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End of the Consumption Era

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* Continue to Overweight Financials, Emphasizing "Business Banks"
* Commercial Sector Must Lead the U.S. Economy Forward
* Consumption Era Winds Down in the U.S. and Other Mature Economies
* "New Abnormal" Continues with Slow Growth & Several "Cliffs" Ahead

We believe financials remain sufficiently disconnected from the economy to be overweighted as the world continues struggling to recover. Despite the many fiscal dramas to come, our 2013 outlook is a lot like re-reading "**The Great Credit Redistribution**", our year-ago outlook for 2012:

Signs of life continue to become increasingly evident in business lending. Critics doubted its sustainability or importance. Business borrowing did not falter in 2012, although many banks still argue being untouched by the cycle, which has actually gained in strength.

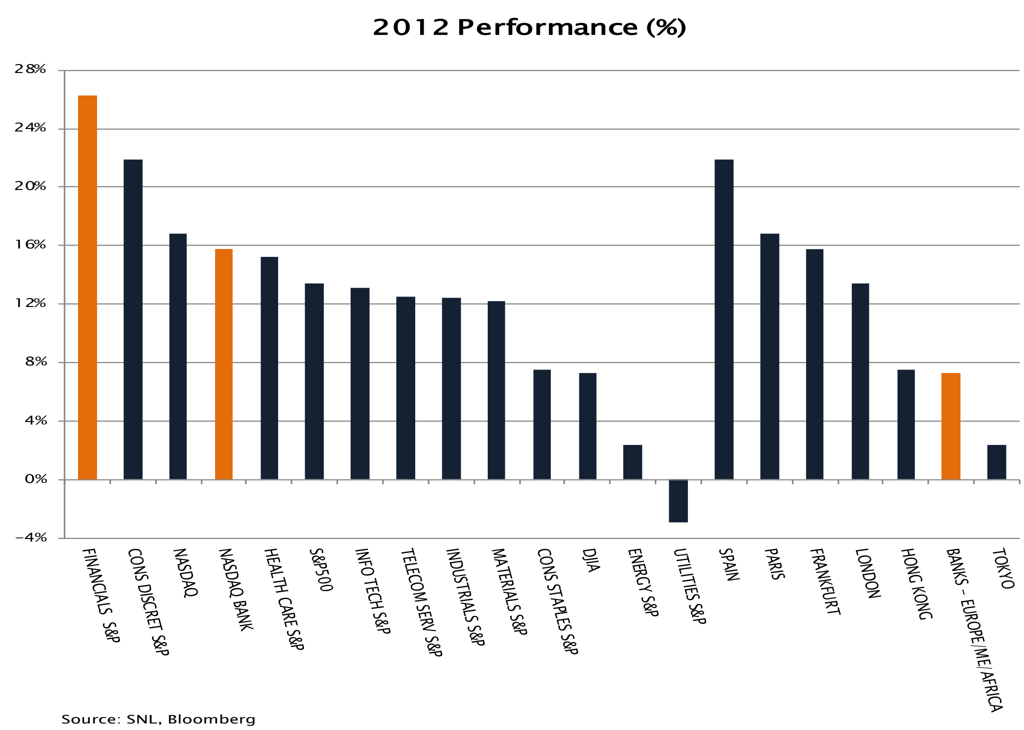
A fiscal crisis had just been narrowly avoided without addressing fundamental problems. The festering core of fiscal unreality manifested itself again in the closing months of 2012 as "the fiscal cliff." Another game of chicken with an over-the-wire compromise – a bad one at that – as the U.S. balance sheet continues to weaken. The Euro currency crisis is another fiscal cliff. There are many to come, as governments resist doing the right thing by doing it the wrong way, meanwhile laying more blame on private wealth and banking.

Interest rates declined even further. Rates remain near record lows in the U.S. and a handful of other countries as sovereign risks remain high elsewhere. Long-term sovereign rates refuse to normalize as global liquidity remains in safe havens, making it appear that central banks can compress rates without end particularly in the U.S. On this we were again wrong. We have repeatedly shown from history that long-term, "risk-free" government securities yield something close to nominal GDP growth rate. Our sub-2% 10-year Treasury clearly refuses to reflect our near 4% and hopefully rising nominal GDP growth.

U.S. consumer spending faltered and remains weak despite short burst of promise. Final demand in terms of personal consumption continues to be sluggish, despite all manner of programs to stimulate spending without insuring the income to pay for it, compounded by a stubborn workforce plateau stemming from immovable demographics.

