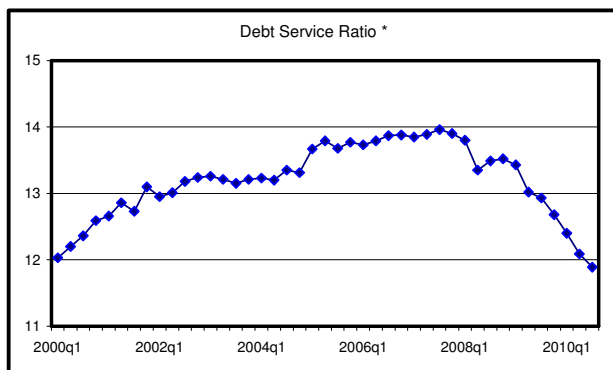


What's Better, and What Isn't

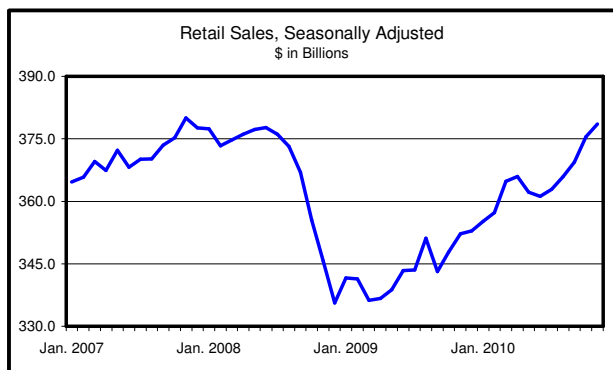
The turning over of the calendar into a new year is a convenient time to look back and try to measure our recent progress. An interesting exercise in this process is to look at what has improved significantly, and what has not.

WHAT'S BETTER

A number of economic and banking performance metrics have shown substantial improvement in the past couple of years; we would point to the following two as important examples:



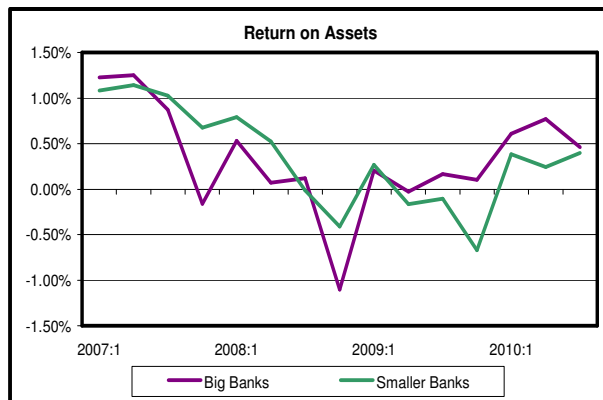
* the ratio of debt payments to disposable personal income
Source: Federal Reserve



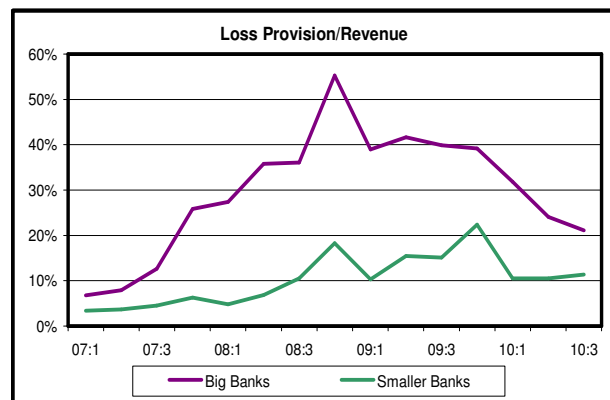
Source: Census Bureau

To be honest, both of these measures have improved more sharply than we thought likely. We have been very concerned about the high levels of debt being carried by many households, feeling that it would take a considerable amount of time for consumers to rebuild their balance sheets and regain the confidence to step out and increase their consumption spending. These two charts are quite good news, especially since we are such a consumer-driven economy.


