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Think Elongated Cycle

Slower But Durable

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*** Neither Advancing Recovery Nor Approaching Recession**

1) **Elongated Cycle ... By a Big Factor ... Almost 3X**
2) **Slower ... Now Trending at 2% GDP Growth**
3) **Monetary Stimulus in Retreat**

*** Cyclical Stocks, Including Financials, Have Further to Run**

*** Consolidation Will Increasingly Be the Solution for Banks**

The U.S. Economy: Market expectations have wearily swung between ignition and collapse ever since the "Great Recession." The interest rate outlook has mirrored these swings. Obviously financials not only mark time with the economic cycle, their operating margins have been pummeled by ongoing net interest margin erosion during a relentless period of extreme monetary accommodation.

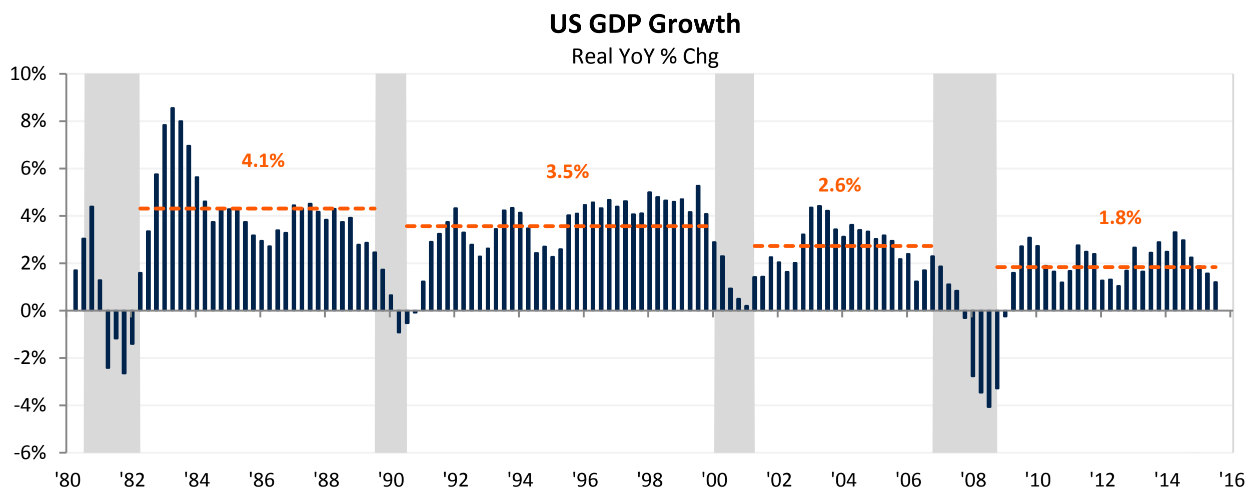
Many expect reviving growth during the second half of this year to clarify the economy's health and to foster further, gradual monetary stimulus withdrawal. Most have also relaxed their fear of oil and gas market dislocation, of China's slowdown and of political populism on an increasingly global scale. Some now consider the possibility that negative interest rates could cross the Atlantic. Both Brexit and the U.S. election pose fresh clouds and potent uncertainties.

Despite this cauldron of drama, we believe there is a revealing, more helpful pattern to the present cycle that strongly suggests a more benevolent outcome, at the cost of subdued economic growth. All recent cycles have repeated a consistent sequence of achievements in economic recoveries. Only the time scales have changed. For example, consumer spending historically took an average of one year to recover to its pre-recession level... However, it took three years to fully recover its pre-recession level since the mid-2009 recession end. Jobs recovered historically in an average of two-plus years versus well over six years in the latest cycle.

Economic data series show a 2.2x to 3.0x time extension to recover their pre-recession levels. Bank loan growth did not begin until 31 months after the recession ended versus 13-plus months historically, at the bottom of the extension range, as business lending recovered rapidly and more robustly than other loan categories. Generally speaking, the sequential pattern of these and other variables has been the same. Only the time period was markedly longer.

Simply put, while the cyclical footprint is nearly identical to a "normal" cycle, the stride has considerably lengthened. Other variables show similarly elongated recoveries. Achievements have taken three times longer on average. Interestingly, the onset of a Fed Funds rate rise has been between two and slightly less than three years after most recessions end. If we use the lengthened time scale suggested in the current cycle, rising rates should roughly occur 7.5 years after the recession ended, which roughly works out to yearend 2016. So it is hardly unusual for the Fed to have held fire this long! The caveat to this analysis, of course, is reliance on coarse, averages. But because of the dramatic time scale shift, it perhaps better reveals the forest from the trees, the latter being streams of macro data which can appear more volatile and misleading against more modest growth than at any time in recent history.

This cycle in slow motion can be easily seen by a steady decline in GDP growth since WWII and can largely be explained by labor force demographics, which began breaking down over 15 years ago! Rather than looking at arbitrary time periods for historical growth averages, we find it more helpful to look at average GDP growth rates between recessions. This isolates normal, organic growth from the extremes in recession and recovery data. A clearer, stair-step deceleration emerges using this approach.



Source: Bureau of Economic Analysis

Presented this way, over the last 35 years the inter-recession GDP growth trend declined from 4.1% per annum in the mid-to-late 1980s to 3.5% for most of the 1990s to 2.6% prior to the Great Recession and only 1.8% since. This is a telling exhibit depicting over 50% reduction in U.S. economic momentum. Consumer spending, the largest GDP component, unsurprisingly shows the same inertial step-down pattern from 4.3% to 3.8% to 3.0% to 2.0% over the last six years (see Appendix.)

While there are many possible explanations for this economic deceleration, the clearest reason can be found in labor force statistics. Average annual labor force growth for the two decades prior to the 2008-2009 recession was 1.2%. Average growth since has been 0.5%, less than half that pace. Furthermore, the labor force slowed but never went negative in past recessions. It did so following this last recession, and took almost six years returning to even reach the 1.2% average historical pace. The demographics of advanced aging, fewer women joining the workforce and sharply lower youth participation all contribute, along with an expanded social safety net. Other factors such as technology and globalization have been suggested as well.

