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# The GREAT CREDIT REDISTRIBUTION

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## * US Bank Lending Contrarily Accelerates as Economic Outlook Remains Weak

## * Consumer Spending Increasingly Over Its Skis as De-Leveraging and Savings Lag

## * The Nationalized US Mortgage Market is Our "Greece"

## * European Governments Need Bank Credit – Not the Other Way Around

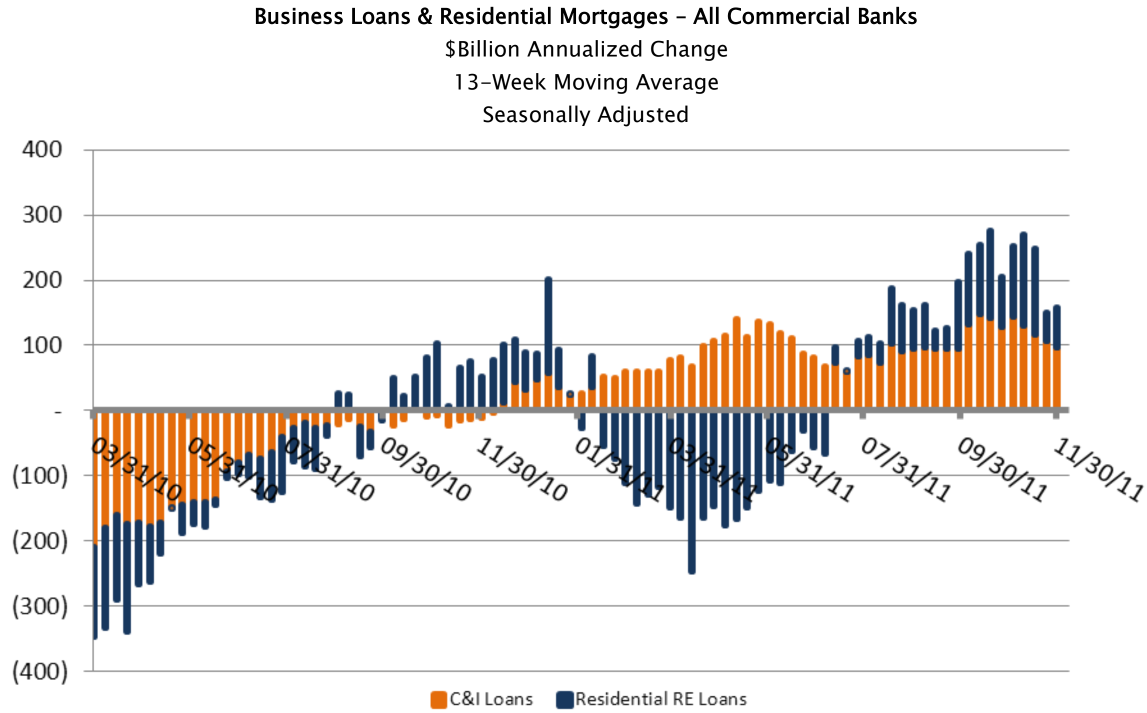
Our conviction on financial stocks continues to improve. Financial stocks have become proxies for global uncertainties rather than sector fundamentals. Their behavior following the ill-confronted US debt ceiling in August and several more turns on the European sovereign debt contagion screw have left them lower and more volatile than they have been for some time. The European banks are the most damaged, with the Bloomberg EMEA Bank Index currently 28% below its three-year average and the US NASDAQ bank index currently about 8% below its three-year average.

Excessive leverage, however, is now more prevalent and problematic at the government level across most of the "developed" world. US private mortgage leverage is largely unresolved, certainly, and overall consumer de-leveraging has further to travel. But remaining losses are mostly embedded in reserves and investor expectations. The corporate sector could actually be considered under-leveraged globally.

While the US economy vacillates between double-dip recession and dubious recovery, bank fundamentals are still impressive. Bank loans are finally growing. Cumulative bank credit write-offs post-2008 are approaching Great Depression levels. Bank capital ratios are dramatically higher. Yet bank stocks have defaulted to book value metrics, with no serious consideration for future earnings power. Investors struggle with future growth. The revival in loan growth bears particular closer scrutiny.

