

How High's the Water, Mama? Four Feet High and Rising

Johnny Cash song lyrics

Looking at the inflow of economic news takes us back to our college days, when we occasionally were focused on the Red River as we wondered when it would stop rising, and if we had put enough sand bags in place. Similarly, every day seems to bring a higher tide of bad news out of Europe that seems to overwhelm what had been a picture of a continuing albeit very modest growth in the domestic economy. As if we didn't have enough of our own problems (not the least of which is incompetent political leadership), we are faced with an increased external threat, more-than-expected weakness in the economies of some of our major trading partners, the possibility of another round of some sort of financial seizures in the European financial system that could wash over into our financial markets, and even the alarming possibility of a break-up of the European Monetary Union and the departure of the Euro.

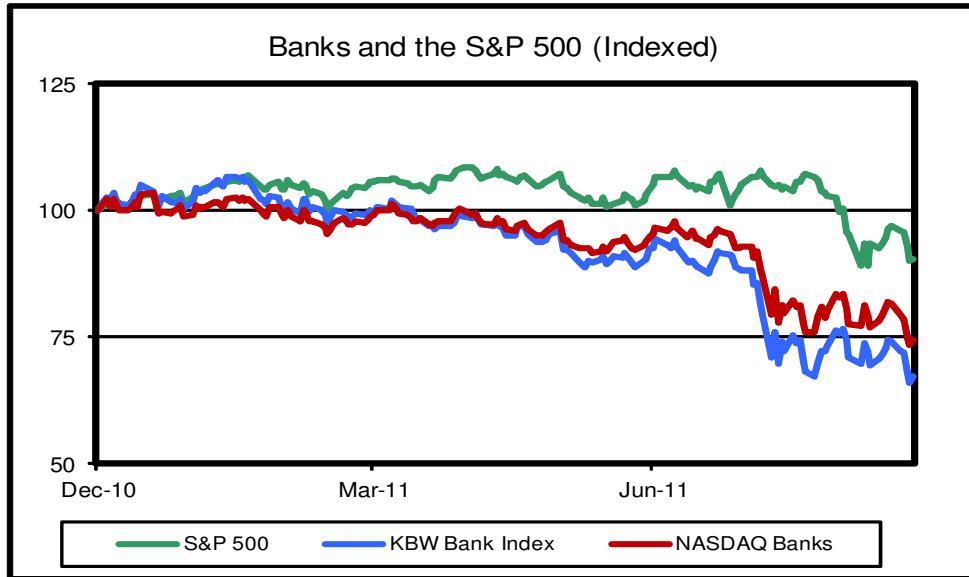
We recently heard a radio interview with a German business reporter that put the European situation in some perspective. He stated that the development of the European Monetary Union had tended to narrow the gap between the cost of debt for northern European economies (which he characterized as disciplined) and southern European countries (which he characterized as happy-go-lucky); thus the union resulted in credit being both more available and less costly than it would have otherwise been for the southern Europeans, and the countries from Portugal to Greece were quite willing to take advantage of the situation, becoming even more dependent upon debt versus income to maintain their spending. Even making some adjustment for the source (Germans tend to be a little severe), and recognizing that Ireland is hardly a southern European country, this strikes us as being a plausible argument for there being a negative side to the development of the EU. The embarrassing part is that it also is a little reminiscent of our own situation, if one substitutes the U.S. homeowner and home buyer (aided by Fannie Mae *et al*) for the debt-fueled, spendthrift southern European countries. Using debt to live beyond your means is not an exclusively Mediterranean tendency.

In any case, Europe is in turmoil. While we tend not to favor doomsday forecasts, falling instead into the "muddle through" camp, it would not take a complete breakdown of the EMU to give us more pain; at a minimum, European economies are being forced into some sort of austerity programs in order to deleverage, and businesses, consumers, and national economies operating under austerity programs do not make robust customers for our output. And although exports are not a dominant part of our economy (about 13% of GDP, and are easily exceeded by imports) and our European trading partners are less significant than countries like Canada and Japan, the impact on the manufacturing sector (a major driver to whatever economic recovery we have enjoyed) could be noticeable. More worrisome, but probably not the most likely outcome, is another financial lock-up such as we saw a couple of years ago, which would put many European banks in precarious position and even erode confidence in our largest banks. As we learned last time, our financial systems are much more interlocked than we fully understand.

Of course, no one knows for sure just how this is going to work out, or what the effect on our economy will be. Nevertheless, it seems (in our relatively unsophisticated view) that these developments increase the probability that economic growth will be minimal for the next few quarters. At this point, economic data continue to be mixed, and although we would bet against an actual recession (two subsequent quarters of declining Real GDP), we can't dismiss that possibility. To maintain our theme, it looks as though the flood waters could stay around for a while before eventually receding.