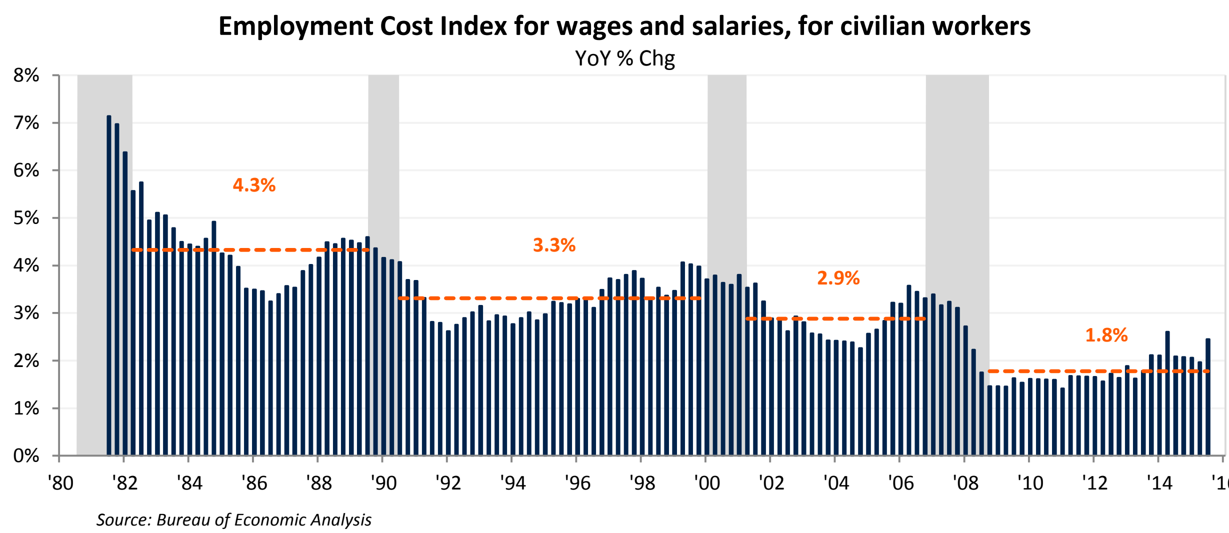
Applying the same inter-recession average method, a similar slippage can be seen elsewhere. A sampling of the largest European economies shows an even more disturbing 65% growth decline over the same period. A sampling of other large economies, including Emerging Markets, shows a more resilient 25% drop (see Appendix.)

The Fed: The Federal Reserve has ricocheted off years of volatile data along with the rest of us.

The initial August payroll gain of 150,000 was below estimates but still sufficiently strong for a month notably vulnerable to seasonal distortions. Initial August numbers are frequently revised upward. It also exceeded the stable unemployment hurdle, which has been calculated in a range of 75,000 to 125,000 per month. Monthly growth in jobs has averaged 175,000 over the last six months and 1.8% higher than the previous year period. But monthly labor force growth has averaged only 96,000 over the last six months and only 1.2% higher than the previous year period.

How the Fed weighs this and other data before its next meeting cannot be known, but unless there is a significant surprise the payroll number alone should not dissuade a rate hike. Although business spending has faltered this year, consumer spending has been building momentum. Consumer spending exceeded disposable personal income growth for the first time in over two-and-one-half years as the savings rate dropped from 6.1% to 5.7% in the last two quarters. The core consumer price index has remained above 2% all year. On the soft side, business spending ex-energy was up only 2.1% in the second quarter after hovering above 5% for over four years (see Appendix.) Confidence has clearly eroded, particularly among small businesses, and can probably be attributed -- at least in part- - to the disruptive and discouraging political outlook.

The missing ingredient for Fed action is a clearer sign of wage inflation. Although the Employment Cost Index has edged higher, it is averaging only 1.8% since the recession and simply mirrors the other step-down patterns, having fallen from 4.3% in the 1980s. The ECI has historically taken two to four years before it begins rising. Once again, through our "slow-motion" economy model with up to a 3x expanded time scale, wage inflation would theoretically not be expected until at least six years following the recession end. Looking at the monthly BLS series, there actually was an uptick in average hourly earnings, albeit barely discernible, by mid-2015.

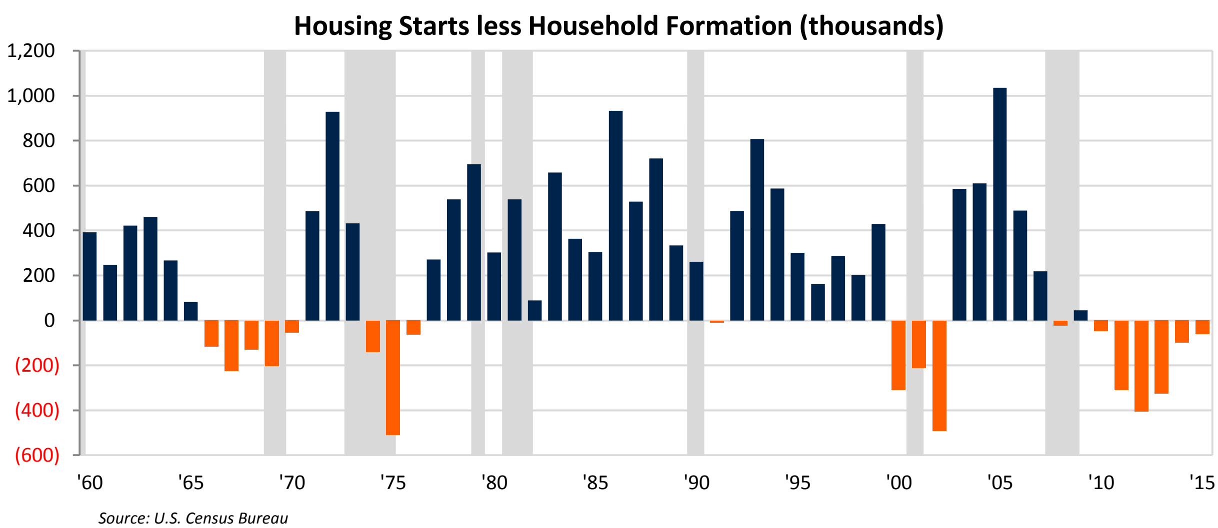


One has to assume that with inflation data generally showing much lower trend line numbers the Fed would adjust its expectations and hurdles lower. On average the CPI runs about 95% of the rate of real GDP growth, which would proportionally suggest 1.7% is now the neutral average for inflation. Waiting for a 2% inflations rate in a 1.8% GDP economy seems increasingly unrealistic. The same can be said for central bank goals in Europe. Nevertheless, some Fed officials have actually suggested raising the hurdles when it strikes us the reverse is called for.

