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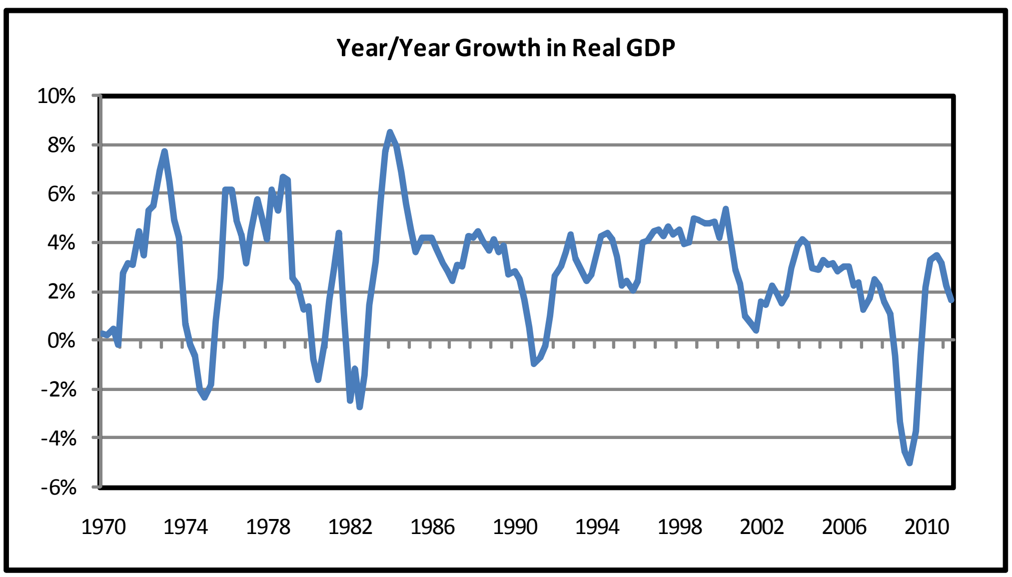
Storm Clouds Gathering

We have been of a mind that the second half of the year would show a pickup in economic activity, not to what might be viewed as robust growth, but to a pace modestly above the approximately 2% trend that seemed in place during the first half. Several things have changed, and we're now a bit uneasy about that forecast. While this does not signal disaster for the bank industry, it certainly is not a positive development, and we're concerned that the recovery in bank balance sheets and income statements might end up being even more gradual than we were already expecting.

For one thing, recent economic reports have seemed to indicate a slowdown, including the below-expectations initial report on second-quarter GDP (and a downward revision in the first quarter number), reports of a renewed increase in layoffs, and a disappointing ISM manufacturing report that showed that key sector operating barely above the contraction level. Growth seems minimal to absent, and a renewed recession now seems much less of a long shot. In that regard, there has been considerable comment about the historical tendency of a period of 2% or less GDP growth to be followed by a recession; as the following chart shows, a break below 2% is usually followed by a drop into negative territory:



Source: Bureau of Economic Analysis

Of course, history does not always repeat itself, and a few indicators do not signify a trend, so these numbers might just be signaling a pause rather than a reversal in the economic recovery. We note that there has been a notable drop in the prices of oil and other commodities, which should be a positive for our economy. Nevertheless, there are also a couple of extraordinary issues in the mix which could weaken any recovery momentum. The first is the ongoing European debt crisis and the resulting erosion in the outlook for European economies. We had been assuming that a solution would be found that would put a fence around the Greek, Portuguese and Irish situations and avoid any contagion spreading to stronger (and larger, and