### BANK LOAN ASSETS RISING

Evidence of meaningful momentum in bank balance sheet loans has appeared in Federal Reserve data along with anecdotal bank management corroboration during several (certainly not all) third quarter




conference calls. With investors distracted by weak and volatile capital markets since mid-summer, exacerbated by imponderable sovereign debt issues, the simple but critical statistical series of bank credit lost its normal prominence. Loans are the core revenue source for banking, and bank loan growth appears promising.

Weekly statistics are noisy by nature, so we smooth them using a 13-week moving average. The exhibit above is based on seasonally adjusted data, and we have further adjusted this data to exclude footnoted restatements. The two sectors currently showing promise are shown. Commercial and Industrial (C&I) loans began growing modestly late last year, and steadily advanced to a $100 billion per annum pace by late spring. C&I loans outstanding have held this pace through November, averaging over 11% annualized growth for the last three months. Residential mortgages began to grow late summer, averaging 6% annualized growth for the last three months.

These are consequential patterns. They also carry some caveats. Much of the momentum emanates from larger banks, which the Fed sequesters above $25 billion in assets. Since corporate credit line utilization rates fell to historic lows over the last years, C&I loan growth may reflect an increased preference to take down existing bank lines while other wholesale borrowing alternatives are in greater disarray due to market volatility. Larger banks have also been more aggressive on underwriting and pricing. It is also probable than European corporate borrowers would be increasingly using their US bank relationships to secure financing. Residential momentum is more puzzling, and could reflect unreceptive securitization, refinancing constraints and backup in foreclosures. The rate-of-change in residential mortgage is much higher in banks below $25 billion in assets, where it skews the total loan growth. Banks on both sides of the size divide are producing approximately 3% to 4% momentum in total outstanding loans.

Overall, accelerating bank loan growth could be less a sign of warming demand than a shift in credit sourcing. We have also frequently argued that bank credit could benefit as a replacement for non-bank credit sources that were decimated in 2008. Banks comprise only about 25% of US credit markets. So-called "shadow banking" has little presence in other countries, but clearly grew dominant in America over the last three decades. Comparing bank versus non-bank credit trends requires looking at the Fed's Flow-of-Funds (Z1) releases, which are unfortunately not seasonally adjusted. Year-over-year, however, asset-backed securities (ABS) have fallen $310 billion, a 13% decline, through September, whereas commercial and industrial bank loans have risen $70 billion, a 7% increase.

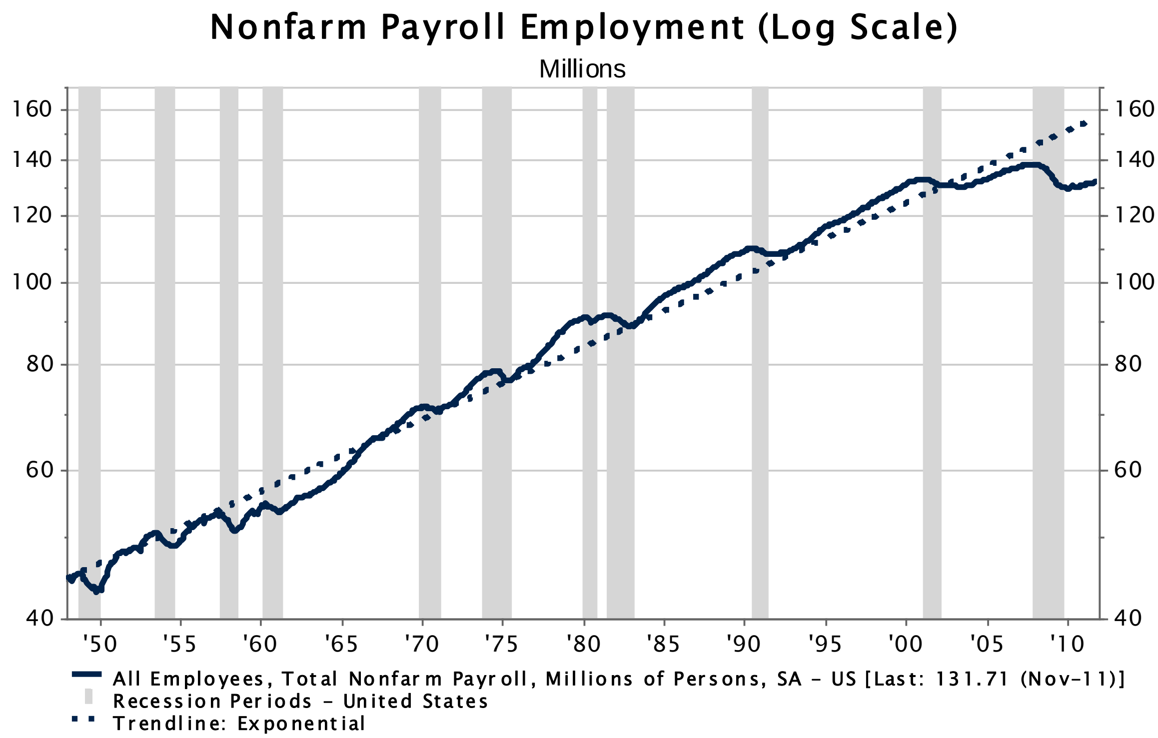
It is too soon to judge whether banking re-intermediation is a contributing cause of the recent bank lending upturn. If it is, this should not be considered an aberration. If not, it may still become a multi-year trend favoring bank earning asset and revenue growth, despite a sluggish economy