In our view the bigger monetary policy question is not just about monthly data confirmation and some recalibration for a new normal, but the unintended consequences (read "bubbles") as central banks remained excessively accommodative over this unusually protracted period of time. There are at least three: One bubble is in pension funding that has seriously fallen behind its obligations. The funding deficit just for state and local governments and the S&P 1500 companies has been estimated at least at $1.8 trillion. Real return from 10-year Treasuries has collapsed to barely 1%, a level not seen since, however briefly, since the 1973 recession and represents an almost 85% decline over the last 35 years - far more than the decline in real GDP growth.

The bond market is another bubble, unless current interest rates prevail in the long term, which would only worsen the pension gap. The U.S. bond market has about $1 trillion at risk for every 1% change in rates.

The third bubble, sadly again, is in home prices which have risen far faster than family income during prolonged, ultra-low borrowing rates. Average home prices have now reached 4x family income, back to the same level just three years ahead of the last bubble peak and subsequent collapse (see Appendix.) This can also be seen from the difference in household growth versus housing starts, which have lagged behind for six years, worse than anything seen since the late 1960s and for far longer following a recession. This also validates our lengthened cycle thesis



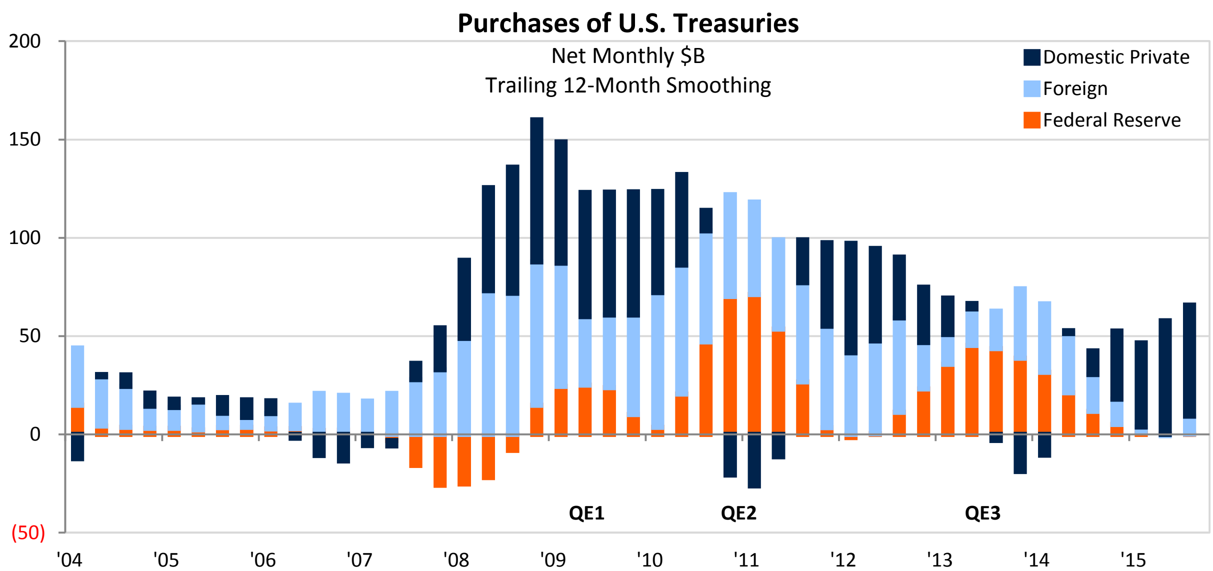
While most central banks continue to ease, virtually all have begun singing a similar, self-doubt refrain this year: Accommodative monetary policy alone can no longer be expected to aid or drive growth - fiscal policy (government spending and tax policy) must now carry the ball. Other than in Canada and Japan, vastly different in nature, there is little evidence of such government thinking, let alone action. Some believe it is simply too late or politically too difficult to finance at this stage.

We have always argued that monetary policy is more effective as a brake and fiscal policy is more effective as an accelerator. The last significant U.S. fiscal package was the $831 billion American Recovery and Reinvestment Act of 2009, which is an inefficiency case study that the Government itself publicly tracked to show how it "saved or created" 2.5MM jobs -- at the cost of $315,000 per job!

Other than for awkward political optics, we believe the Fed has been more than ready to raise rates, however gradually. Unless other domestic data or external events to the contrary raise doubts, we believe the odds of one or more hikes this year are higher than the current consensus. With that said, it continues to be a very difficult call. Factors external to the U.S. have become the tail wagging the dog.

Brexit, which was arguably the main reason the Fed passed in July, could potentially delay action again, but not so likely in the near term. The real risk for Brexit, and it is a large risk, is not a U.K. recession but further splintering in mainland Europe which has weaker economic momentum and poses far greater contagion to other markets as it is the largest block of global import demand - roughly triple that of China. Perhaps counterintuitive, in the near term the better it appears to be looking for the U.K. the more likely mainland proponents for departure will build momentum.

Furthermore, external forces have far more influence on the long end of the U.S. yield curve. We have frequently emphasized this point with a summary supply/demand bar chart of U.S. Treasuries, segmenting the shifting mix in domestic, foreign and Fed purchases. This chart clearly indicates the magnitude of past Fed quantitative easing - now gone -- and the magnitude of foreign buying -- now almost gone. As the budget deficit again begins an upward climb expanding supply, domestic demand must rise to crisis levels to clear the market.