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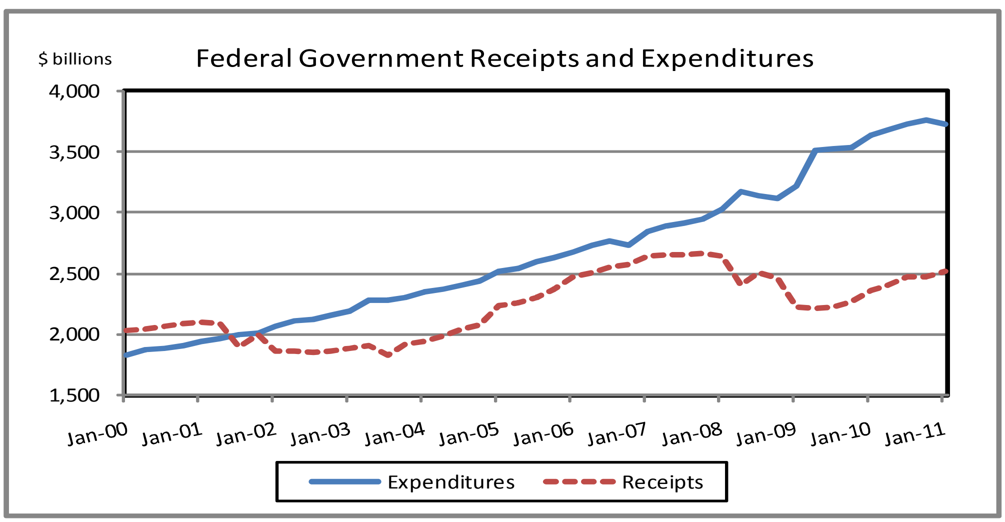
more important to us) economies. This does not seem to be happening; solutions have been elusive, Spanish and Italian bonds are under attack, and there is renewed focus on the heavy debt burden in France. In sum, it seems there is the potential for some form of austerity in even the large European economies (excepting Germany), which suggests that our exports to Europe might be disappointing.

At home, we have the passage of the Budget Control Act of 2011, a spectacle of political leaders finding it more important to maintain partisan purity, and to position themselves for the next election, than to face the difficult task of working out a long-term solution to our very challenging fiscal problems. While the legislation may have averted a near-term U.S. default, it did little to close the budget gap, did virtually nothing to solve our longer-term fiscal policy imbalances, and still left us vulnerable to rating downgrades (beyond that of Standard & Poor's) and future default concerns.

As to the budget gap issue, we note that the legislated cuts will be staged over several years (beginning in 2013) and that the $2.1 trillion in planned cuts through the rest of this decade is not a huge amount relative to expected federal outlays of about $44 trillion during that period. In other words, the legislated cuts should do little to close the gap, especially if Federal expenditure cuts take something of near-term GDP and we see higher government spending in the area of unemployment benefits. So it is highly questionable that the legislation provides any real help at all; indeed, by focusing attention on our inability to develop a credible long-term fiscal plan and probability of further downgrade talk, it seems to be a clear psychological negative. Furthermore, all the controversy and lack of substantial progress on the fiscal front has almost certainly contributed to the unsettled currency markets, and it is hard to see what will settle those markets down, at least over the near term. And almost no matter what, there will be some fiscal policy drag on the economy.

We're going to attempt to dig into these issues, not because we pretend to be economists (neither a realistic nor perhaps even desirable goal) but because there is no avoiding the direct tie between economic activity and the business of banking. We'll start off with the following chart:



Source: Federal Reserve

As the chart shows, our revenue problem is at least as important as our expenditure problem. We have been (and effectively remain) in a recessionary environment, and we would argue that there

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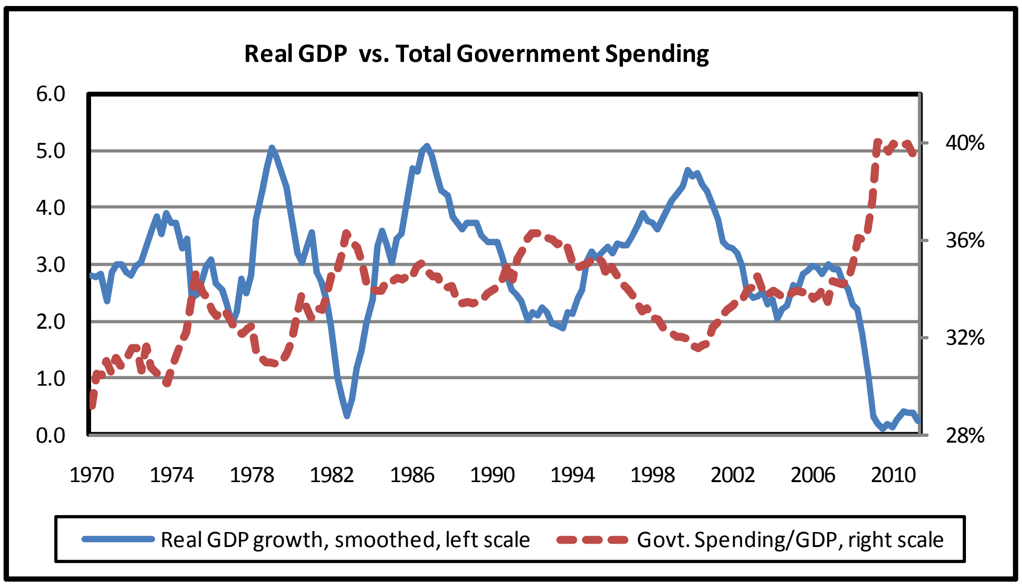
should be an expenditure-receipts gap in a recession, with an expansive fiscal policy attempting to counteract the shrinkage in the private economy that leads to the drop in federal tax receipts. But while there is a good case for deficit spending in recessions, there is an equally strong case for running balanced or surplus budgets in stronger economies, yet our politicians never seem to be willing to toe that line. In fact, one could argue that our current budget trouble is in large part due to receipts lagging behind expenditures throughout the "good" years of the previous decade, when we should have been running surpluses.