## CONSUMER SPENDING FACES A LENGTHY DEFICIT

While the revenue outlook for financial services is improving, the underlying economy remains weak. Despite modest positives in holiday sales and home sales, employment data continues well beneath levels necessary for sustainable consumption. "Contra" employment data, such as jobless claims, may not be the best indicators. Perhaps the most misleading contra indicator is unemployment. In a healthy recovery, the unemployment rate initially trends up, not down, as more return to the ranks of active job seekers. The recent and trumpeted decline in unemployment, from 9.0% to 8.6%, unfortunately reflects the opposite, and is corroborated by the still declining "participation rate." A decline in the unemployment rate can also be an irresistible target for political spin, sending the wrong signal despite deepening structural unemployment. A far more relevant measure of job and resulting income growth is simply the actual level of employment and not a ratio.

The non-farm labor force in America, as shown on the next page since World War II on a log scale, has been strikingly consistent in growth until very recently. Post-recession job gains have always returned to a well-established 1.7% trend line, or CAGR, through eight economic cycles, only failing to do so after 2001. Extending that trend line through to the present would define recovery only after adding another 25 million jobs! This is disturbingly distant from where we stand after two years of extremely sluggish growth. Periodic drops in jobless claims provide little comfort against this yawning structural gap.

Considering the need for much further consumer savings and de-levering after a severe and continuing impairment to home equity, along with what appears to be a decade-old structural plateau in employment, the largest component of US GDP, consumer spending, is likely to remain in a period of lengthy deficit. Earlier this year we named this one of two dangerous "aneurysms" in the US economy. Consumer spending has many reasons for faltering, even collapsing. Timing this or assigning any probability to this may be difficult, but its existence and threat should be quite clear.




OUR GREECE – RESIDENTIAL MORTGAGE OVERHANG

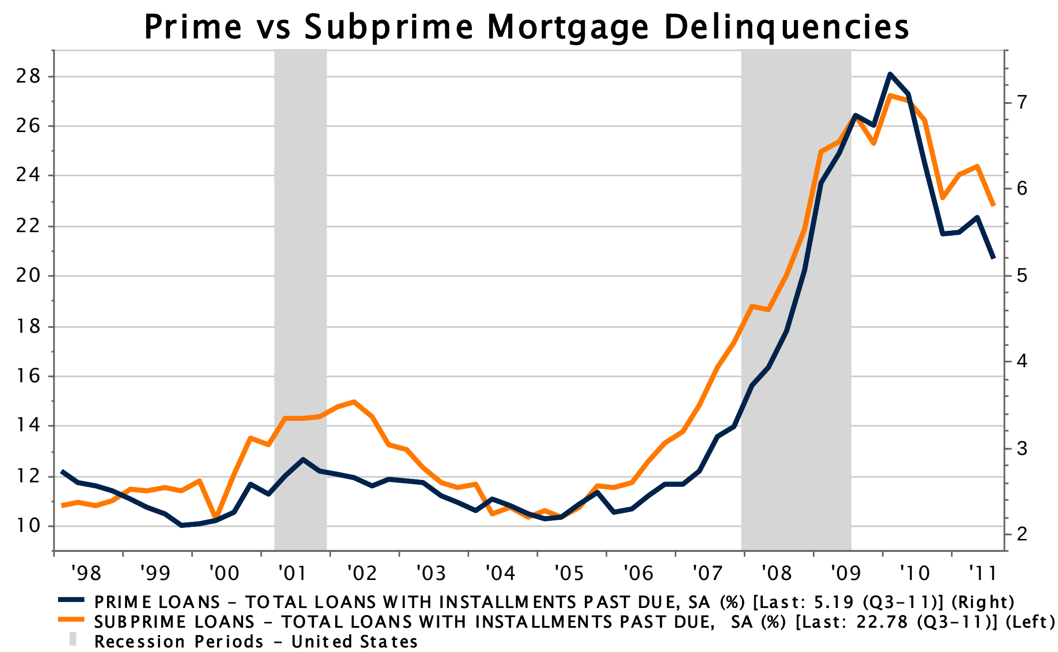
The broad macro risks to financials now fall in two different buckets – domestic and international.