Source: U.S. Department of the Treasury, Sandler O'Neill

This is unlikely to happen without rising interest rates, especially in longer-term Treasury bonds. Conversely, it is very unlikely if foreign demand for U.S. debt revives in fear -- as it did several times during and post crisis. Brexit still has that potential. The answer is not within the Fed's wheelhouse at all in our view. The answer is whether foreign central banks, particularly the European Central Bank, begin to accept cycle "elongation" and the reality of slower global economic growth rather than manage monetary policy for unreachable goals. In recent weeks a transition to such acceptance has begun to emerge. Whether and when policy follows is still uncertain.

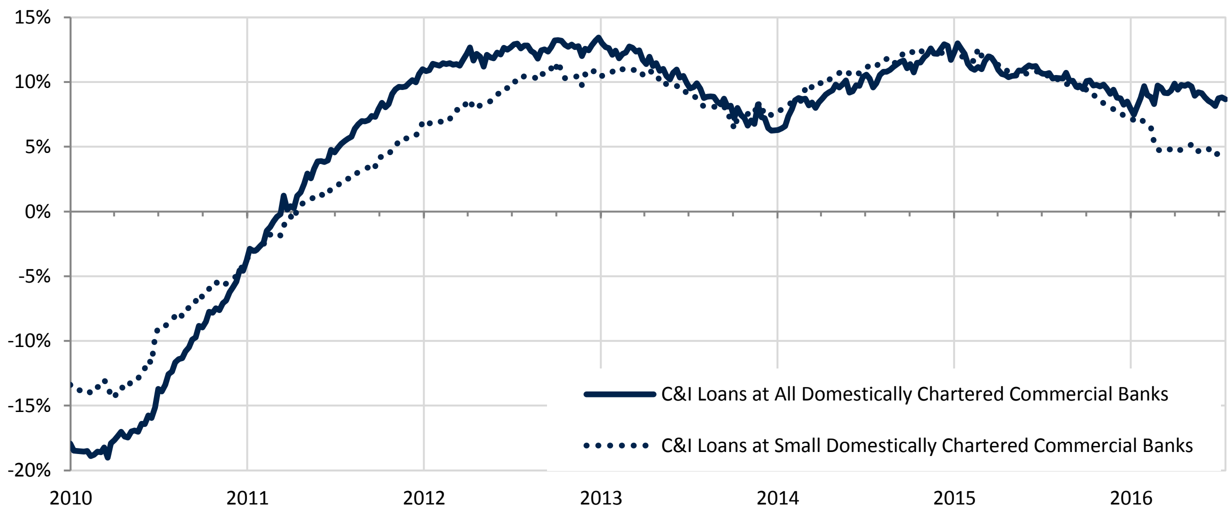
As markets contemplate an end to monetary stimulus, a period of disruptive transition is also preordained. This is evident in the recent market retreat as investors question whether the lack of further stimulus changes anything. Without question addiction to excessive easing has supported equity markets for years. Withdrawal symptoms will now disturb investor confidence and add volatility. It will take time to assess what effect a more normal rate environment will have on both economies and market valuations. For this reason, if and when central banks ease easing it is highly probable they will do so gingerly and slowly as they watch a myriad of fundamental indicators.

Implications for Financials: Assuming our stretched-cycle analytical conclusion is correct, several considerations come to the surface for investors in cyclicals, particularly financials.

1) Monetary accommodation could and should come to an end. The risks outweigh any remaining stimulative upside in the U.S. in our view, but at the same time it is extremely unlikely to end sharply. This may present the best alternative for bank stocks where, despite solid asset growth, margin compression has stolen much of the revenue upside. A slow rise in short rates would restore lost earnings power and end the quarterly drag from ever-weakening net interest margins The low trajectory for interest rate increases seems assured as the Fed is in the unprecedented position of having to raise interest rates without restraining already slow economic growth. In all past cycles the Fed begins raising rates for the opposite goal -- to purposely slow growth. This cannot be over-emphasized.

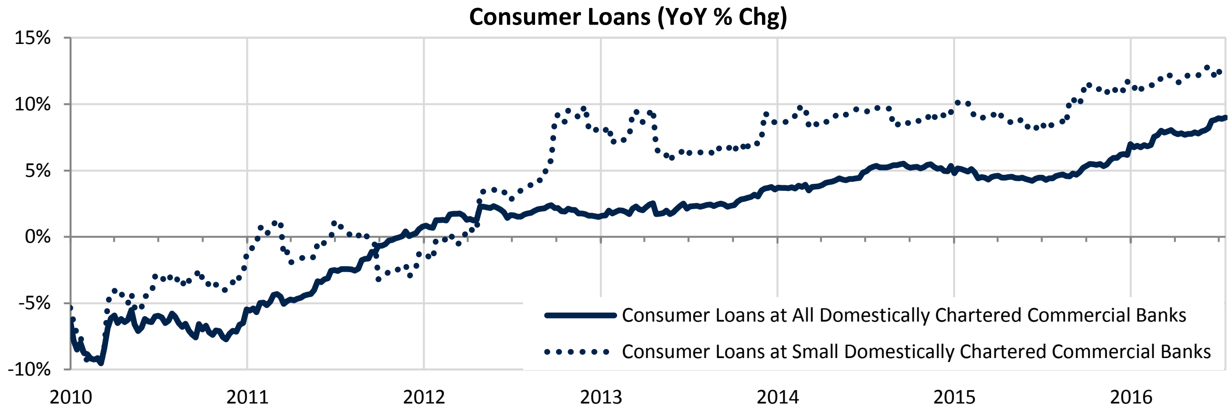
2) Credit demand has further to run, possibly measured in years not quarters. Aligned with other variables mentioned earlier, sectors of credit growth recovered in a traditional sequence, with only the timing elongated, albeit inconsistently. For example, commercial and industrial loans lag the business spending cycle by about nine months historically. Business spending in the current cycle recovered early and very sharply relative to past cycles, and the lag was just twelve months. Consumer loans normally recover with a five-month lag to the consumer spending cycle, but lagged by eighteen months, proportionally more consistent with other variables.

