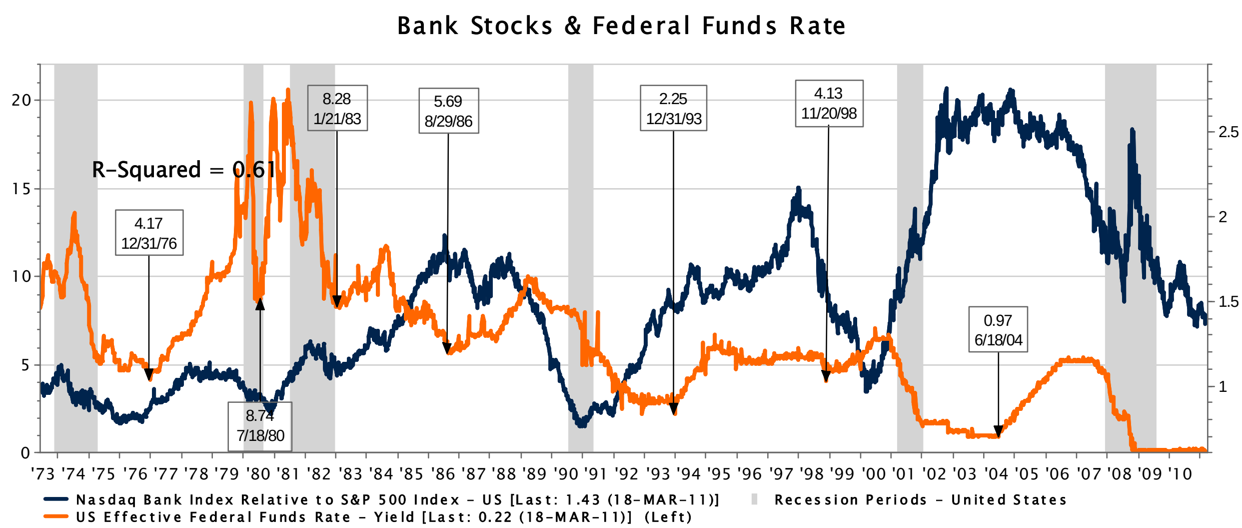
Not so fast – running the S&P 500 against the 10-year produces a 0.62 R-squared as well. This actually suggests that banks are no more rate sensitive than equities in general.

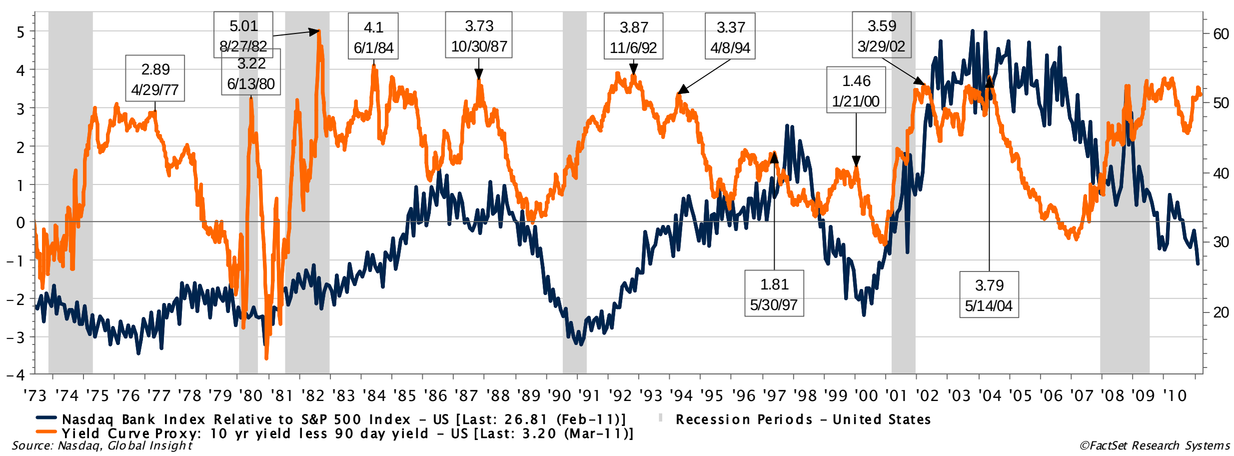


A second variant on this analysis looks at relative performance from rising rate and yield curve inflection points. There have been seven meaningful rate cycles and eleven periods of yield curve compression over the last 35 years. We show an arbitrary twelve month period for relative performance measured from the onset of rising rates in each period as well as from early yield curve declines.



Rate Upturn Start	Dec-76	Jul-80	Jan-83	Aug-86	Dec-93	Nov-98	Jun-04
One-Year Performance:							
NASDAQ Bank Index	2.8%	23.4%	31.9%	14.6%	1.1%	-1.4%	6.4%
S&P 500 Index	-10.9%	8.9%	15.3%	32.1%	-2.1%	23.3%	6.4%
Difference	13.7%	14.6%	16.5%	-17.5%	3.2%	-24.6%	-0.1%

Bank Stocks & Yield Curve



Yield Curve Peak	Apr-77	Jun-80	Aug-82	Jun-84	Oct-87	Nov-92	Apr-94	May-97	Jan-00	Mar-02	May-04
One-Year Performance:											
NASDAQ Bank Index	15.3%	28.6%	42.1%	43.2%	19.6%	46.3%	15.2%	49.3%	20.7%	18.2%	6.0%
S&P 500 Index	-1.2%	14.0%	37.1%	24.8%	20.6%	11.0%	12.8%	28.9%	-8.7%	-24.0%	6.7%
Difference	16.4%	14.5%	4.9%	18.4%	-1.0%	35.3%	2.3%	20.4%	29.3%	42.2%	-0.7%

What emerges: Little evidence of bank stock vulnerability to rising rates or yield compression. In the former case, banks more often outperform the market by the one-year mark. The two instances of underperformance were very late in the economic cycle, not at the beginning. In the latter case, yield curve flattening has never produced an absolute decline in the bank index, and only twice on a relative basis - both times quite modestly.

We should conclude our thoughts on the subject by suggesting that yield curve compression may not even be as certain or dramatic in the current economic cycle as in past ones, simply because the long end of the market may need to correct before the short end follows. This is often reversed when short-term monetary rates are managed up to restrain growth or inflation. This task may be pre-empted at the long end of the rate curve, particularly since foreign authorities hold more of our Treasuries than we do.

Deja vu all over again. Quoting from our own report in August 2003: *" We have suggested all year that interest rates will rise sooner and farther than expected. Short rates far overshoot the* *levels necessary to assist and assure a recovery, we have argued. Long rates initially took their cue from the short end of the market. That left long rates unsustainably low as well. While the Fed is telegraphing everything it can to assure that the short end won't rise anytime soon, the long end is watching cyclical economic reality, and coming to a different conclusion ..."*

Bank stocks, along with most financials, are headed for an inevitable speed bump when interest rates turn up, as they must. Not only will this present an interesting buying opportunity, it will likely occur when the sun sets (or is seen setting) on quantitative easing. **QE2 has accomplished a lengthy market recovery, not an economic expansion. The financials seem to know this.**

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