The largest domestic risk lies in failing to address the principal cause of the Great Recession: the housing meltdown, not the financial crisis. To test the patience of those who know the history, as well as those who interpret it differently, the seeds of housing finance subsidy were deeply sowed 73 years (and 13 Presidents) ago. Seven decades of devoted nurture ultimately drove easier financing more than it increased home ownership, producing serious, if unintended, home price appreciation into a catastrophic bubble that plateaued in late 2005. We should remember the chronology better. The housing bubble peaked two years ahead of the recession's onset and three years ahead of the financial sector crisis. To be sure, components of mortgage finance were responsible for this final and furious leg of appreciation. The responsible parties are many, including regulators, the regulated, and especially the non-regulated.

Bubbles generally can't happen without multiple enablers or co-conspirators, however inadvertent. In retrospect, seven decades of increasingly subsidized US Federal housing policy included 1) fixed rate borrowing terms to 30 years, 2) government guarantees to lenders, 3) full interest expense deductibility, and 4) ever-smaller down payment requirements. All for the noble purpose, the gains in home ownership ultimately diminished and barely exceeded those found in other mature economies with none of these powerful subsidies. Started as one of several attempts to escape the Great Depression, government housing policy led to financing untethered from sound supply/demand mechanisms, which then ignited an uncontrolled explosion in home prices. Housing finance ceased to be a free market many decades ago.

Defenders of this policy blame the advent of sub-prime mortgages, complex securitizations and irresponsible greed in the financial sector. However, these factors were more effect than cause for two simple reasons. First, the actual need for funding home ownership overtook the deposit base in regulated banks many decades ago. Sourcing institutional investment funding was the unavoidable alternative, and developing the financial engineering to support fixed borrowing rates as well as greater hospitality to those with insufficient down payment resources was necessary to achieve political home ownership goals even with the GSEs.

Secondly, **when we review the resultant financial crisis by examining the history of mortgage deterioration in delinquency trends, which we show yet again in our favorite exhibit below, subprime risks were no different than full documentation prime risks. This strongly suggests excess leverage per se, across the mortgage spectrum, was to blame. Credit soured severely even where not driven or instigated by stretched underwriting mechanisms.** Prime mortgage deterioration occurred simultaneously with sub-prime, and proportionally fell as far. Moreover, the post-recession improvement has been slow and meager in both categories.




Long term fixing of mortgage rates drove securitization through many lives and forms. Banks cannot and could not hold such assets on their balance sheets, as the interest rate mismatch is ultimately unbearable. The sheer size of the banking sector's deposit base became dwarfed by the size of mortgage debt (almost five times larger). Funding mortgages long ago forced securitization vehicles to tap the capital markets. Government guarantees and high ratings by agencies were met with a tolerance for disappearing down payments. We now have an essentially nationalized mortgage market with 1) most of the residual risk held in Washington and 2) terms of lending still distorted by archaic housing policy. The GSEs have absorbed $150 billion in taxpayer funds since their conservatorship, and are expected to require multiples more. (The banks have absorbed $700 billion in credit losses and repaid the lion's share of TARP capital, all absorbed by shareholders.) Incredibly, the FHA still offers and encourages home ownership with only 3.5% down, capitalizing most closing costs in the loan!

