Community Banking Monitor
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On Balance, Feeling Better

The Economic Clouds Start To Clear – A Bit
It has been a long time coming, but we are finally beginning to see what looks to be a real upturn in the economy. Retail sales have increased, the number of new jobless claims has retreated somewhat, mortgage delinquencies have declined, factory output has moved up, and economic forecasts are being notched up. As Jamie Dimon, CEO of JP Morgan Chase said in the bank's first-quarter earnings release, "While the economy still faces challenges, there have been clear and broad-based improvements in underlying trends". Although this does not mean that the economy is vigorous, it does suggest that we are finally moving in the right direction.

Having said all of this, we should not overlook some caveats: economic activity may have improved, but is still far below healthy levels; mortgage delinquencies and foreclosures remain near their peaks; consumer debt (which fuels so much of retail sales) is still far too high and needs to continue to be worked down; and unemployment remains stubbornly elevated. Moreover, it seems clear that a significant portion of the economic recovery is directly related to Federal government actions (deficit-funded economic stimulus programs, foreclosure mitigation policies) that are relatively short term in nature, raising questions as to how strong the underlying economy really is. Our conclusion is that the economy does indeed seem to be making a turn in the positive direction, but that the turn could be long and slow due to the need for both consumers and businesses to de-leverage.

First Quarter Earnings: Looked Good At First, Now More Mixed
Just as with many of the economic indicators, recent bank earnings reports presented us with several positive surprises, particularly for the large banks which reported early in April. In some cases, these results were driven by strong gains in capital markets activities. Importantly, however, asset quality trends generally made for good reading, with problem assets and charge-offs both declining, sometimes considerably. Particularly encouraging were statements from several of these banks that credit quality was improving across a broad range of geographies and loan types.

As the earnings season progressed, however, the results became more uneven; some regional banks reported fairly mediocre results, with loan volumes and spread income continuing to shrink. Moreover, several have reported unfavorable trends in asset quality measures. We suspect that several factors may be at work: 1) the large banks typically operate with more of a mark-to-market mentality, and may have taken more of their hits on the front end; 2) the larger banks typically have more of their portfolios tied to residential mortgages, while smaller banks have more relative exposure to commercial real estate, and it very well could be that the resolution process in single family mortgages is further along than in commercial real estate; and 3) several larger banks are in the midst of integrating major past acquisitions, a process which typically is characterized by an aggressive working down of problem assets (and operating costs). And, as already mentioned, several large banks have significant exposure to fee income sources of revenue, such as capital markets or processing activities, and have not been held down so much by the challenges in the lending business.

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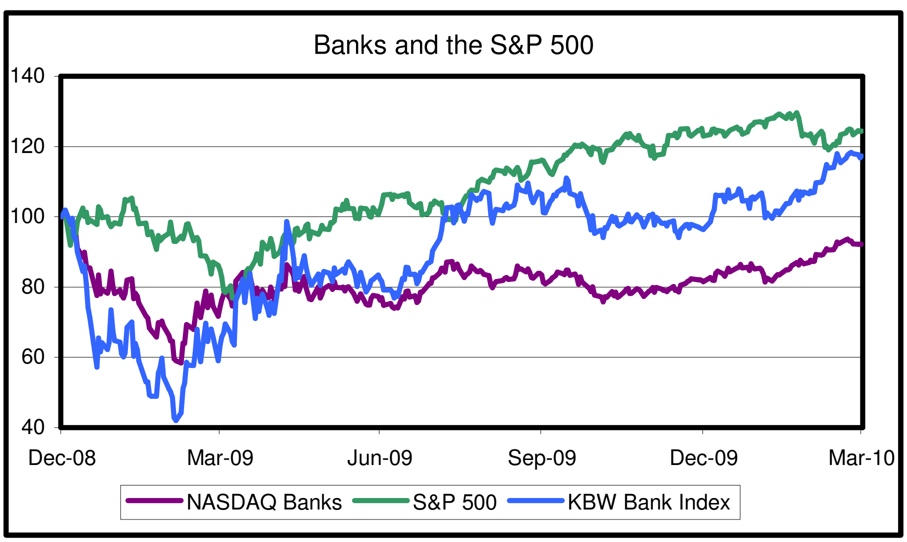
In other words, the first round of positive earnings news may not completely carry over to the full industry, since the part of the banking business which characterize the bulk of the industry (lending to consumers and to businesses) remain sluggish, with loan volumes frequently on a downtrend. Consequently, we expect that the final earnings report card for the entire industry (which is more spread income-dependent than the large early-reporting banks) will show more B's and C's than the A's we are seeing at the moment. In general, however, we need to say that the first quarter earnings season so far has been a nicely positive change from the previous several quarters, with few F's on the report card, probably indicating some sort of turning point in bank industry earnings.