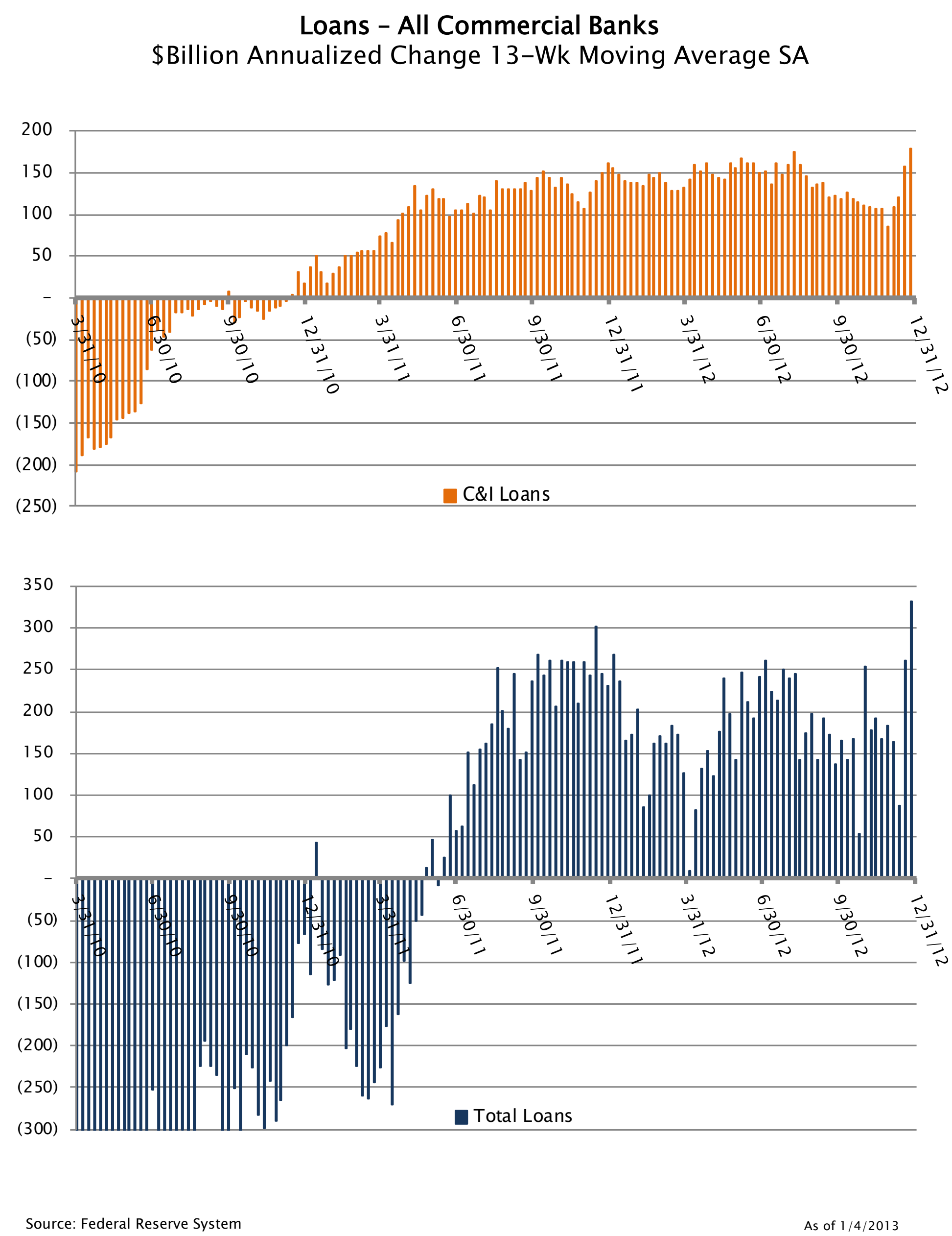
We therefore see three familiar and constant trends again for 2013 and beyond: 1) A consumption deficit preventing decent GDP growth; 2) de-leveraging (or better said, the loss of leverage) and 3) ongoing regulatory retribution.

The more things change, the more they truly seem to stay the same. Nonetheless U.S. financials were among the strongest performers for 2012 and we are predicting they will perform well again in 2013.



Business Banking Models, Rare but Becoming More Common: We continue to recommend overweighting financials, but with a strong bias toward balance sheet lenders, especially those serving clients on the commercial side of the economy. Early signs of life in lending actually appeared early in 2011, roughly six quarters after the official end of the recession. It was, and to a large extent still is limited to the commercial & industrial (C&I) category.

But it is no longer a nascent or sluggish phenomenon. By October 2011 and throughout 2012 annualized C&I growth consistently exceeded $100 billion, averaging $125 billion, comfortably in excess of 10% per annum. Although only 18% of total loans in the banking system, C&I lending has powered the expansion of the total loan base to a bit above 3% per annum, despite greatly reduced consumer lending, episodic commercial real estate lending, home mortgage lending dominated (effectively nationalized) by the Federal government and its agencies, and continued runoff of legacy loans.



Another persuasive positive for top-line revenue growth in financial services is the re-intermediation of credit onto bank balance sheets following the sharp shrinkage in non-bank credit. We have been loudly ringing this bell since mid-2011. Both investors and bankers have greeted this revelation with skepticism, but the evidence continues to gather by both anecdotally and by concrete Fed data.

Since mid-2009 private sector non-bank credit in the U.S. fell by over $7 trillion – an unprecedented and extraordinarily dramatic collapse larger than total outstandings for the entire banking industry! Much of this can be explained by a massive disappearance of mortgage loans and mortgage securities into the hands of the Federal Reserve and the Government-Sponsored-Enterprises (GSEs). We can only be grateful that the Federal Government resisted the temptation to nationalize banks themselves, although it was a close call back in 2009.

The unfortunate side effects of the Fed's control of the residential mortgage market – once the largest bank asset sector – include politically motivated, aggressive legal actions being taken at both federal and state levels, as well as ongoing rate subsidization and wafer-thin down payments. Until these side effects abate, most banks will continue to shun mortgage lending, postponing the return of bank balance sheets to their more relevant, historical function. Although the future may see the steroidal growth of bank mortgage lending, for now few but the fearless have remained in or re-entered mortgage finance.

We are absolutely not willing to count these chickens anytime soon.

However, the narrower replacement of non-bank credit with bank loans supporting commerce and industry is now very visible. Perhaps the most compelling case can be made as C&I loans rise with seemingly negligible economic momentum at this early stage. We think that part of the explanation for this is that bank loans are, indeed, beginning to replace non-bank credit. Ask any banker about the impact of this nascent re-intermediation trend and most will respond "Where? We aren't seeing it," and "Where we do see business borrowing demand, the price and underwriting competition is brutal."

Yet the Federal Reserve Flow-of-Funds quarterly database suggests otherwise. In combination, asset-backed securities (ABS) and credit from finance companies have together fallen $3 trillion since the 2008 recession began! Their $650 billion fall since the recession officially ended has averaged over $70 billion per quarter, and over the last twelve months ending September 30th the pace of quarterly decline continued at $53 billion. Meanwhile, the pace of bank loan growth has risen from an average of $40 billion since recession end to over $80 billion during the past twelve months – mostly from expansion in loans to businesses. ABS and finance company credit combined has fallen from 17% of the U.S. total in late 2007 to only 8% currently. Bank credit share has been largely stable at 25% for this period. This certainly looks like re-intermediation.