C&I Loans (YoY % Chg)

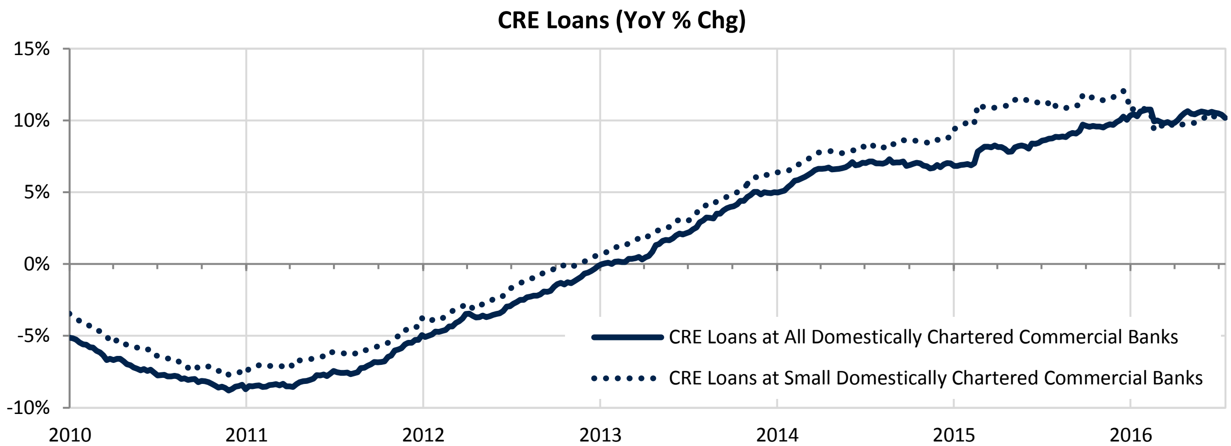


Source: Federal Reserve, Sandler O'Neill

The differentiation for banks under $100 billion in assets is shown in the adjacent graphs. It is clear that business lending has softened slightly, with more to come without a revival in business spending. The weakness is more profound in regional and community banks reflecting more competitive pricing and terms at larger banks but also may reflect less access to external capital. Their preference has opportunistically shifted to consumer lending.

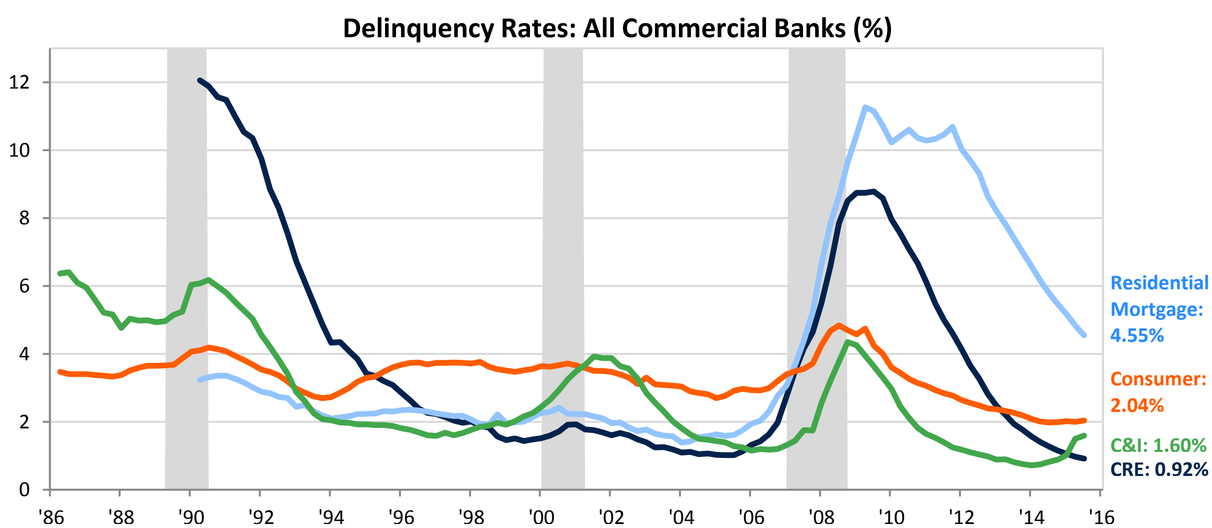


Source: Federal Reserve, Sandler O'Neill



Source: Federal Reserve, Sandler O'Neill

Encouragingly, credit quality shows little sign of a maturing cycle. The 30-day delinquency rate continues to decline for commercial and residential real estate, while only consumer and business credit appear to have bottomed -- but both at historic lows. The business (C&I) delinquency uptick is energy-related, a sector already stabilizing and fully if not over-reserved. The sluggish economy, coupled with an extremely vigilant regulatory network, has likely limited the amplitude of future losses as well as extended their timing.



