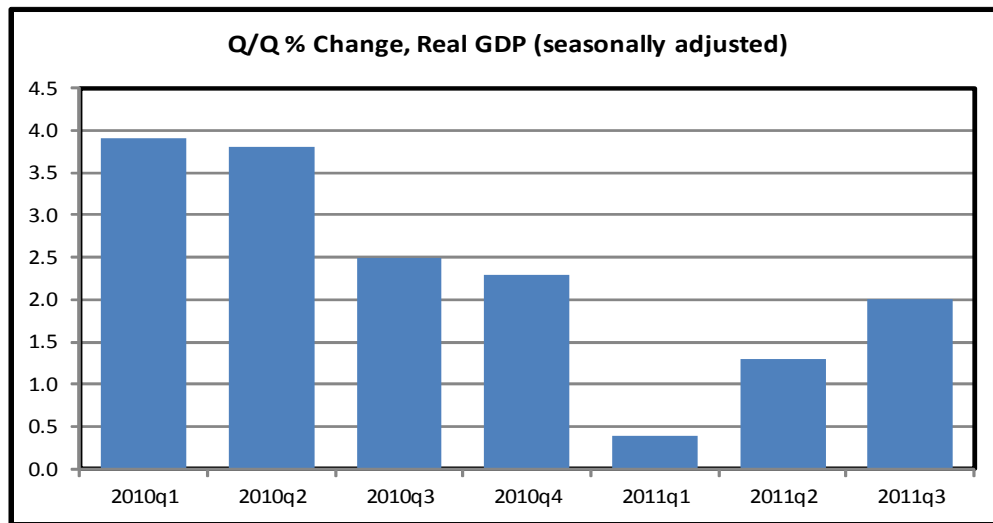


Did We Just Squeak By?

The early November passing of an asteroid not far from earth and within the moon's orbit could be considered something of a near miss; the roughly 200,000 mile margin of safety is not a great deal of distance in astronomical terms, although we were able to be sure that there was no chance of an actual collision. It did, however, make us think of another apparent close call – the recent possibility of falling back into a near-term recession. As we discussed in a previous report, history suggests that our economy tends to slip into recession if Real GDP growth lingers at less than 2%, and we were looking a little vulnerable based on first-half results. Third quarter numbers appear to ease that worry somewhat:



Source: Bureau of Economic Analysis

Supporting the more positive conclusion is the fact that recent economic data have tended to show a better tone – the continuing moderate decline in initial unemployment claims, reasonably good retail sales numbers, or the moderately positive comments in the Philadelphia Fed's survey of manufacturing activity, for example. So it is no surprise that economist forecasts (for whatever they may be worth) are suggesting fourth-quarter GDP growth will be a bit over 3%. While we might want to be a little more cautious, it does appear that we may have slipped by the risk of another recession (several sequential quarters of negative GDP growth).

But.....

Although there is a fairly broad acceptance of the idea that the internal workings of our economy are in OK shape, there are at least two caveats. The first is that economic data are notoriously imprecise and subject to revision, so we had better be careful about counting our chickens too quickly. The second is that there is an external threat that cannot be disregarded – the potential backwash from the turmoil in Europe.

We see two primary elements within the Europe-related risk. The first, the most clear-cut, is the

probability that the austerity programs, reduced lending by cautious banks as they try to strengthen their capital ratios, and economic stress occurring in the major European countries strongly suggest downward pressure on their spending, and therefore downward pressure on our exports to those countries. Luckily, ours is not a heavily export-driven economy – according to BEA data, gross exports accounted for 12.6% of current-dollar GDP in 2010, which is a lot lower than many countries. By comparison, exports to Europe account for 40% of China's GDP, so they have more to worry about than we do; China has apparently said that it may run a trade deficit next year. While Canada and Mexico are by some margin our largest individual foreign markets, Europe in the aggregate is bigger than either, accounting for 24% of last year's exports, or 3-4% of GDP – a serious but not overwhelming issue.