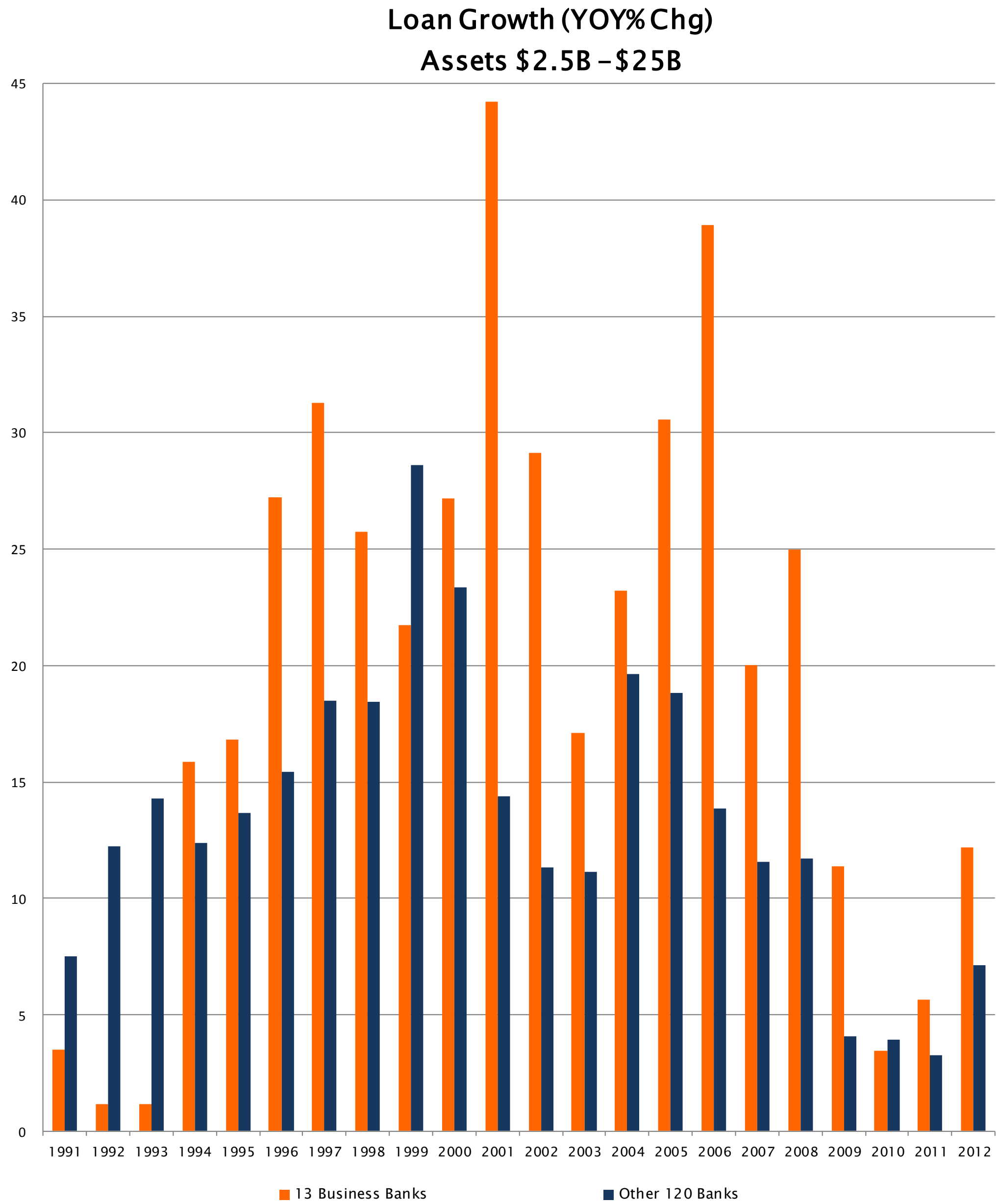
During many bank CEO forums we hosted last year many of the attendees were puzzled by such statistics, but in virtually every session we found a growing minority of bank CEOs, usually those with strong commercial banking credentials, who could corroborate this encouraging trend. This was true in many different geographies. Several have found their way back to markets previously dominated by non-banks that no longer exist. Equipment finance tends to be the more common and clear example, after the exodus of so many large non-bank credit suppliers.

Terms and price for such finance are, indeed, tight. But they always are in the early stages of commerce and production cycles and will offer improving yields above available securities portfolio returns once re-intermediation becomes more prevalent.

The strategic and investment implication for banks is relatively straightforward. Focus on business-banking models. Frankly, more banks claim they have such a bias than we can analytically demonstrate. In the following exhibit, we examine banks between $2.5 billion and $25 billion in assets. Of these we aggregated a small list of banks that are commonly accepted as having successful business-banking models. There are 13, and they average a little over 31% of their loans in the C&I category. The remainder average a little under 18%. The bars show total loan growth for each group on an annual basis over the last two decades. Except for the first three years, and again in 1999 (which was a heavy year for acquisitions) business banks have maintained a significant loan growth advantage for the other 18 years, including during the last two recessions. Total loan growth averaged 21% per annum for the 13 business banks, significantly stronger than the 13% average for the remainder.

One Door Closes, Another Opens: We are increasingly convinced that a lengthy re-balancing of GDP componentry favoring fixed investment (commercial versus consumer) in the U.S. has already begun. As it is likely to be a long term trend with unfamiliar repercussions after so many of decades of consumption growth, investors should watch, dissect and understand it. Like all long-term trend changes of scale, the proof can be subtle and irregular before anyone goes out on a limb to label it a megatrend. We see this trend as a slow but steady shift toward commerce, production and ultimately exports to world markets that are rapidly expanding and domestically present strong final demand for goods and services.

Evidence of domestic consumption deceleration in the U.S. has been growing. We have long been arguing that the days of robust consumer spending growth, which unquestionably dominated U.S. GDP growth as far back as the 1960s, would come to an end from both demographic and financial factors.