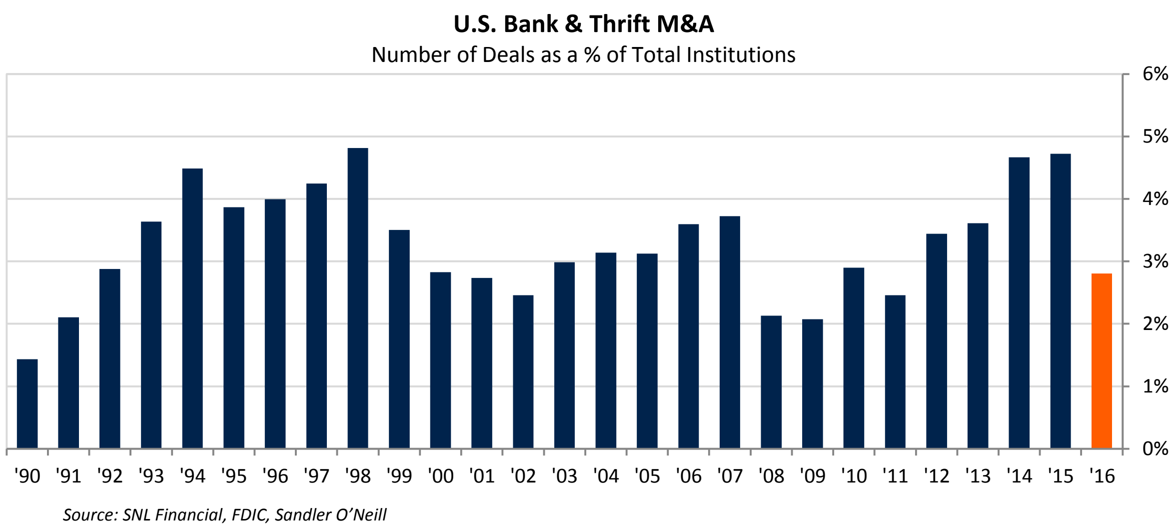
Source: Federal Reserve

3) Productivity and consolidation will be increasingly emphasized in a slow growth economy. In fact, consolidation should be much more robust than in past cycles as demand for financial services, while durable, cannot recover to the norms of previous cycles and as scale increasingly matters for regulatory compliance, for capital access, and for competitive pricing.

The nature of consolidation has also changed from past cycles. Emphasis on stronger product capabilities, access to deposits and greater geographic diversity have taken merger strategies well beyond mere cost saves from branch overlap and systems efficiencies.

The number of banks in the banking system is slightly over 6,000 currently. This number has been cut in half over the last 22 years. Over the last five years consolidation has averaged 257 institutions or currently 4.2% of remaining banks and thrifts. This ratio has been rising, consistent with a relatively stable number of deals per year. At the current deal pace the industry will be cut in half again -- to 3,000 – in just eleven years. We think it can be even shorter.

Most of the shrinkage will be in institutions with assets below $1 billion. Most of the market share gain will ultimately be in institutions with assets between $10 and $50 billion. This is becoming consolidation's "sweet spot" objective. The latter's share should at least double to 20% of banking system assets. The upper end of the range could well rise pending regulatory relief. The $1 to $10 billion asset category is becoming a transitionary staging ground for candidates prepared to breach the $10 billion threshold, absorbing Durbin income loss and DFast regulatory burdens.



In an elongated, slower growth economic cycle, earnings accretive acquisitions should become a key, if not the key differentiating strategy for banks to pursue shareholder value.

Risks: Of course our elongation analysis could prove incorrect. Second half data will shed more light on our thesis. In order of importance, not timing or likelihood, we see the principal risks as follows:

1) Brexit will be a multi-year unknown. Due do sheer size the European economic impact is still open-ended. It is still too early to assess whether the U.K.s economic future has been dented, if at all. The far more serious risk is that the departure is to be negotiated at least through 2017, and ensuing data and other indicators could remain innocuous long enough to spur copycat referendums among other E.U. members.

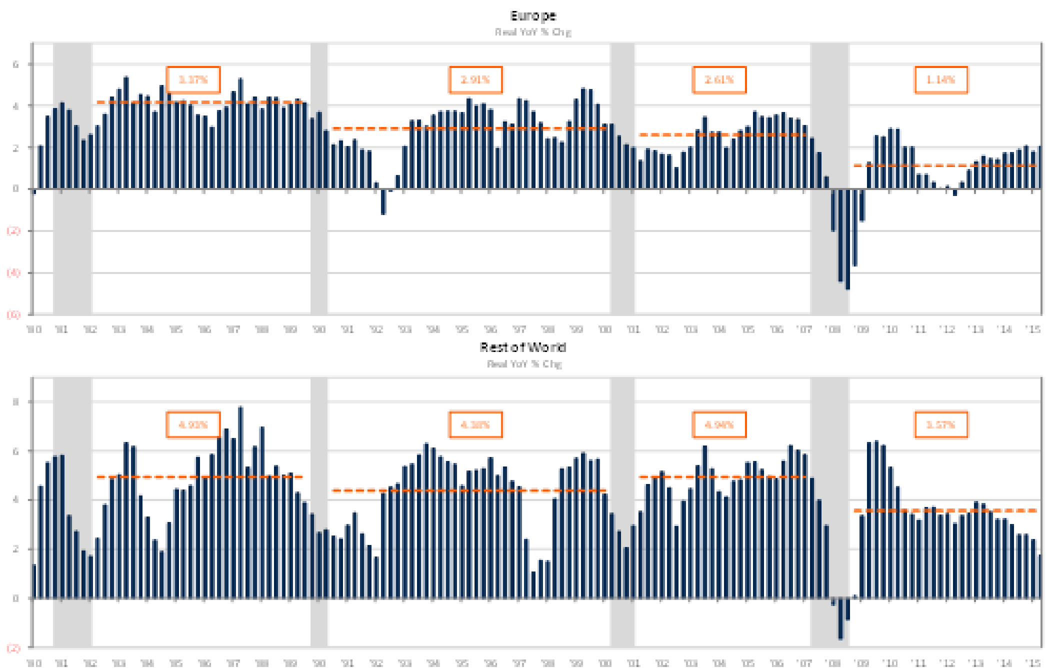
2) U.S. fixed investment remains sufficiently weak for an extended period. This would ultimately erode job creation and could conceivably produce a premature cyclical slowdown. The U.S. election will undoubtedly influence the outcome. As it is unclear whether either candidate offers a better business environment, the impact is already embedded in business confidence.

3) The transition period away from monetary stimulus, if it indeed happens, can be tumultuous and far-reaching.

4) There are more uncertain variables than usual in the immediate outlook. This is not meant as an apology but reflects the confluence of unprecedented political populism on a global scale after more than a decade of monetary distortion.