The blame narrative is now for history to sort out, but a more balanced recognition of causative factors recently emerged from President Obama's first Council of Economic Advisors Chair, Christina Romer. In a December 18th NYT's Op-Ed exploring the well-known book by Reinhart and Rogoff, which argues recessions following financial crises are more lengthy and severe, Ms Romer states: *"The most recent recession would likely have been severe – and the recovery slow – even if the financial system hadn't been stressed, simply because of the decline in wealth and the climb in household indebtedness."*

The largest obstacle to a US economic recovery still seems to be the housing sector in two ways: home building and mortgage integrity. Homebuilding is obviously a major employment driver, both direct and indirect, that remains tepid at best. The price explosion has left a residue of uneconomic residential mortgage debt. Estimates of "underwater" mortgage debt are in the vicinity of at least $1 trillion. This is debt that no longer makes sense for lender and borrower alike. Most bankers would argue the long-term fix is to transition the GSEs out of government and, better yet, eventually out of existence. Homebuilders argue otherwise. But short-term resolution remains elusive. How can we correct such a massive error fairly?

Looking at our economic house through another window, the American consumer remains over-levered and under-saved. Recent bursts in consumer spending have occurred as consumers attempt to re-lever, lessen savings, or both. If American consumers restored their savings rate to historical norms and partially reduced their leverage to even more recent norms, we estimate that future spending would be reduced by over $1 trillion. Not that underwater mortgage debt is the only root problem, but it pencils out to be the same $1 trillion order-of-magnitude.

This is our "Greece."

## RISING RISKS FROM EUROPEAN GOVERNMENTS, NOT EUROPEAN BANKS

The political appetite for saying "no" has left us with a directionless and unconvincing long-term solution, and there are many parallels to Europe's current crisis. Governments on both sides of the Atlantic over-promised and under-delivered. Both have socialized private sector credit, with dangerous accumulation of leverage.

The international risks embedded with the embattled Euro have again caught the banking system in the middle. While political narrative has unfortunately laid primary blame on US banks for economic damage, despite gross regulatory failures and government domination and subsequent distortion of mortgage finance, it is a little harder for that political narrative to catch on in Europe. While a similar EUR 1 or 2 trillion "bazooka" with TARP-like costume is being sought to shore up European banking capital, current banking exposure to un-marked sovereign bonds is nowhere near such numbers.

In the more recent European Banking Authority stress tests, pressure to mark down held-to-maturity sovereign risk was lacking, but the data to adequately calculate the exposure is now rather transparent for 90 banks against all EU sovereigns, by asset category including gross, net, bank book and derivatives. We have run many spreadsheets with harsh discounts for troubled countries against held-to-maturity positions and cannot arrive at a number much more than EUR 200 billion. Considering bank management mitigation efforts, we suspect the damage could be well less than that. The EBA's recent capital shortfall determination calls for 114.7B EUR of additional capital for sovereign risk, which would roughly reflect the same magnitude of potential sovereign markdown.

**The ten-fold larger Euro-stabilization "bazooka" is clearly not necessary to make Europe's banking system whole. It is to assure liquidity at a size that would instill investor confidence that the banks can weather, carry and finance even greater government debt resulting from the very fiscal failures of many ill-disciplined governments within the European Union!** The supreme irony is that Basel's new liquidity hurdles for banks would drive seemingly inappropriately-named "risk-free" government securities to even higher levels on bank balance sheets than today.

International risks extend beyond Europe and the Euro, unfortunately. In addition to potential "uncontrolled" revision of what constitutes the Euro, which would in almost all scenarios promote a European recession, the primary global growth engine of emerging markets is also slowing. However, the big, under-appreciated difference is that emerging markets rely on far less leverage. Government debt ratios in most of the larger EMs generally range between 15% and 35%, against the larger mature economies where such ratios are easily four times higher! This does not protect them from incremental deceleration in global demand for their exports, but most have settled on and are proceeding with domestic demand acceleration. It also provides them far greater financial scope to absorb credit problems.