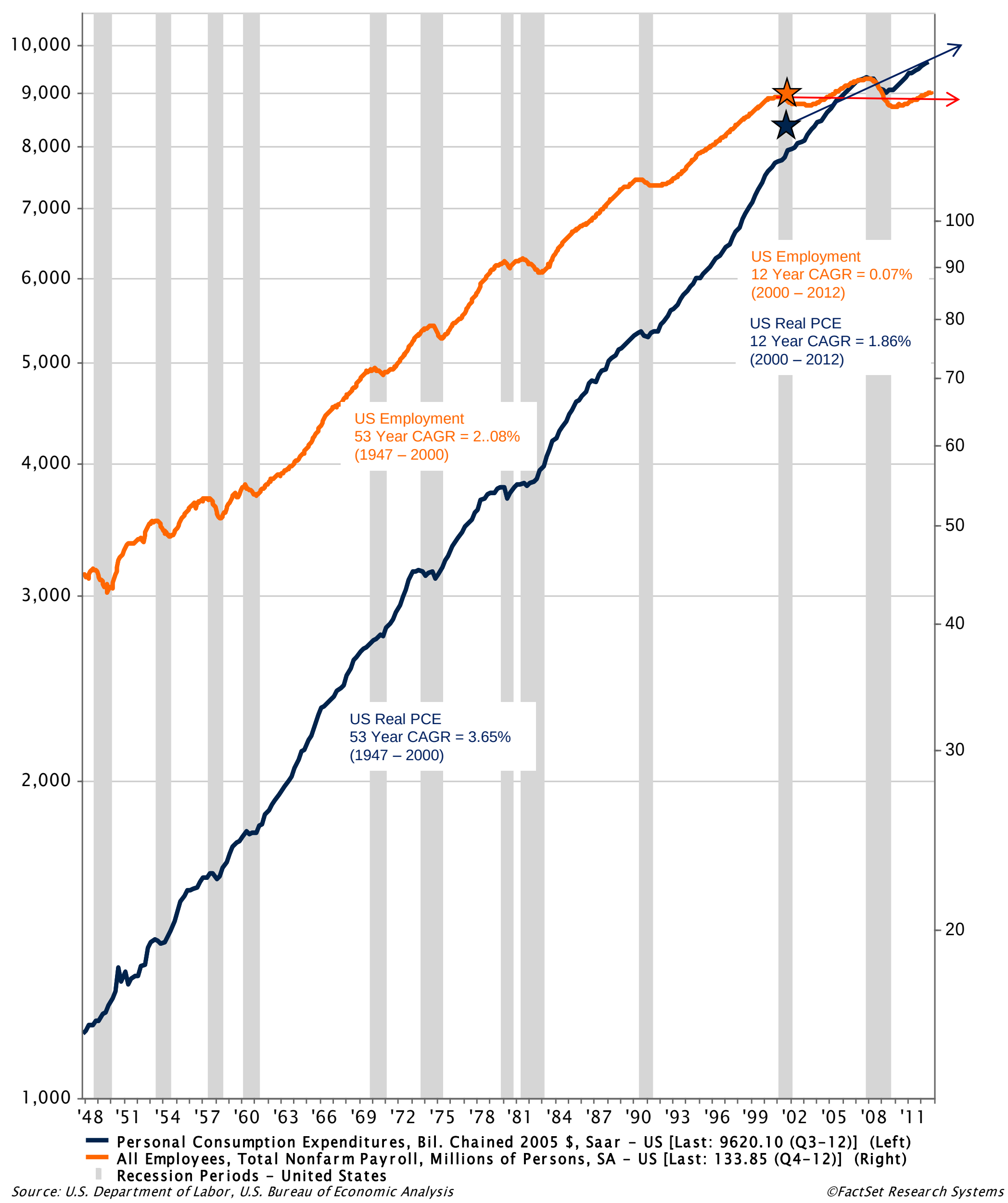


Source: SNL

There are actually two important realities that augur quite poorly for consumer spending: 1) A workforce that has essentially flat-lined since 2000 and 2) a consumer balance sheet with severe damage. Regarding the former, while the focus is always unemployment, trends in the employed base are more relevant to

GDP growth because they determine the course of consumer income and therefore the long term ability to spend. The exhibit below is particularly revealing, showing jobs and spending on a log scale since the late 1940s. Throughout the first nine economic cycles jobs have returned to a constant 2% trend line. Yet that trend was convincingly violated almost 12 years ago! Since the 2000 recession the employed base has shown virtually no growth, mostly attributable to demographic factors. We note that consumption has historically grown at a 75% faster pace with a 3.6% versus 2% CAGR until 2000.

Employment vs Real PCE (Log Scale)



This differential has been consistent since, with PCE decelerating to a 1.9% CAGR. This helps explain why we see U.S. GDP growth of only 2% per annum going forward. To put it differently, if we were to somehow return once again to the job trend line established from the previous five decades, we would require another 26 million jobs added to the employed base as it stands today! Unlikely.

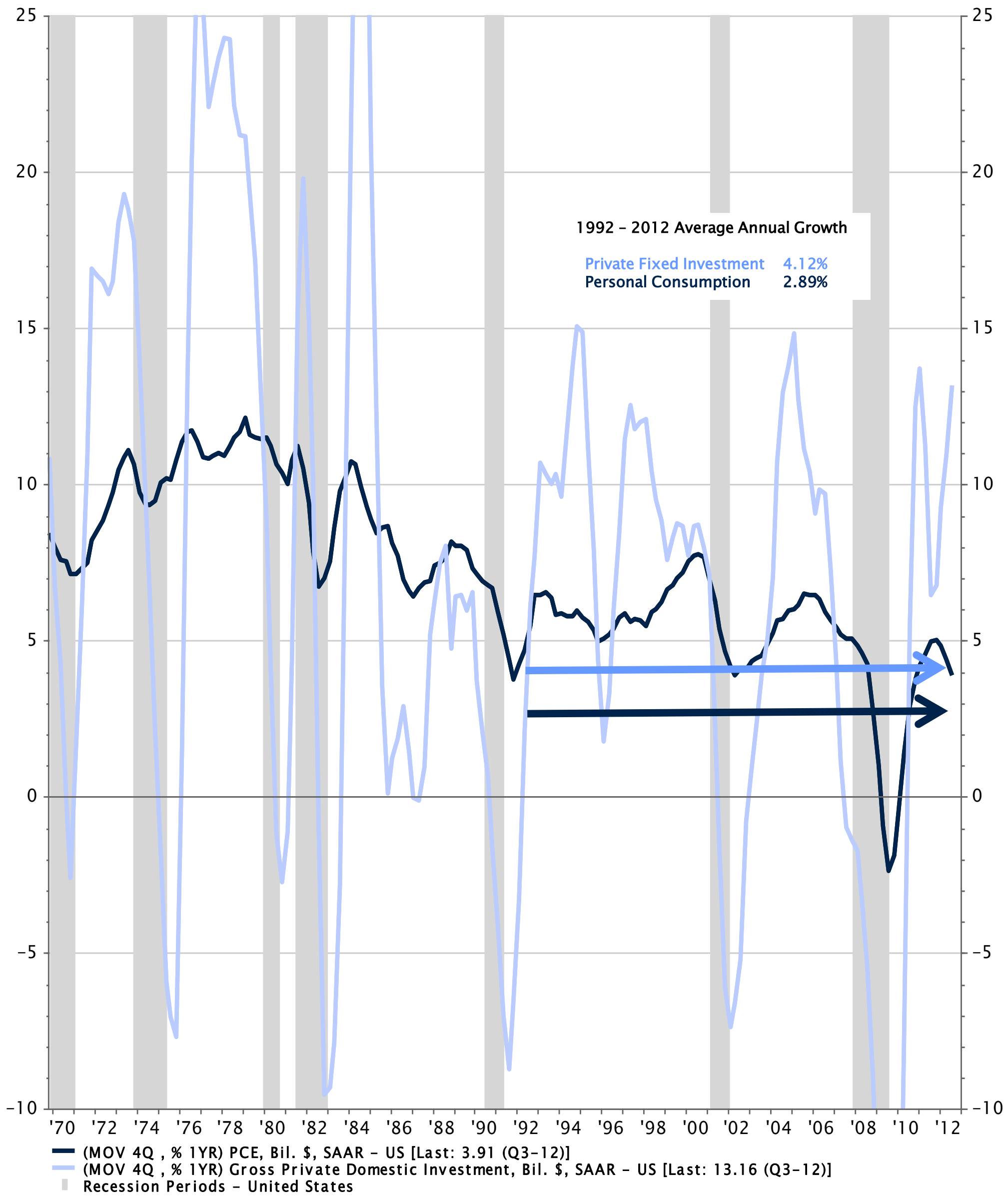
The other consumption restraint is a weak, albeit improving consumer balance sheet. We have shown very convincing quantitative analysis of this damage in prior reports. To summarize here, we still estimate dysfunctional mortgage debt (negative equity) well in excess of $1 trillion and roughly another $1 trillion gap combined from excess leverage and shrunken personal savings. We have repeatedly pointed out that even a gradual closing of these gaps would be a serious consumer spending headwind as they represent approximately 22% of annual spending at current levels! Theoretically, if the consumer were to take the next ten years to pay down debt levels and rebuild savings, PCE growth would be zero.