APPENDIX

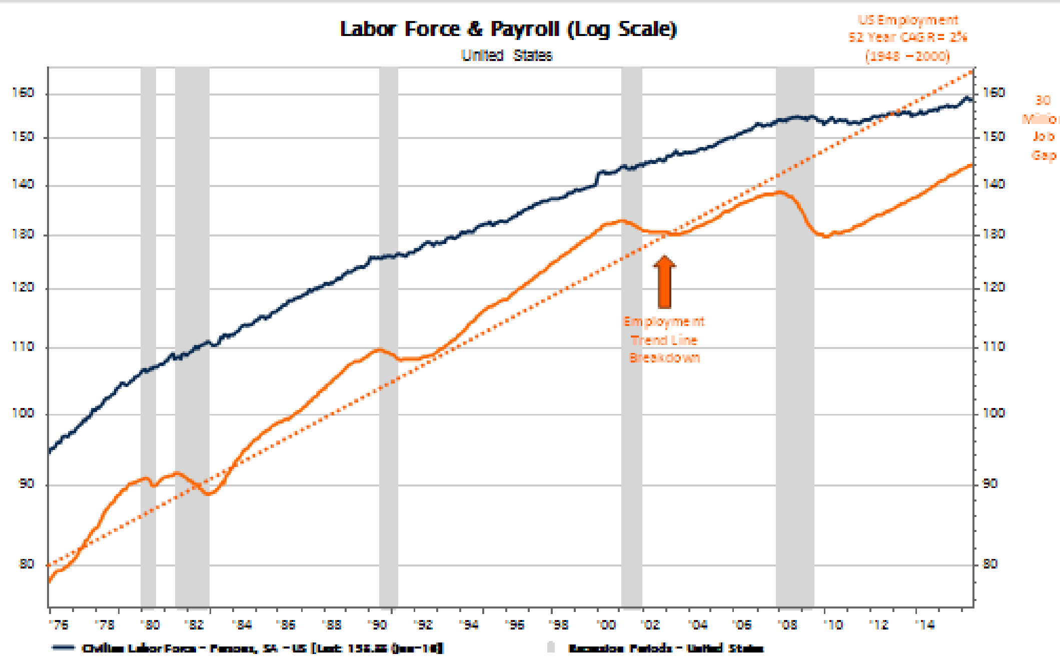
European GDP Pattern - Similar to U.S.



Source: FactSet, Sandler O'Neill

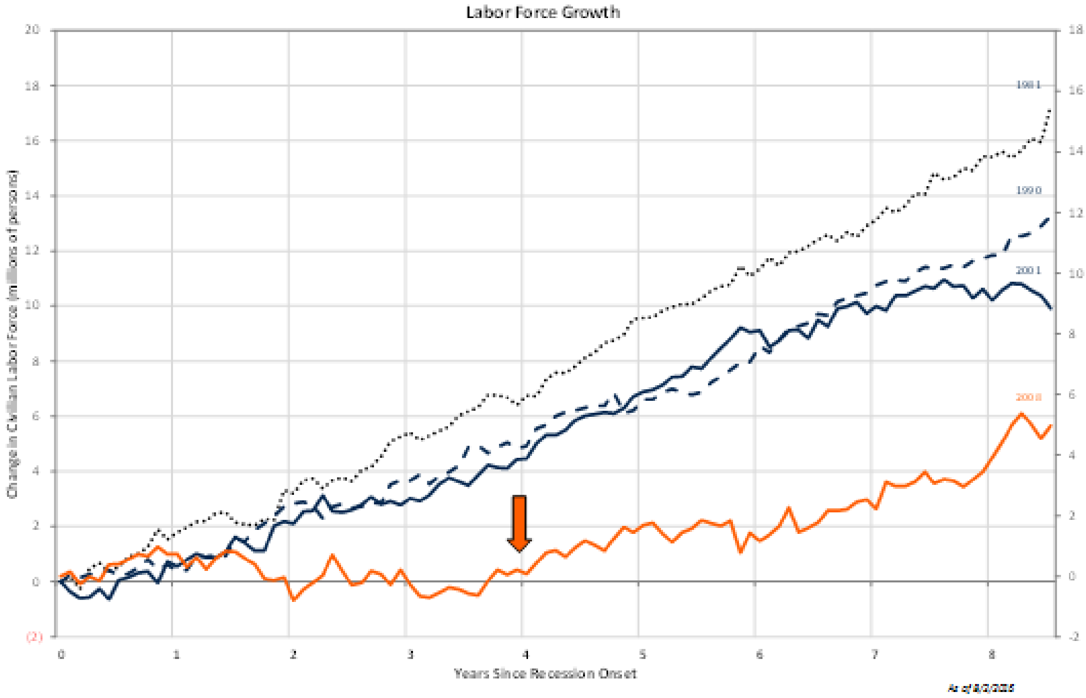
Note: Europe includes Germany, United Kingdon, France, Italy, Spain, Switzerland, Sweden, Norway, Austria
Rest of world includes China, Japan, Canada, South Korea, Australia, Taiwan, South Africa, Philippines

Labor Force Deceleration ... Restrains Jobs, Income, Spending



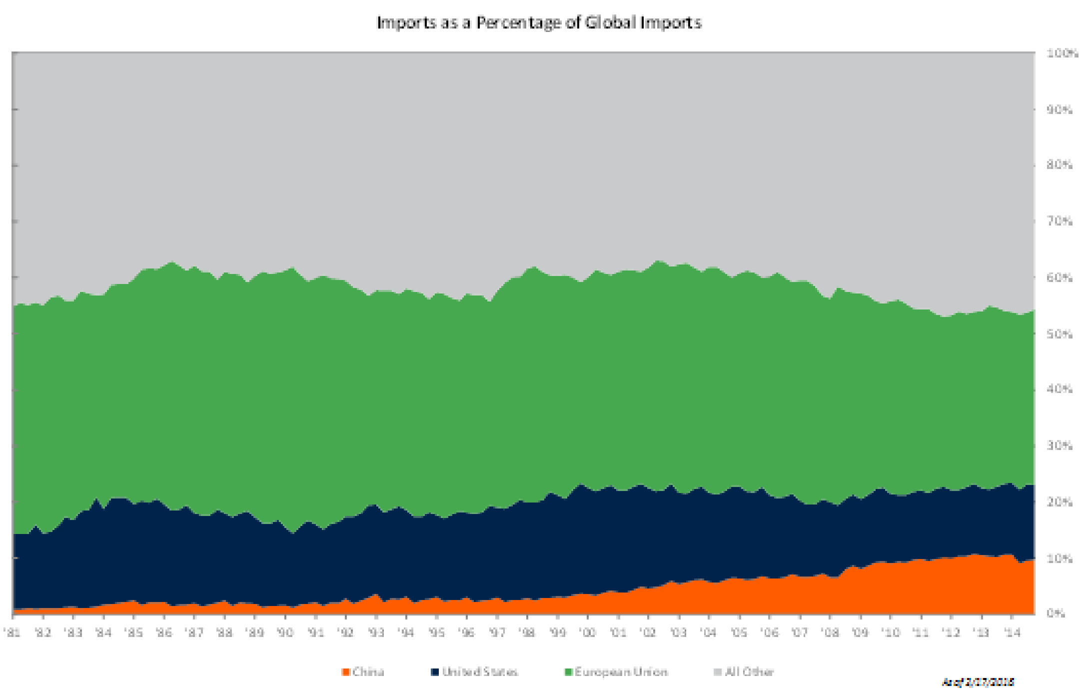
Source: U.S. Department of Labor *©FactSet Research Systems*