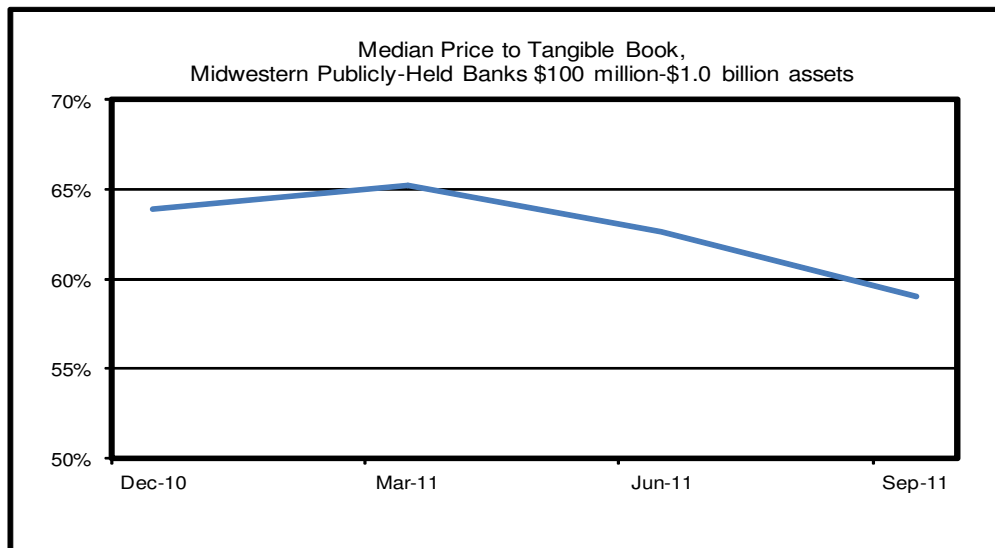
How Things Look Depends on Where You Stand.

Not surprisingly, this big new dose of economic uncertainty, coming on top an already-existing pile of uncertainty, has had a negative effect on bank stocks, as shown in the following chart. While the monetary and fiscal problems in southern European countries and in the EMU are not new developments, their continuation and intensification have led to increasing concerns about financial markets and financial companies. This has been hard on bank stock prices, as seen below:



Source: Yahoo Finance

And the valuations of smaller banks, already irrationally low in our opinion, have dropped even further:



Source: Highline Financial data, Oak Ridge calculations

Although there is some difference between the drop in big bank stocks and smaller bank stocks, we think the gap should be greater – the smaller banks should have dropped much less than the very large banks. We find it frustrating that investors tend to paint all banks with the same brush, even though community banks do not finance much European trade, do not feel much direct effect from turmoil in currency markets, do not lend money in Europe, and certainly do not own bonds of southern European countries. But perhaps it’s asking too much of the equity markets to make such a distinction.

As we see it, while the headline-grabbing European issues have been very unsettling to the markets, and do indeed reflect some increased risk to our economy, conditions down in the trenches don't seem so bad; based on what we can see throughout the upper Midwest, the muddle-through, very slow growth scenario still seems a reasonable expectation. Moreover, in terms of the bank industry, we believe that there is a clear distinction to be made between community banking fundamentals (which are not directly threatened by the events in Europe, and are holding up fairly well) and those of the major banks. Admittedly, community banks haven't climbed all of the way out of the valley of credit problems, but those problems do not seem to be worsening and indeed show signs of continuing gradual improvement. After all, our surviving community banks have been wrestling with the essentially the same problem assets for many quarters now, most managements have evolved to a much more realistic recognition of those problem assets, and the assets have typically been heavily written down or reserved against – perhaps not fully, but close. In other words, the bulk of the risk is behind us. Indeed, we are hearing that nonperforming loan levels tend to be flat to modestly lower, and that it has been increasingly possible to move OREO properties off the books with minimal further hits. In sum, the gradual healing process in the community bank industry may have been stretched out a little bit, but probably not cut off, and that the sector should be much less affected by the mess in Europe than are the big banks. So the gloom and doom indicated by the behavior and valuation of small bank stocks does not seem appropriate to us.

One Man's Ceiling is Another Man's Floor.

Pardon our reliance on song titles, but it does appear to us that there is sort of a perverse element to all of these stormy skies; one can make the argument that current conditions are actually positive for some community banks, *at least on a relative basis*. While economic trends are in turmoil, and basic industry fundamentals are not inspiring, the competitive environment presents real opportunities for banks equipped to take advantage of them. Banks that are stuck in a “circle the wagons” condition are in no position to aggressively go after new business, and in fact find it challenging to hold on to the customers they have; the same could be said of high-value, productive lenders and other employees.

In other words, this is the time for strong banks to take business away from weakened and inward-looking competitors. Just as the seeds of each credit quality crisis are generated in the excessive optimism of an expansion cycle, the seeds of strong and healthy loan growth are sown as the economy is bottoming out but pessimism runs high. At such times, banks that are willing and able to lend can offer a solid and growth-capable banking relationship to customers, and write loans with adequate pricing and terms, the kind of loans that generate true economic returns. Just as in investing, exceptional returns are gained not by following the crowd, but by being a step ahead of the crowd. And in today's environment, when pessimism is rampant, indeed probably overdone, the opportunity lies in leaning against that wind.

We are not suggesting that caution be thrown to the winds; underwriting standards need to remain solid, but they should not be unrealistically severe. And, of course, loan growth will not come easy, with the economy still struggling, business confidence still low, and the appetite for credit still subdued. But the virtue of a market share-driven strategy is that it does not require a vigorous economy, but instead depends on relatively weak responses from weakened competitors, which would seem to be the current state of the industry. Furthermore, there is even some chance that both consumers and businesses have grown, or will soon grow a bit tired of being defensive, and might be interested in some expansion-oriented credit. If you're a healthy bank, with strong capital and effective employees, go for the business. Go carefully, but go for it.

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