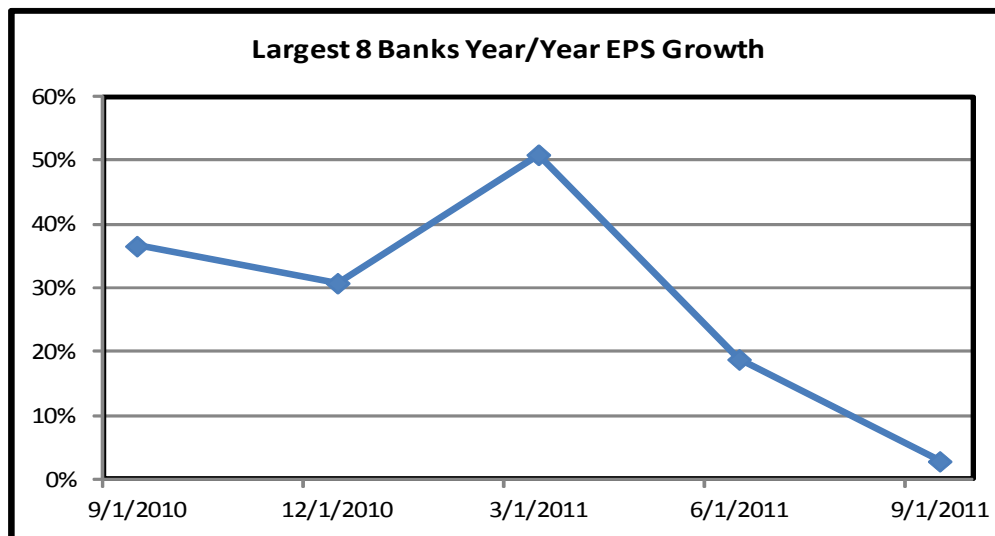


## So Far, So Pretty Mediocre

The Merriam-Webster dictionary defines mediocre as “of moderate or low **quality**, so-so”. That’s basically how we feel about the third-quarter earnings results we have seen so far – pretty so-so. As the Wall Street Journal observed, we have seen “fair-to-middling-to-worse quarterly results from the major investment banks and diversified megabanks”. Up to this point, most of the earnings reports have been for the largest banks, with a few larger regional banks thrown in; as the following chart shows, the bigger (and earlier-reporting) banks seems to be running out of steam, in large part due to lower capital markets activity. We should note that all of the charts in this report are based on data released up to October 25, and thus should be seen as preliminary, especially regarding the later-reporting smaller banks.



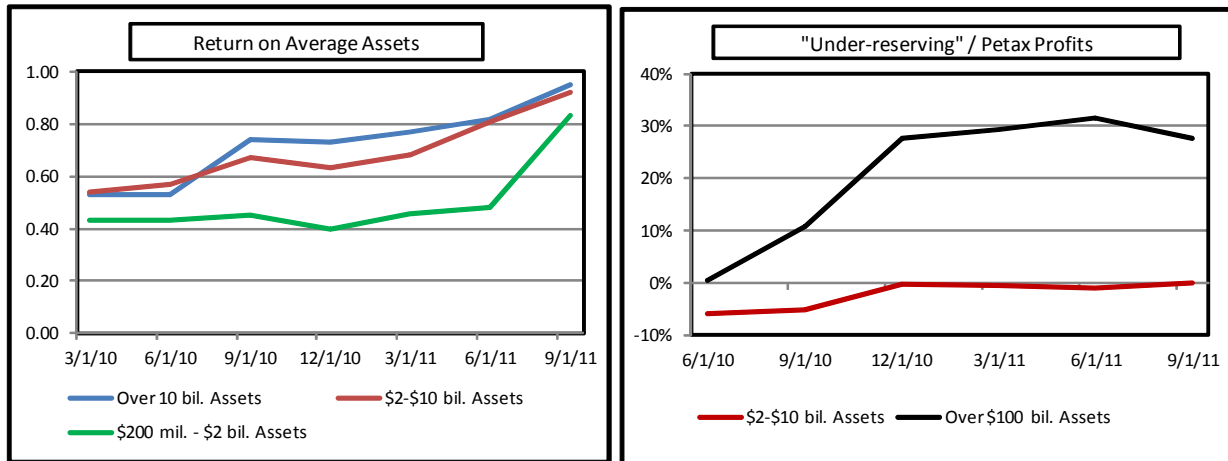
Source: Highline Financial

### **BIGGER IS NOT BETTER.....**

While earnings performance seems to be slipping for the biggest banks, it seems to be picking up for smaller banks, as indicated in the chart below left; while the big banks saw an earlier rebound in profitability, the smaller banks are now catching up. Additionally, earnings quality (a long-standing issue for us) continues to be low for the big banks (in keeping with the definition of mediocre) as a run-down in loss reserves continues to provide a major portion of earnings; this is shown in the chart below right, which measures the earnings contribution of holding loss provisions below net charge-offs. And while it very well might be that internal improvements in loan quality could theoretically support a reduction in loss reserves, we find it interesting that the big banks are doing this at a time when the economic outlook remains quite clouded.