As to what the results might imply for the future, we are a bit cautious because revenue trends being less positive than earnings trends. As with the quarter's results, the prospects seem mixed:

- the large banks seem to have pretty strong momentum, suggesting a continuation of pretty healthy earnings numbers;
- traditional banks that have clearly passed the peaks in their asset problems should be able to show solid earnings gains, even with only slight net interest income growth, because of significantly lower loan loss provisions, but;
- Those traditional banks that have yet to achieve major reductions in their problem assets (and there are quite a few) must still focus virtually all of their energy inward to shrink their still-alarming levels of problem assets. These "walking wounded" will not only miss out on opportunities to gain market share through traditional competitive means, but also the chance to increase share via acquisition. Next month, we will have the earnings reports for almost all banks, privately as well as publicly held, and it will be interesting to see where they fit within this scenario.

Bank Stock Performance – Too Much Too Soon?
There are a couple of interesting facts revealed by the following chart. The first is that bank stocks in general easily outperformed the S&P 500 in the first quarter; the second is that larger banks (those which make up the KBW Bank Index) in turn outperformed the smaller banks (those which make up the NASDAQ Bank Index). In fact, during the first quarter, the KBW Index was up 22%, versus a gain of 13% for the NASDAQ Bank Index.



Source: Yahoo Finance

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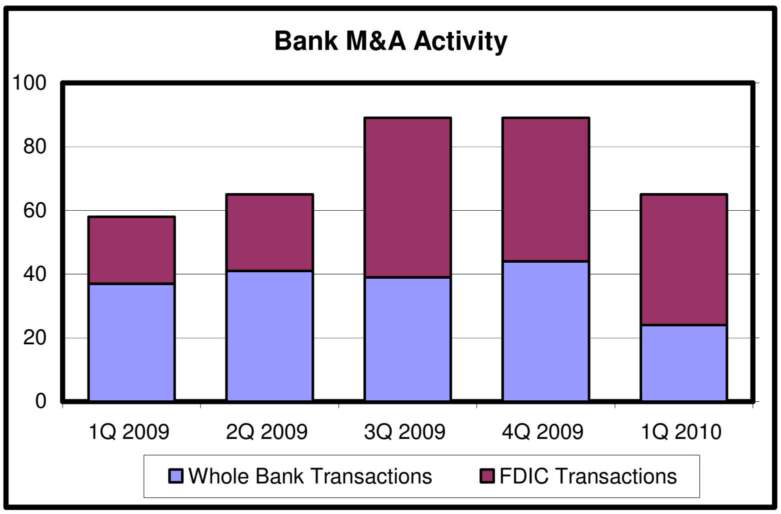
Given our previous discussion of differing momentum of the capital markets versus basic lending parts of the business, this makes sense. It is also a bit disconcerting as regards the outlook for most banks, and particularly our community banking universe – banks have a hard time generating sustainable respectable earnings growth in the absence of healthy revenue growth, and healthy revenue growth will depend on healthy increases in employment and real economic activity. Cost control will become more important, and so will acquisitions.

Mergers & Acquisitions – Still Playing the FDIC's Game

As we discussed in a past report, the FDIC's recent practice of moving failed banks off its books via some very generous terms for the ultimate buyer of those banks has pretty much taken over the bank acquisition landscape. And even though the terms have recently been changed to be somewhat less generous to the buyers (a straight 80% cap on the FDIC's share of losses), it is still the best deal in town, in pure economic terms, for an interested acquirer. As the following chart shows, such deals have accounted for over half of all bank mergers in the past three quarters after showing single-digit shares until the past couple of years.



Source: Highline Financial

This is a very cyclical phenomenon, and as the credit cycle and the resulting resolution of failed banks fades, we should see a significant drop in FDIC-assisted deals and a corresponding pickup in more normal M&A activity. As soon as it appears as though asset quality measures have stabilized (and most importantly, can be forecasted with reasonable confidence), we are likely to see traditional M&A become part of the strategic discussion for many banks: how do we grow in a slow-growth, de-leveraging world, and if we can't grow enough to satisfy our shareholders, don't we need to be either an acquirer or a seller? And if we want to be a buyer, what should we be doing right now to position ourselves with the requisite capital, management depth, and healthy regulatory relationships needed to pull it off?

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