As for the banks, they also have shown important fundamental improvements, as suggested by the following two charts:



Source: FDIC

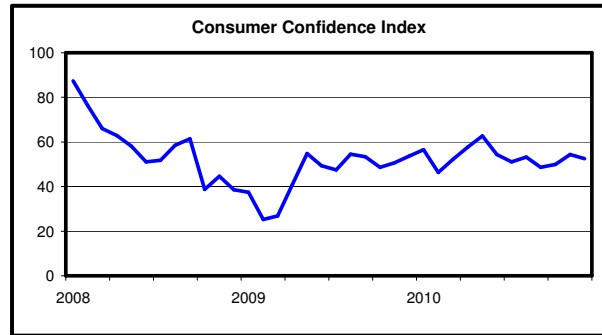


Source: FDIC

A “Square Root” Recovery? There is one issue of concern in the banking charts, however: notice that the recoveries from the worst levels have been pretty vigorous, but seem to have flattened out in recent periods. We have for some time been thinking that the current recovery would not be a “V” shape, but rather sort of a reverse square root pattern (), a sharp rebound off the bottom, but running out of steam fairly quickly, well before getting back to pre-recession levels. In fact, such a pattern is also visible in some key economic indicators, such as:



Source: Federal Reserve Board



Source: Conference Board

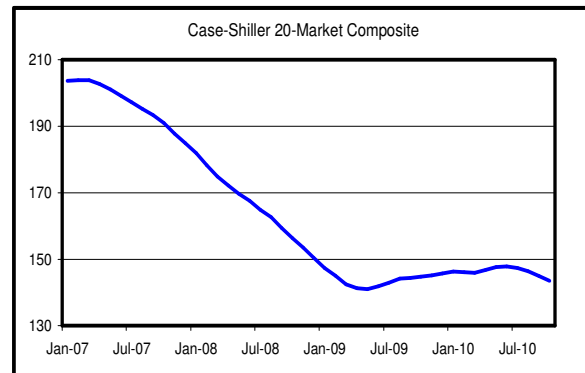
For those of us who were around to actually experience the post-1974 bear market recovery, this may strike a chord of remembrance. Then, and perhaps now, the economy needed to spend several years working off the excesses of the previous up cycle, and the stock market reflected this is a long period of what we might call moving sideways.

So even though we have been surprised by the degree of recovery in consumer balance sheets and consumer spending, we continue to believe that economic growth will be relatively moderate in 2011; we look around for a driver for truly strong economic growth, and are not finding much. Furthermore, we note:

WHAT’S NOT REALLY BETTER



Source: Bureau of Labor Statistics

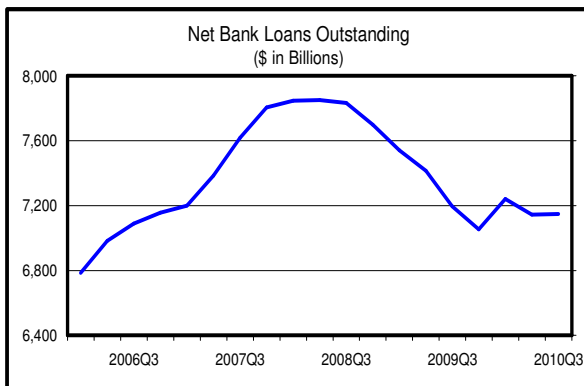


Source: S&P

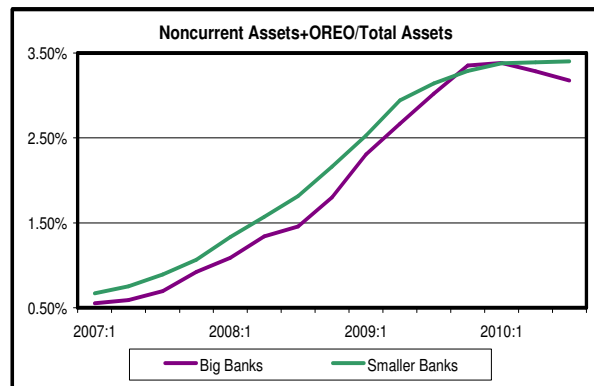
These two charts say a lot about a consumer-driven economy, especially one in which a typical household’s primary asset is its house. Such an economy needs its population to be well-employed, generating enough income to pay its bills, save a little, and have enough to occasionally step up its spending. While we certainly did step up our spending in the first part of the previous decade, this was unfortunately built not on growing incomes, but on a growing dependency on debt, which was facilitated by unsustainable gains in residential real estate prices which significantly eroded housing affordability and brought unqualified people into home ownership. This was a classic bubble, and when it collapsed, it brought the whole economy (indeed, the world economy) down.

