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# Slow to Heal

Those of us who are well beyond our youth must regretfully recognize that our "bounce-back" time is considerably slower than when we were younger; whether it be from a cut, a sprained ankle, or just joint stiffness after a round of golf, our recoveries have become less of a bounce-back and more of a slow and gradual healing.

Well, it appears as though the banking industry is showing its age as well, since the recovery trajectory after its body blows of the last couple of years also appears to be quite slow and gradual. For example, below are some key second-quarter performance measures for the roughly 85 publicly-traded community banks that make up the American Bankers Association's ABQI Index.

The table presents a pretty clear picture of a somewhat halting and uneven upturn. Net interest income and pre-tax earnings are showing modest growth, but loans continue to slip, and asset quality measures do not yet suggest that an all-clear signal is warranted; note the increasing NPL and charge-off ratios, while the reserve/loan ratio actually declined a bit and remains far under the NPL/loan ratio.

| | Q2 2010 | Q1 2010 |
|---|---|---|
| Return on Assets | 0.55% | 0.58% |
| Net Interest Margin | 3.68% | 3.71% |
| Sequential Loan Growth | -0.7% | -0.5% |
| Sequential Net Interest Income Growth | 1.6% | 0.2% |
| Sequential Pretax Income Growth | 4.1% | 1.1% |
| Nonperforming Loans/Loans | 3.19% | 2.85% |
| Net Charge-offs/Loans | 1.46% | 0.81% |
| Loss Reserve/Loans | 1.68% | 1.70% |
| Tangible Common Equity Ratio | 9.3 | 8.1 |

Source: Highline Financial Data, Oak Ridge calculations

What the table does not show is that earnings per share for the group were up 0.7% versus last year's second quarter, and up 2.9% versus the first quarter of 2010. While we can take some encouragement from the fact that EPS no longer seem to be heading downward, it strikes us that these are pretty slender gains, given that we are coming out of a recession and one of the most stressful banking environments in at least a generation. The downtrend seems behind us, but what about an upward follow-through?

## Closer to Home

At Oak Ridge Financial, our primary focus is on community banks in the Midwest. As in our report reviewing the previous quarter (Community Bank Monitor, May 2010), we looked at banks, both public and private, in 8 Midwestern states (including 4 larger metropolitan centers in those states), using some of the same performance measures. As in our previous report, the good news is that banks in this region typically outperformed the national peer group in key performance metrics such as profitability, growth, nonperforming loan ratios, and capital ratios. The bad news is that, like the national peer group, there


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was little progress versus the first quarter, and even some slippage:

| | Return on Average Assets | | Net Interest Income Growth | Nonperforming Loans/ Loans | | Nonperforming Assets/ Assets | | Loss Reserve/ Nonperforming Loans | |
|---|---|---|---|---|---|---|---|---|---|
| | Q2 2010 | Q1 2010 | Q2/Q1 | Q2 2010 | Q1 2010 | Q2 2010 | Q1 2010 | Q2 2010 | Q1 2010 |
| Iowa | 0.94 | 0.96 | 2.4 | 1.50 | 1.33 | 1.80 | 1.96 | 0.92 | 1.02 |
| Illinois | 0.48 | 0.50 | 2.2 | 3.24 | 2.93 | 2.92 | 2.92 | 0.52 | 0.52 |
| *Chicago* | *0.12* | *0.23* | *1.7* | *5.12* | *4.89* | *4.91* | *4.85* | *0.40* | *0.43* |
| Kansas | 0.62 | 0.62 | 0.4 | 2.96 | 2.97 | 2.45 | 2.54 | 0.68 | 0.63 |
| *Kansas City* | *0.25* | *0.34* | *-1.7* | *7.31* | *5.64* | *9.59* | *7.85* | *0.40* | *0.42* |
| Minnesota | 0.53 | 0.51 | 1.7 | 3.27 | 3.53 | 5.28 | 4.88 | 0.55 | 0.59 |
| *Twin Cities* | *0.30* | *0.16* | *1.2* | *4.37* | *4.06* | *6.02* | *5.81* | *0.54* | *0.54* |
| Nebraska | 1.13 | 1.27 | 4.1 | 1.20 | 1.11 | 1.27 | 1.14 | 0.94 | 1.29 |
| North Dakota | 0.74 | 0.75 | 3.9 | 1.58 | 1.75 | 1.77 | 1.59 | 0.90 | 0.81 |
| South Dakota | 1.27 | 1.24 | 1.9 | 1.70 | 1.64 | 1.55 | 1.43 | 1.19 | 1.00 |
| Wisconsin | 0.67 | 0.65 | 1.4 | 3.11 | 2.88 | 3.32 | 3.31 | 0.58 | 0.56 |
| *Milwaukee* | *0.50* | *0.46* | *0.6* | *4.29* | *3.83* | *4.66* | *3.68* | *0.58* | *0.52* |