Just as the consumption side of the economy shows repeated signs of incapacity and exhaustion, the commercial side appears heating up. Evidence of production recovery can be found in recent fixed investment trends. Domestic private fixed investment (PFI) averaged 17% of GDP against 69% for personal consumption expenditures (PCE) for the decade leading up to the last recession and promptly fell to only 11% by recession end. Since then it has recovered to a little over 14%.

But is it reasonable to assume such a small component could replace one so much larger, especially since both of their multi-cycle trend line growth rates have been similar (4% versus 3% for the last two decades)? The answer is two-fold: The size of fixed investment has slowly but steadily grown relative to GDP for many decades. More importantly, fixed investment traverses a much wider range of cyclical growth than consumption. Since 2009, for example, investment growth has averaged over 10% per annum growth against a paltry 2% for consumption. Over the last four quarters PFI has averaged 11.7% growth against only 1.9% for PCE.

Putting some quantitative perspective on a re-balancing of GDP is helpful. PCE has averaged 67-68% of U.S. GDP over the long term. It is currently at 70.5% and we have frequently argued it could at least return to its average. If we assume it drops those three percentage points relative to GDP, say over the next three years, what would be required of PFI to offset this? Further assume that Government Spending and Investment (GSI) continue to decline three percent per annum, which happens to be its average shrink over the last two years. Because net exports should improve in a transition to commerce and production, we assume improvement from the current $400 billion deficit to a $300 billion deficit. Although a level this low hasn't been seen in a decade that was a robust consumption decade, with ballooning imports.

PCE vs Fixed Investment (YOY% Chg)



Source: U.S. Bureau of Economic Analysis *©FactSet Research Systems*

These assumptions would require a $935 billion increase in PFI over the next three years, or 14% average annual growth in real terms, to achieve 3% GDP growth. This is 20% faster than its average over the last two years. While not impossible, we think that would be a stretch – a pretty hot capital spending boom. If we lower the GDP growth assumption to 2%, however, then PFI could get us there at 12% per annum, an $800 billion advance that looks more realistic.

The 2% GDP growth numbers also work when decomposing private fixed investment into sectors. Within PFI most look to a housing recovery as the obvious and critical fixed investment driver, but in reality residential construction currently makes up only 20% of total PFI. (During the housing boom it was as high as 35%.) Moreover, residential construction has already swung from a 25% rate of decline at its nadir in 2009 to 14% growth as of the latest reported quarter, so for a mid-point growth rate we feel comfortable assuming a steady but brisk 18% annual rate for the next three years. The largest spending category is actually information processing, currently at 33% of total PFI, and is one of the few components that have already passed its pre-recession peak, while averaging 4% annual growth for the last two years. There has been some deceleration since last spring. Perhaps we could use a real 5% per annum growth rate going forward. The other category of probable strength is in infrastructure which includes mining, exploration, power, communication and transportation equipment. Together these represent 19% of total PFI, and would need to grow 12% per annum.

So the numbers can work. America can return to a more balanced economy despite sluggish consumer spending, but GDP growth is unlikely to return to the 3+% vicinity for any sustained period of time.

Cliff Drama More Distraction Than Insight: One can still revel in the dark drama of fiscal collapse. We take the view that the US fiscal cliff was not averted so much as pushed back, and we all know another fierce battle looms shortly on spending cuts packaged with another waltz around the U.S. debt ceiling.

While they may not carry the same moniker, fiscal "cliffs" are readily found outside the United States. The other steep cliffs are in Europe and Japan, all with the common cause from mushrooming debt burdens that took a long time to build. As they hardened over a decade or more, it seems logical to expect that they will take many incremental attempts to repair. The simple reality is that the political class has no choice but to keep chipping away at these structural problems, but "Grand Bargain" solutions are wishful thinking.

The politics that have shrouded fiscal solutions and soured willingness to make hard choices have become exceptionally hideous. We can all agree on this. How many times in a discussion over the flawed Euro, or the absurd math embedded in the U.S. budget, has someone among us boldly announced that in an afternoon they could spell out the program, the famed "roadmap" that would ultimately and more directly solve these problems?

Fiscal cliffs are providing more distraction than insight for investors. Their artificial triggers and deadlines have taken on much more prominence than the underlying problem. These cliffs are more symptom than disease. The disease is simply excess sovereign leverage, in no small part exacerbated from socializing unwieldy private sector indebtedness onto the public balance sheet and by inefficient, sloppy stimulus programs attempting to re-ignite consumption and economic growth after the severe global recession.