Four Years Before Growth … Six Before Moderate Acceleration … Eight Before "Ramp"



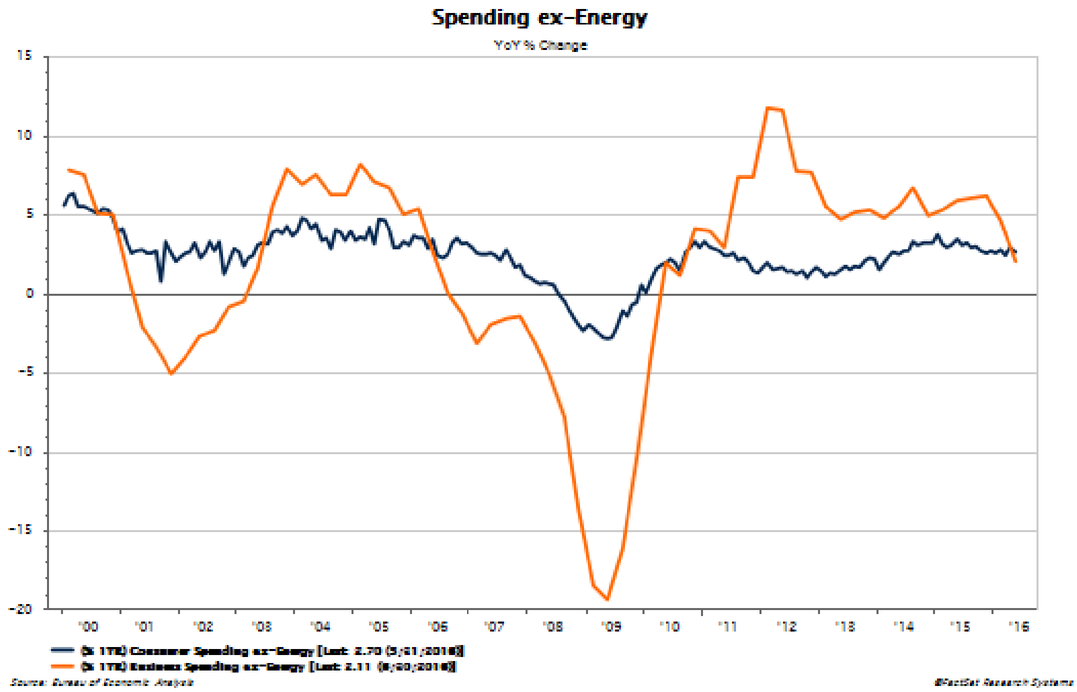
Source: U.S. Department of Labor

Global Trade Demand – Europe the Key

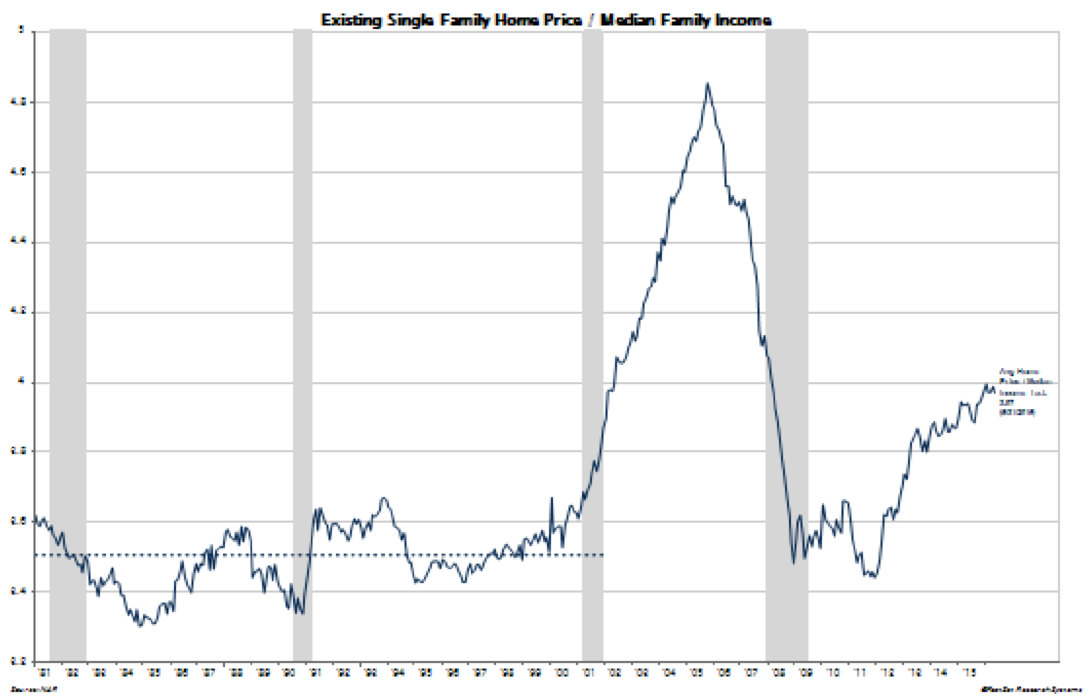


Source: IMF Direction of Trade Statistics

Business Spending Growth Excluding Energy
... Remains Above Consumer Spending Growth



Policy Stimulation Driving Prices More Than Construction



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