Source: Highline Financial Data, Oak Ridge calculations

So no matter how we look at it, this seems to be a recovery that is at best slow and gradual. Perhaps "bouncing along the bottom" would be a better characterization, with no clear sign as to when the eventual upturn might come, or how vigorous it might be. And while we have taken encouragement from recent solid evidence of a rebound in the manufacturing segment of our economy, we remain very cautious about the consumer and housing sectors.

**Beware of Big D**

No, this is not the trepidations of a Vikings fan regarding the mid-October visit from the Dallas Cowboys (they did, after all, steal a playoff game from us in the distant past), but rather our concerns about the possibility of deflation, the current worry of choice for the investment and economic communities.

We need to confess that we have been pretty skeptical of the likelihood of deflation. We're convinced that most people focus on nominal rather than real (inflation-adjusted) economic trends and measurements, which leads them to a clear if unrecognized preference for a "moderate" amount of inflation. And what the people want, politicians are happy to provide; nominal growth, whether real or not, can create the illusion of well-being and economic progress, and happy (or at least complacent) voters are a positive for re-election.

Admittedly, things do look a little different this time. Inflation has been barely above zero for months (as have short-term interest rates such as the Fed funds rate), and the recent erosion of economic momentum has raised the possibility that the numbers might slip down into red ink over the near term. Many of the prerequisites for deflation are in place -- production capacity is in considerable excess supply (U.S. capacity utilization is near the lows of the past 50 years), there has been a massive destruction of wealth, government spending is on what will almost surely be a multi-year downtrend, savings rates (including debt pay-downs) are up substantially, and money supply growth is near zero.

But what about the impact of all of the Fed's liquidity injections – how can the money supply and