The mere fact that a known and critical "anti-cliff" action proved nearly impossible politically in the U.S. until the last conceivable moment brightly illuminates both the seemingly insurmountable scale of accumulated budgetary excesses and the lack of will and discipline to get it done. While the latest cliff was averted, after hysterical media narration, a comprehensive plan to restrain future deficits was not achieved. Many cliffs are coming. We think investors are becoming numb to the drama.

The New Year's Day stopgap in the U.S. was an excruciatingly small, contrived and ineffective step. Nothing consequential happened on the spending side, as everyone knows. We would also argue that nothing meaningful was accomplished on the revenue. The estimated revenue benefit is no more than $60 billion or 15% of the $400 billion per annum ($4 trillion over a decade) goal post. Viewed from another perspective, this minor achievement would be completely erased by a mere 40 basis point increase in U.S. Government borrowing rates! That's all they got after throwing the "wealthy" under the bus.

This should tell us two things. First that it will take several more marches toward the cliff to force more effective political response. Second, that investors will likely recoil less and less with each new act in this drama. Why? Because investable private savings and wealth must eventually go somewhere outside safe havens with negligible returns. Frantic worry over a single impasse has already left the timid, risk-averse investor even further behind. In short, we're all getting more accustomed to catastrophes that somehow never happen, and we increasingly should recognize that the three trends cited earlier will be with us for the foreseeable future. We have called these collectively the "new abnormal."

Similarly, the Euro crisis is becoming less of a crisis or cliff and more like a marathon. It has become conventional wisdom that the common Euro currency was flawed from inception. When launched over a decade ago, it only envisioned a common monetary structure, neglecting any central or common fiscal administration, other than routinely ignored debt limit bands. That will not be corrected anytime soon, although ultimately it must be sometime in the distant future. For now, excessive debt across the spectrum, from governments like Greece, and sectors such as Spanish real estate, requires ongoing, corrective treatment. That treatment ultimately includes further credit write-downs, which in general requires a stronger European banking system. As we highlighted in our report **"The Right Rubicon"** last July, the straightest, least costly path for now is through a pan-European deposit insurance system.

Feedback after that report rapidly turned cynical. The deposit insurance proposal was seemingly dead on arrival and little else was heard. But months later its general concept resurfaced with the help of some German capitulation and the compelling logic of least cost. Once a large enough guarantee base is formed, deposit insurance or the promise of pan-European support effectively ends the risk of bank runs. Surprisingly few know that in the U.S. the FDIC never held more than $50 billion in reserves for a banking system with $14 trillion in assets. The Federal guarantee was and is sufficient, and the banks themselves absorb any FDIC reserve depletion over time. U.S. commercial bank failures cost the Government nothing and the risk of a bank run is off the table.

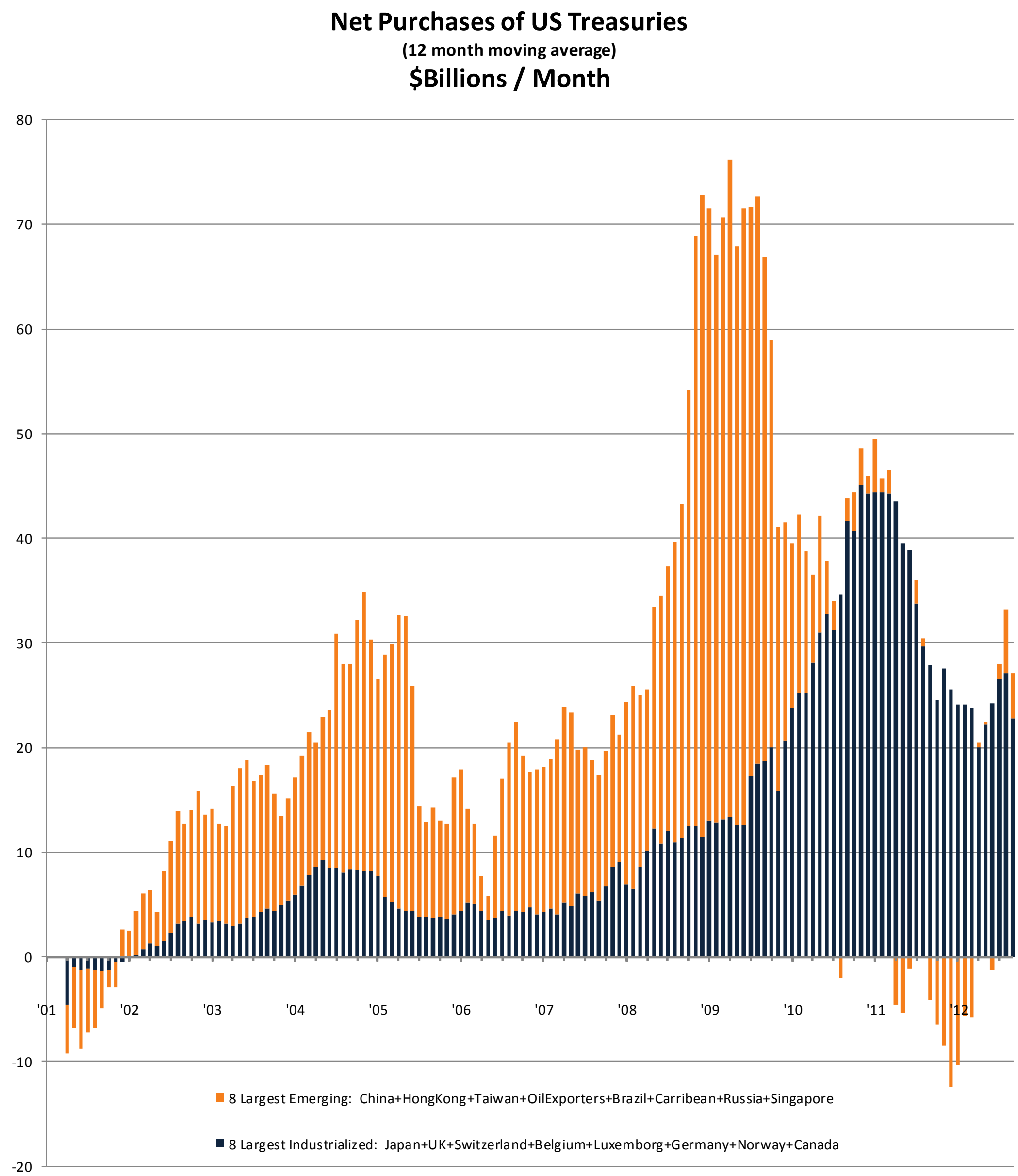
For a common currency Euro system, the 23 governments must collectively underpin an effective support, like a deposit insurance scheme and not just rely on individual country support. The prerequisite to this is, of course, a common regulator. This logically should be the ECB. EU Finance Ministers just came to an agreement on that last month, putting the 100 largest banks in Europe under the ECB's supervisory umbrella, finally surprising critics and the media. Regardless of differing cultures, the political class can readily understand that this is, by far, the cheapest solution. Of course a cliff remains, as the centralization plan is targeted for 2014.