We also find it interesting that only the largest banks are generally using this technique to boost earnings. It took the smaller banks longer to get their arms around their credit problems, in part because they did not have ready access to the additional core capital that could offset the hits from aggressive problem loan write-downs, but enough quarters of heightened reserving and

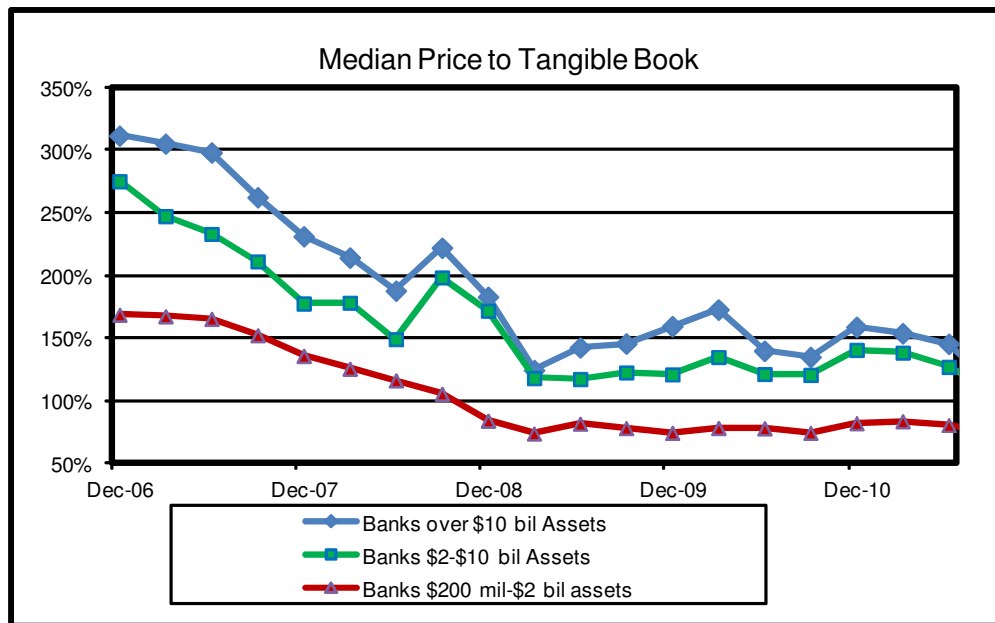
more conservative asset valuations seem to have significantly reduced the earnings burden from loan loss provisioning.



Source: Highline Financial

**BUT THE MARKET THINKS IT IS**

We frequently bemoan investors’ tendency to undervalue the business models and future prospects of smaller banks, as compared against the largest banks that get most of the headlines (and which caused most of the stress in our financial system). In our view, the following chart (combined with the two above) is evidence of this:



Source: Highline Financial data, Oak Ridge calculations

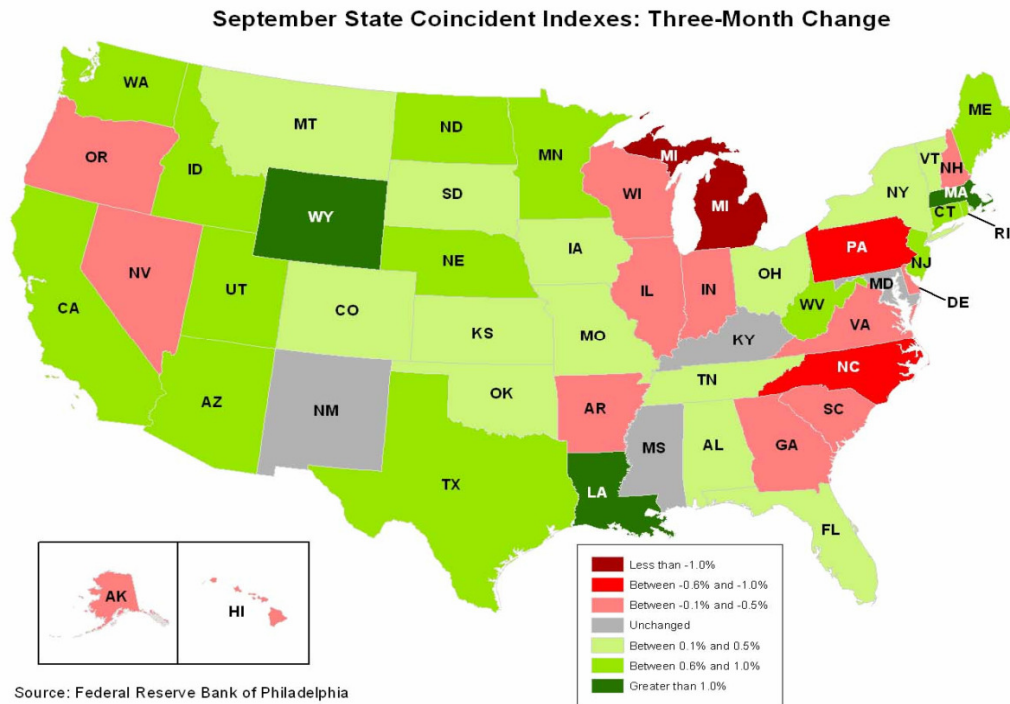
In the past year or so, one might have made the argument that the big banks were coming out of the pits faster than the smaller banks, and therefore deserved a better valuation, but this is highly questionable today; the profitability differential has shrunk, and the big banks’ business models are under increasing threats from intensifying regulation and ties to the turmoil in Europe. In sum, we think one could make a good case that there is a considerable amount of long-term investment opportunity to be found within the small-bank segment of the bank stock market.

