

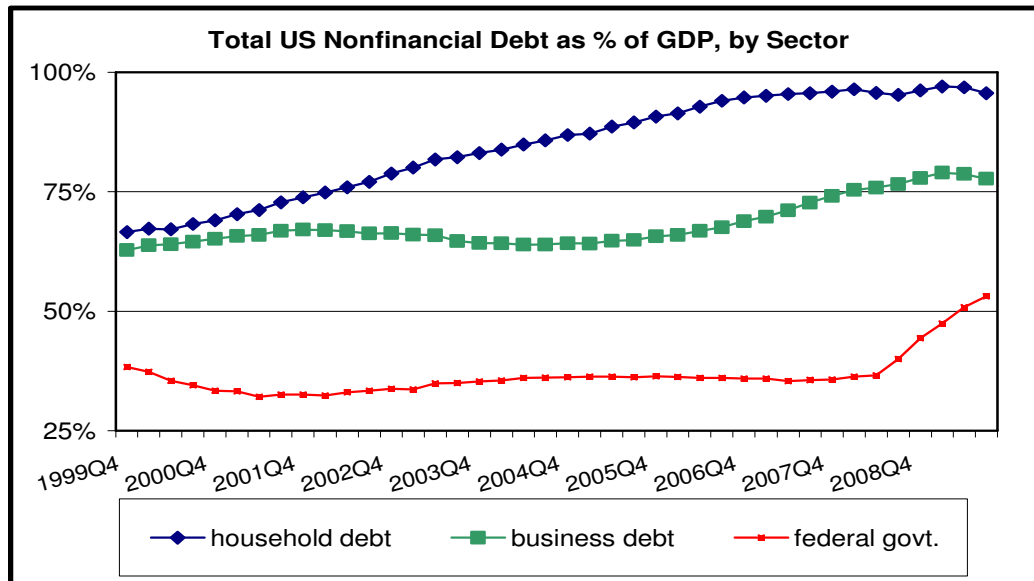
The Dark Side of Leverage

These days, we often see the image of a two-edged sword applied to the issue of debt leverage (sometimes its cut is positive, sometimes it's negative). We're more inclined toward another analogy, however: our society was swept up in a multi-year party that (as often happens) was fun for a while, but progressed to excess, and now we face the payback phase – the hangover.

Even that analogy strikes us as a little too soft, however; it would be more accurate, in our view, to say that our economic party was like one fueled by dangerous stimulants (speed? heroin?), reached the point of being demonstrably unhealthy and unsustainable, and has moved on to the expectable spin, crash and burn phase.

We suspect that it is not adequately appreciated how dependent our economy was on this leverage stimulant, and we're even more inclined to believe that most of us (investors, bankers, politicians, and the media) are unprepared for how painful the withdrawal period will be because of that heavy dependence.

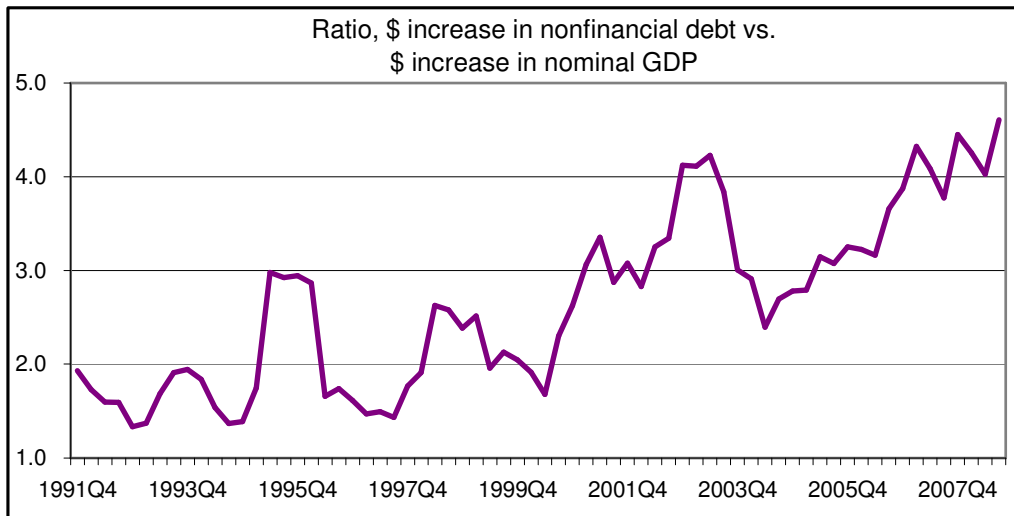
As to the first part of this, note the following chart:



Source Federal Reserve - Flow of Funds

This chart makes sense, once you think about it – for the first 2/3 of the decade, the economy was driven by households' increasing willingness to live beyond their means (in particular via the use of increased mortgage borrowing), the next period was driven by businesses expanded reliance on debt to fund their growth, and the last phase has been characterized by the federal government stepping in (via sharply increased debt) as the first two engines ramped back, attempting to maintain liquidity in the economy.