This will not be a solution to Europe's sovereign debt problems, but it greatly reduces systemic risk and may prove to be a "back door" into longer-term structural reform for the Euro. The Euro is still functioning and most members see the need for it to continue. Denial is receding. ECB President Draghi has won a critical battle to buy European sovereigns, not as the Fed does to hold long rates unnecessarily low, but to control excessively high rates in countries like Italy and Spain. This is a big distinction. The Euro is up 11% from its summer floor. It is working, but ongoing recessions in Europe may push the ECB to the next cliff.

More immediately, anything that moves Europe away from any of its cliffs can be seen as negative for U.S. government debt service. This is because the largest remaining buyers of U.S. Treasuries are no longer emerging markets but mature economies. The U.S. supply of Treasuries continues to be $100 billion per month. During the worst of the Euro crisis, foreign holdings of European sovereign debt outside of Germany and France were falling at about $70 billion (USD) a month! It is reasonable to assume that a significant portion of the proceeds went into U.S. Treasuries as well as a dwindling number of other safe haven sovereigns. It is noteworthy that the Fed has recently returned with a QE3 for purchasing Treasuries that is only slightly larger than this outflow.

The reverse probably will happen as the need for safety lessens and as a broader list of Euro sovereign debt regains some of its appeal. We are seeing signs of that today. Meanwhile the mix of buyers of U.S.

government debt has changed rather dramatically. Emerging markets have been net neutral at the auctions, although this buying base swings between an inflow or outflow of about $10 billion per month. (At their peak, emerging markets were buying as much as $60 billion net!). Industrialized countries are currently buying about $20 billion per month, which could drop further or even swing negative. The remaining $80 billion in new monthly Treasury supply must appeal to domestic buyers, and any return to the Euro could quickly make this number higher. As private and institutional investors increasingly look for higher yield the unhappy fact is that the Fed could be the only alternative buyer unless Treasury rates were to rise.



Source: US Treasury International Capital Reports & SOP adjustments

Shaded Areas reflect quantitative easing periods

So it is only a matter of math and timing as to when the longer end of the US Treasury curve reverts to something considered more normal. Normal for the 10-year, as we have repeatedly noted, would be somewhere slightly above the nominal GDP growth rate, which has averaged 4% over the past year, and will hopefully be rising. We have been badly off on this timing so far, but as liquidity both domestically and globally moves away from safety, the result should be obvious. Moreover, the Euro bloc could simply improve relative to the USD either from more coordination within the bloc, more progress on fiscal issues and/or lower systemic risks. Any of these would be a considerable challenge for QE3 to offset.

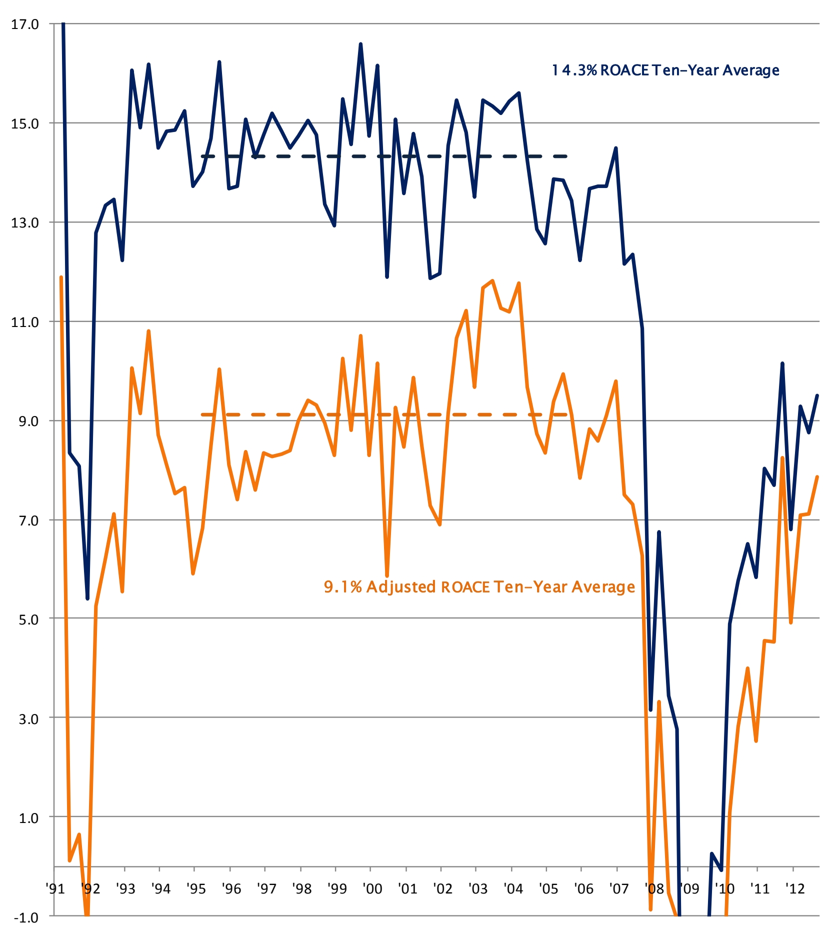
Valuations & Expectations Must be Taken in Context: While there certainly are divergent views about global economics, there are primarily two schools of thought if we over simplify the narrative. One is for a bigger and broader recovery of GDP that would quite readily trigger monetary restraint and drive interest rates higher. The other is for prolonged weak growth with presumably little reason for rising interest rates. In the latter case, we question whether interest rates could remain at current levels, however because the comparatively higher growth from domestic demand and infrastructure expansion within emerging markets is a considerable factor driving prices for commodities and goods higher. The industrialized world will be importing inflation for some time to come. This ultimately must be reflected in higher interest rates for more mature economies despite their far more sluggish growth. So we have a win-win situation for bank investors, with the only difference being how big.