In any case, one might ask why we don't just increase government income (say, through higher taxes) to close the budget gap? While we agree that we need significant adjustments in the tax structure, and revenue increases need to be part of the long-term solution, it seems pretty clear to us that simply upping the government's take would not work. Note the following chart:



Source: Bureau of Economic Analysis

One doesn't need to be a chart geek to see the pretty consistent correlation between changes in relative total government spending (federal, state and local) and offsetting changes in the sustainable growth of the real economy. While heavy government spending can help soften the blow of a recession over the short term, this chart makes it pretty clear that it has not been a positive over the long term. So a further ramp up in government spending at this point would just create additional pressure on future economic growth and therefore government receipts.

Put The Emphasis Where It Belongs. For reference, consumption accounts for about 70% of our GDP over the long term, with private investment running in the high teens until the last couple of years, when it dropped to 12-13%. Government expenditures have generally held in the 18-20% area in the past few years, with the Federal government accounting for about 60% of that. Net exports tend toward a negative contribution of 3-5%, since we consistently run an unfavorable trade balance.

We need to recognize that, while government can indeed increase consumption through open-handed programs, it does not create wealth; it just moves the wealth around, while chewing up some of it in expenses. Real wealth is created by the private sector, via the investment function. And consumption is only what it says it is; it consumes the output generated by the production of

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goods and services that is facilitated by investment. So consumption does not create wealth so much as it monetizes it, and the real powerhouse factor in this equation is the investment & savings function. If we could get the investment weighting of our economy back up to the high teens, the majority of our economic challenges would be manageable.

Unfortunately, it is not completely clear what would stimulate higher investment, given the questionable outlook for consumer and business spending in a deleveraging economy. Would business invest more in new plant with the outlook for aggregate demand remaining cloudy? Would reduced regulation really generate a meaningful increase in investment? Would a spending-driven cut in the Federal deficit really be a major boost to confidence? Maybe so, maybe not.

In our view, a more balanced fiscal policy combining major investment-friendly tax revisions and some sort of value-added tax or a modified flat tax with few deductions would be the best alternative. A shift away from consumption and toward investment would be a major piece of a long-term solution, but it would require a long period of very subdued economic growth which allows corporate, consumer and government balance sheets to be rebuilt and savings to grow. We need to do it, let's hope we have the fortitude. The longer we wait, the more painful the cure will be.

The Bank Industry – A Continuing Slow Healing.

As we see it, an extended slow economic recovery argues for little change in the key drivers for bank earnings: interest rates are likely to remain very low, hurting bank revenues; loan demand could show some expansion, but only on a limited and inconsistent basis; and credit quality should show continued but only gradual recovery. Inflation remains a concern. Most banks should be better off a year from now, but not dramatically so. On the more positive side, we have seen signs of an improving regulatory environment, a subject we will discuss in some detail in next month's report.

As we said earlier, this should by no means be a disaster scenario for the bank industry, but it should continue to be a challenging one, and it suggests the need for continued rigor in managing the issues of the day: shrinking problem assets and enhancing capital. In addition, close attention to costs is particularly relevant in an environment of limited revenue growth. So 2011, rather than being an all-clear year of renewed growth, looks to be another time to strengthen your bank, your management, and your strategic plans in order to take advantage of the opportunities for market share gains and organic growth that will come later.

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