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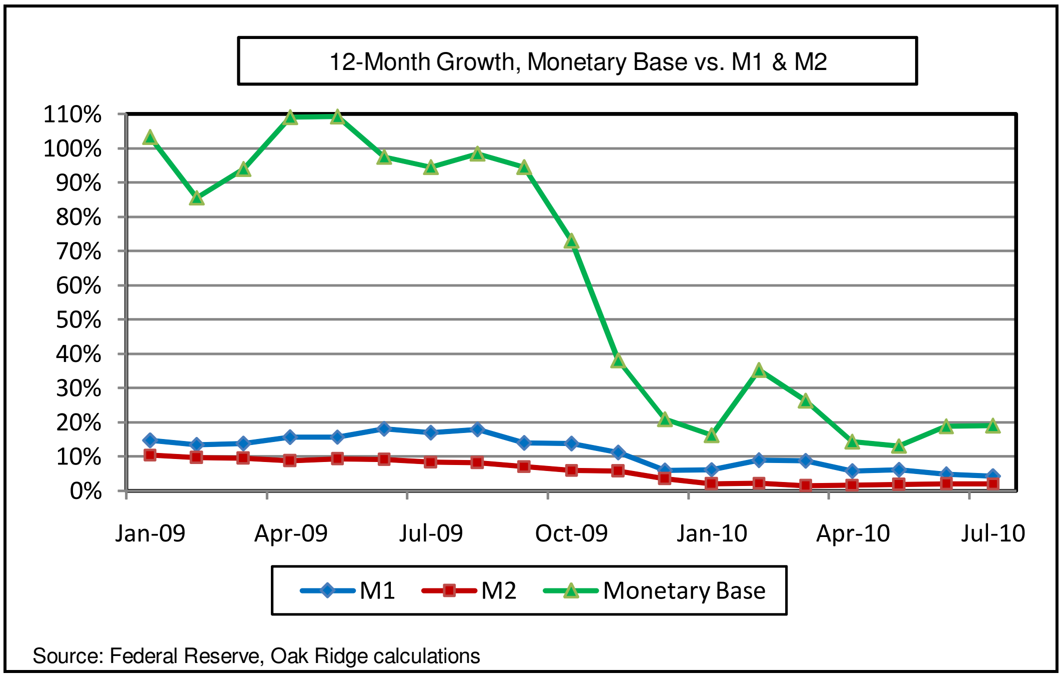
economic activity be flat, and inflation (which is, after all, primarily a monetary issue) be non-existent? The answer lies in the difference between what the Fed can push up (the monetary base) and the money supply that directly affects the economy (so-called M1 and M2). These measure of money have shown very little growth for almost all of 2010, with the explanation being a sharp drop in the velocity of money, which in turn is largely due to weak loan demand; it is mostly the multiplier effect of bank lending that translates the monetary base into the broad money supply, and as well all know, loan demand has been and continues to be limp. Simply put, businesses and consumers are neither spending nor borrowing much, and are not providing much stimulus of their own.

The following chart shows a comparison between the growth rates of the monetary base and two higher and broader (more powerful) forms of money, M1 and M2:




As the chart shows, we have had an extreme drop in the velocity of money resulting from the caution of businesses, consumers, and lenders that has largely subverted the Fed's extraordinarily massive liquidity boosts. Perhaps we are looking at another case of pushing on a string, leaving the Fed unable to truly boost the effective money supply and leaving us vulnerable to deflation.

## Be Careful What You Wish For

While most would initially like the sound of the possibility that prices might be going down, we believe deflation would be a negative for banks – declining prices are a disincentive for borrowing (saving is favored), and we have always argued that a moderate amount of inflation translate into increasing asset values, upon which a lot of loan balances (and collateral balances) are based.

So we are a bit uneasy about the predictions (often by learned observers) of deflation. Given our long-standing tendency toward "muddle through" expectations, as well as the clear political benefits generated by moderate inflation, we fall back on a less severe (but not exactly uplifting) forecast: an economy that struggles along with sluggish final demand (and sluggish loan demand) for several more quarters, well into and perhaps through 2011. Eventually, business and consumer confidence will recover, the velocity of money will pick up, and economic numbers will look better. On the other hand, we will then need to deal with what could well be the really big problem: how do we remove all the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excess liquidity that is now residing in the monetary base without driving up interest rates and pushing down on an economy that is likely to still be somewhat vulnerable?

## When the Going Gets Tough…….

One of the maxima of banking is that good loans are made in bad times, and vice versa. Similarly, we have seen good banking organizations put together in previous bad times (notably in the early 1990s), and weaker banking organizations established in good times, such as the hyperactive pace of *de novo* bank openings in the early 2000s. In the environment we foresee, mediocre banks will struggle to maintain their positions, and weak banks will eventually need to throw in the towel. On the other hand, banks with strong capital and management, and rigorous operational standards, will have the opportunity to emerge with significantly more valuable franchises, whether through making acquisitions and/or just using their strengths to gain market share. For banks with the capabilities, this is likely to be an opportunity time of a generation.





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