For financials at this juncture, either represents a favorable reward to risk ratio. In the first case, better economic growth would clearly drive top line revenues in credit and financial services and the concomitant rise in interest rates would do great things for spread income. We still believe the more likely macro backdrop will be continued economic sluggishness, with the day of interest rate reckoning uncertain. If this is our future for 2013, financials still have sufficient scope to outperform.

The easiest way to recognize this is to envision our "New Abnormal" becoming normal, with low GDP growth perhaps holding down corporate profit growth. But with ultra-low interest rates the bar for relative performance of all equities is lowered. Take, for analytical purposes, the new normal arithmetic for pension return assumptions. If the 10-year stays around 2% it is unreasonable for pension fund managers to look for total returns much better tha, 3-4% as compared to the universal 7-8% assumptions during better times. If banks can grow their loan balances at 3-4% with some eventual price improvement on the commercial side, it is reasonable to assume this growth increasingly falls to the bottom line. If we are correct on re-intermediation, loan pricing eventually must improve. Adding dividends, banking can be a sector offering steady, high single-digit returns.

We illustrated that the bank earnings model has recovered more than is generally thought in our **"Scale Increasingly Matters"** report last July. To do so we subtracted the risk-free interest rate (using the 10-year U.S. Treasury) from return on common equity for the industry. On this basis, banking ROE had actually recovered almost 80% of its return over the risk-free hurdle rate. The updated exhibit below shows that recovery has now reached 86% of its 10-year average prior to the recession. As we pointed out at the time, this is in spite of an average common equity to asset ratio over 11% versus the 8.8% ratio during that same 10-year average period. So the 86% recovery includes a 27% increase in the denominator! In preparing this exhibit we excluded banks with assets above $100 billion and banks below $25 million in assets solely to eliminate capital markets and international influence in the largest and sub-scale noise in the smaller institutions. We were looking to reflect profitability in the industry core.

Return on Common Equity (%)

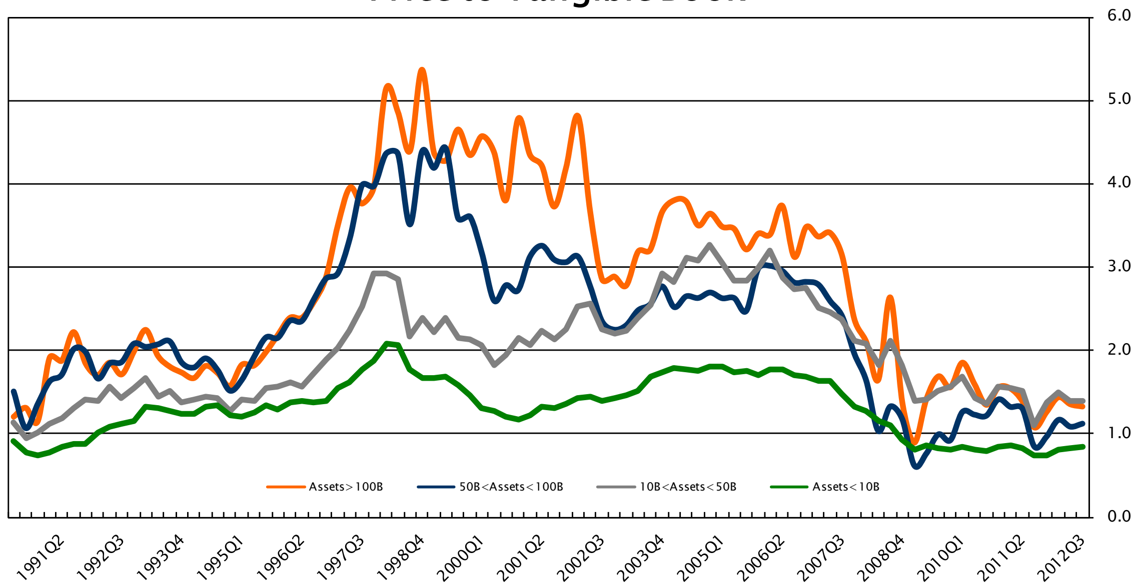


Note: All U.S. Commercial Banks

Source: SNL

The tangible common equity ratio has risen 20% over the same period. Yet the current price to tangible book ratio has fallen from approximately 3.5x to 1.3x for banks exceeding $100 billion in assets, and from approximately 3x to 1.1x for banks between $50-100 billion in assets. These reflect 65-70% valuation erosion. Banks in the $10-50 billion asset range have fared somewhat better, falling from a little over 2x to 1.4x representing a 30% valuation loss. There is an obvious disconnect when viewed this way.

Price to Tangible Book



Source: SNL As of 1/4/2013

In that same report we demonstrated that both profitability recovery and capital expansion deteriorated with smaller size. Scale increasingly matters for both. Profitability is damaged by regulatory excess driving costs at smaller institutions without the resources to absorb them. Capital is scarcer for smaller institutions. These restraints have immeasurably added to the need for industry consolidation.

Finally we are seeing valuation gradually returning to earnings from book value. It is still early in this transition, but U.S. bank valuations have been historically based on earnings when they are finally discernible and cyclically responding. Top line loan growth is the first stage in this transition. Prior to the crisis, forward Price/Earnings ratios for the larger regional banks averaged 14x. These are currently selling at 9x earnings, a 36% decline paralleling valuation erosion on book. The big difference is that valuation begins to reflect future earnings power as confidence returns to the sector.

This valuation transition also supports acquisition math. In a primarily price-to-book valuation framework, book dilution in an acquisition is quickly translated into lower market value. In a price-to-earnings framework, earnings accretion usually enhances valuation. While acquisitions have been scarce, they have recently been carrying substantial earnings accretion - much higher and quicker accretion than they did several years ago. Rapid realization of double-digit accretion is now becoming the norm, but it is largely ignored when valuation fixes primarily on book or tangible book. When this transition matures these penalties can become material rewards. This will also propel consolidation.

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