With so many uncertain moving parts globally, it is unusually difficult to take any stance on investment strategy. The US economy can certainly be confronted by additional international headwinds, but the direct exposure of US financials is still quite limited. All of the largest have generally disclosed sufficient information on sovereign holdings and hedging to be convincing. But in the current environment, easily as disturbing as the 2008 liquidity panic, any serious case for direct contagion or damage can only be made by completely discounting any form of hedging. Unfortunately, this has been too readily presumed in a few recent episodes, and is unlikely to retreat without fundamental success in reforming Europe's core problems.

Since these are devastating confidence and liquidity, it is impossible to predict short-term shock or calm. Since liquidity runs are usually correctable by central banks, we can have some greater confidence in longer term market decisions, particularly for US financials currently captured as canaries in the proverbial coal mine where valuations have been hopefully over-reacting.

## US INTEREST RATE RISK FROM EMERGING MARKETS

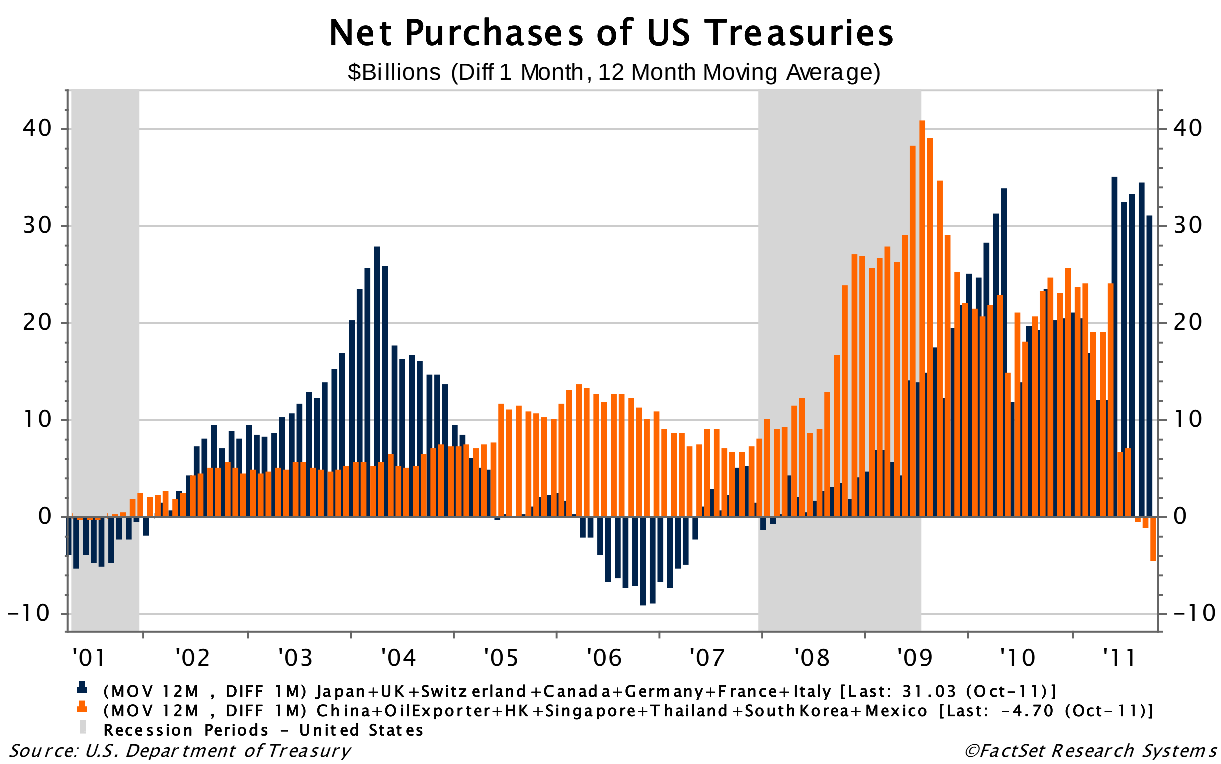
Future funding of our US government debt is also showing new footprints of global disorder. This is the second dangerous "aneurysm" we see for the US economy. We (and many others) have long held the concern that long rates gravitate toward a fixed spread to the nominal GDP growth rate. The 10-year Treasury is essentially 1:1 with nominal GDP over time. CPI + Real GDP is currently at 4%, 200bp higher than the 10-year, and with real GDP predicted to exceed 2% and year-over-year CPI already at 3.5% the math suggests a significantly higher 10-year Treasury rate.