Another interesting way to look at this issue is to measure past increases in nonfinancial debt relative to contemporaneous increases in GDP; in other words, how much growth in debt did it take to drive growth in GDP? As the chart below shows, the ratio fluctuated around \$2.00 of increased debt for every \$1.00 of GDP growth in the 1990s, but jumped sharply in the most recent decade:



Source: Federal Reserve Board data, Oak Ridge calculations

In our view, there is just no way to look at these charts without concluding that the economic growth in the 2000-2008 period was poorly based, not only overstating the true growth capacity of our economy but also leaving us with far too much debt. Eventually, we would run out of investors/bankers willing to fund our debt expansion -- a point which we might now be approaching. Unfortunately, we can see no real way out of this other than reducing our reliance on debt (deleveraging) in order to get ourselves back on solid ground. In the immortal words of Bank of America's Ken Lewis, we've had all the fun we can stand.

Sadly, this is unlikely to be easy, quick, or enjoyable. McKinsey & Co. recently published an extensive review of financial crises that have occurred in the world since the Great Depression – 32 in total. The key conclusions in the study (*Debt and Deleveraging: The global credit bubble and its economic consequences*) were:

- A long period of deleveraging nearly always follows a major financial crisis.
- Historic deleveraging episodes have been painful, on average lasting 6 to 7 years while reducing the ratio of debt to GDP by 25%. GDP typically contracts during the first several years and then recovers.
- If history is a useful guide, we should expect many years of substantial debt reduction in specific sectors of some of the world's largest economies (e.g., the U.S. consumer), a process that would exert a significant drag on GDP growth.
- The process of deleveraging is just beginning.
- Rising government debt (e.g., in the UK and the US) may limit any significant deleveraging of the total economy over the next few years.

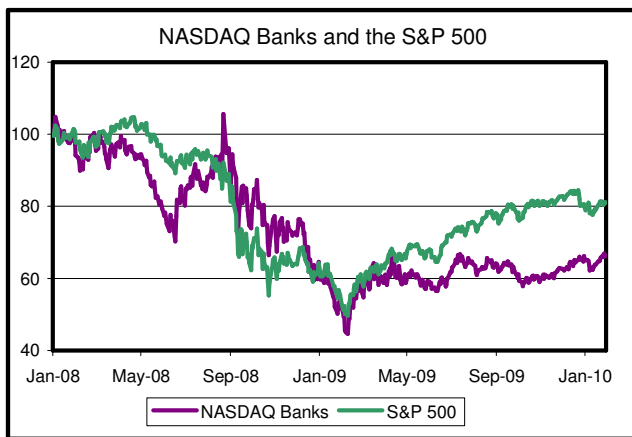
Notably, fully half of the deleveraging intervals were accomplished through “belt-tightening”, in which GDP growth was subdued and the debt/GDP ratio was gradually worked down -- in other words, slow economic growth, and even slower growth in debt. Incidentally, the remaining “remedies” were about

equally split between periods of high inflation or massive defaults, either of which would be even less desirable than the period of belt tightening.

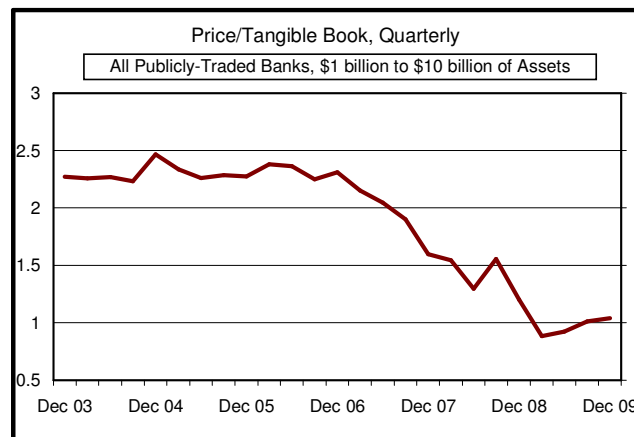
Within this context, it is a bit unfortunate (especially for those of us involved in the bank industry) that the business of banking is, after all, to provide leverage to the economy. We will take another look at this issue in a future Community Banking Monitor, but suffice it to say that banking revenue and growth is likely to be harder to achieve in the next several years than it was in the much of the most recent decade.

Bank Stock Market Trends

We’ve touched on it previously, but the price charts below show that investors are realizing that avoiding death is not the same thing as living well; the specter of financial collapse may have faded, but that does not mean that the economy (nor bank stock prices) are going to show vigorous increases over the next few quarters.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

Given our concerns about the need for, yet the somewhat depressing effect of deleveraging -- as well as uncertainties about the prospects for inflation and interest rates -- a period of watchful waiting would seem to be a logical reaction. Consequently, we suspect that bank stock prices are likely to essentially mark time for the foreseeable future.

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