In our view, we need to see significant improvement in employment, as well as stability and some modest appreciation in housing values, before we can expect the consumer to resume a driving role toward a solid growth economy; as the above charts show, we have seen virtually nothing of this so far. We suspect that the eventual expansion cycle will be fueled by some sort of technology boom, as in the late 1990’s; anything resembling the real estate-driven boom of the early 2000’s seems highly unlikely.

As far as the banking industry is concerned, the “not much better” characterization would apply to several key fundamental measures, such as these:



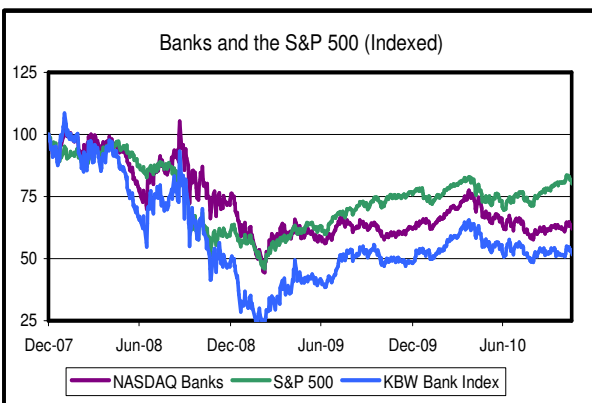
Source: FDIC



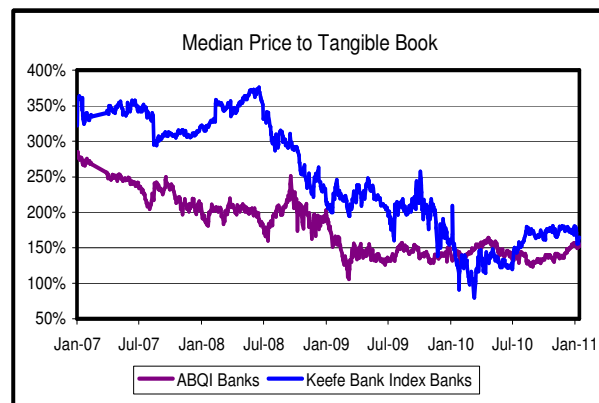
Source: FDIC

While there are signs of improvement in both these indicators, it appears as though much of the improvement is occurring within the larger banks. Smaller banks, with their greater relative exposure to commercial real estate-related loans and their smaller relative weighting of fee income, have shown less loan growth and less clearing out of bad assets.

Bank equity value indicators such as these also show a picture of an initial recovery that has given way to a sideways trend:



Source: Highline Financial data, Oak Ridge calculations



Source: Yahoo Finance

So things are indeed better than they were, but there has been little follow-through since the initial bounce out of the abyss. We also note that bank stocks have begun to lag behind the broad market.

CONCLUSION: GETTING BETTER, BUT NOT QUICKLY

Interestingly, fourth-quarter 2010 results could look pretty strong for both the economy and the bank industry. In the economy's case, however, much of the strength has probably been due to extraordinary government efforts that should soon run their course, or on very low interest rates that also may be unsustainable; there may indeed be a double dip in housing, as suggested by the Case-Shiller trends.

For the banking industry, particularly the large banks, a dominant part of the earnings increases in the past couple of quarters have been due to sharply lower loan loss provisions (which may be sustainable), but also and importantly to loss reserve releases (loss provisions well below charge-offs, effectively running down loan loss reserves), which is clearly unsustainable over the intermediate terms.

So with both the economy and the bank industry being boosted by what are essentially one-time factors in the past several months, we will not be inclined to regard fourth-quarter results as a measure of ongoing momentum.

In sum, the economy and most of the bank industry have made it out of the life-threatening danger zone, but from here on out we will need to see true top-line revenue growth to generate real progress. In sailing terms, we could say that we are neither becalmed nor facing threatening head winds, but we're going to have to work hard to grab any wind we can find in order to achieve forward motion, and the degree of success is likely to depend far more on the skill of the crew than on any boost from the conditions.

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