This has been the wrong predictor for some time, largely due to earlier fears of deflation followed by several crises in the world's other large reserve currency, the Euro. Should Euro fears subside, our 10-year rate would logically rise. Should the Euro be bifurcated to exclude weaker members it would logically emerge stronger and still presumably large enough to re-assert its reserve currency status, and the US 10-year rate would logically rise even higher.

Obviously what makes our government debt so entwined in global liquidity flows is the fact that it is heavily owned by foreign buyers, particularly central banks and other "official" buyers. More importantly, emerging markets have mushroomed as major new owners since 1999, which is why we try to follow US Treasury data tracking the domicile of Treasury bond and bill holders. Net purchase by emerging versus industrialized buyers is depicted below.

We have aggregated the seven largest emerging market buyers against the seven largest industrialized market buyers, presenting their monthly rate of net purchases smoothed on a trailing 12-month basis. While the latter group represents considerably larger economies, the former became significant buyers a decade ago, recycling their rapidly expanding current account surpluses. We have estimated that all emerging market and OPEC countries together amassed nearly $10 trillion in hard currency surpluses between 1999 and 2007.

The most important point is that they represented a new pool of funds into the US economy larger than anything seen since the 1830s, certainly contributing to the decline in interest rates and, effectively, the rapid housing price expansion that depended on low interest rates.



The seven sampled here handily exceeded Treasury debt purchases from the largest industrialized nations since 2005. However, these buyers were retreating to a minor role in 2011, actually depleting their positions in three of the last ten months. China, which rose to exceed Japan as the largest holder of our debt, has dropped from $33 billion in monthly net purchases during 2009 to several negative months. This should be compared against the Federal Reserve's second quantitative easing, which was $50 billion per month, essentially filling in for much of the drop in EM purchases of our bills and bonds.

Japan and the United Kingdom have recently become larger buyers, adding $65 billion on a trailing 12-month basis through October, and are up $305 billion year-over year. Excluding these two would have left the total foreign buying in negative territory, with China down $41 billion and Russia down $84 billion year-over-year.

We recognize that mature economies have few places to safely store their surpluses, while emerging economies have substantial hard currency bills to pay to keep domestic infrastructure expansion ahead of domestic growth. With the retreat of EM buyers, a major source of incremental Government debt funding has dwindled. The decade-long flood tide of foreign buyers is now an ebb tide. Other than the Fed, no other significant source of new funding is to be found. This eventually will demand higher rates on our debt, after the Euro exodus subsides.

Foreign oil is not our economy's only hostage.

## INVESTMENT STRATEGY CONCLUSION

In summary, there are many and varied uncertainties of historic dimension to argue against heavy weighting in the financials, other than as trading positions with appropriate hedging. We were caught and recently reminded that we were telling institutional investors that financials were "un-investable" over two years ago. We failed to identify the March 2009 bottom, not because we saw insurmountable hurdles for financials, but for the simple and analyzable concern that the banking system could well be nationalized. Political uncertainty was vividly on display, and there were patterns of inconsistency in Washington that suggested policy mistakes could lead to even further unraveling. In the end the banks were not nationalized, but the mortgage market was.

The external political risks have risen to similar levels today. While the US is an unhappy economy with sadly increasing social problems, left alone it could well muddle through. The European Union is clearly another matter, with the same interbank liquidity evaporation combined with a serious currency problem and a more muddled mix of political considerations than we faced after 2008. While we mostly dismiss the direct contagion risks to US financials, the indirect impact through global economics is harder to dismiss.

But the new variables are strengthening balance sheets now beginning to show revenue growth in US banks, as well as longer-term investors, such as private equity, REITs and business development corporations, that are searching for mispriced or credit-abandoned assets to finance. This is becoming a **potentially mammoth redistribution of credit, largely insensitive to our economy's weaknesses**.

We continue to be constructive on selected financial stocks within these sectors, despite global uncertainties. Our criteria would favor domestic credit providers now showing signs of loan or credit growth. Among banks, we would be agnostic to both size and geography, focusing on those with the least legacy credit issues and strong capital positions.

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