**Still Betting Against A Recession, But....**

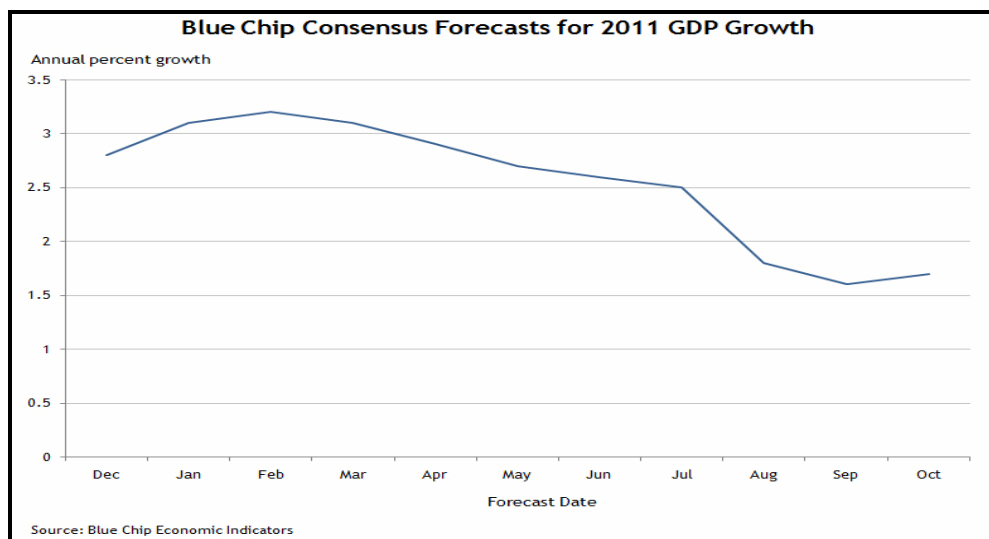
As we mentioned in last month’s Community Banking Monitor, the odds of a near-term recession have increased due to the turmoil and austerity in Europe, but we still think we can skate through the next several quarters without an outright drop in GDP. We note the following economic comment from an Atlanta Federal Reserve publication:

*In the months leading up to July, the downside surprises in the data dominated. In August and September, upside and downside surprises were roughly equal. But in October, the surprises have generally been to the upside.*

This is not to say that the economy is truly healthy, nor that we can stop worrying about the possibility of a recession, but it does make us more comfortable with our “muddle through” stance. The following graphic, published by the Federal Reserve Bank of Philadelphia, recently caught our eye, as it seems to confirm a scenario of continuing but quite modest improvement through September. Things are indeed getting better, albeit very slowly.



Although we recognize that the economic signals are still mixed, that we have not seen much progress against the problems in Europe nor in our own fiscal policies, and that we remain vulnerable to renewed shocks, we are still inclined to remain in our “no recession” expectation. Given the well-known inaccuracy of economic forecasts, the following chart should be viewed as an illustration of subsiding fears of a near-term recession, rather than any sort of proof of that expectation:



Certainly it's not a bullish chart, but neither is it a frightening one. At least expectations have stopped declining and might be bottoming out.

We also took note of the following quote from the Atlanta Fed, probably because it squares with our general longer-term outlook:

*Most private sector forecasters envision growth in 2012 approaching 2.5 percent. In the opinion of many economists, that 2.5 percent approximates the steady-state growth rate of the economy's potential. This rate would certainly be an improvement over 2011 as a whole. The problem is without growth measurably better than 2.5 percent, little progress will be made in absorbing slack in the economy—above all, labor market slack.*

In sum, there's not much to get excited about in the economic outlook, but neither is there much reason to slip into a gloom and doom forecast. And it's certainly not a scenario which should push a bank management into inaction. Indeed, we repeat our argument that banks with relatively strong balance sheets and solid management teams should be redoubling their efforts to achieve quality growth in this environment – not because it's all that easy, but because there are a lot of weakened and vulnerable competitors. We will have more on this subject next month.

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