The second risk – the possibility of major disruptions within the world financial system – is less tangible and much more complicated, but is perhaps more disquieting. Part of the reason that the recent recession was so intense was that we experienced a broad tightening of credit, as investors became less willing to provide funds to stressed countries and shaky banks, and banks curtailed lending; since healthy credit markets are a necessary element for healthy economies, a dwindling of liquidity added to the downward momentum in a broad range of economies. The inflated interest rates now being required by buyers of Italian and other European bonds suggests that liquidity issues are again coming to the fore. And since global financial markets are deeply interconnected, this is not just a European issue. If European credit markets are in turmoil, ours are likely to be unsettled too, affecting our interest rates and our bankers' risk tolerances.

On the one hand, it appears that US net exposure to European banks is not all that large, which suggests that the euro-zone's threat to our financial system should be pretty manageable; we suspect that it will all work out that way, after several more quarters of whistling by the graveyard. But there is one aspect of the situation that seems both scary and unknowable: the counter-party issue. One of the reasons our vulnerability to the Euro financial system looks to be manageable on paper is that our financial institutions' exposure is typically measured in *net* rather than *gross* terms, with the difference often involving some sort of financial insurance sold by (for example) a European bank. In other words, there could be a considerable amount of counterparty risk in the situation. And since our giant financial institutions have so far been able to forestall any serious regulation – even transparency – in the area of financial derivatives, we don't know how much risk there is, or where it might reside.

In any case, as a recent report by Fitch Ratings said, U.S. banks could be "greatly affected" if contagion spreads outside the stressed European markets of Greece, Ireland, Italy, Portugal and Spain. And even though there is a world of difference between our giant banks and our community banks, deteriorating confidence seems to be able to migrate from one to the other, as we saw in July.

Best Guess: More “Muddle Through”

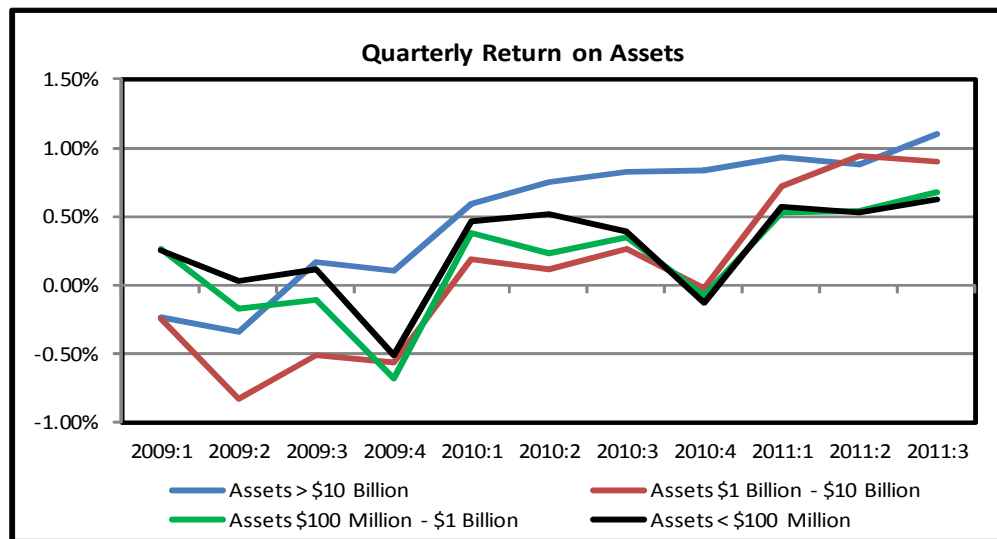
To be absolutely clear, we don't know how this tenuous situation will unfold, and we doubt that anyone else does either. We do believe that some sort of a solution will be found that avoids a break-up of the Euro and any sort of true “run on the banks” in Europe, for one simple (and perhaps simplistic) reason: the alternative would be so catastrophic that the political leadership will eventually find a way to avoid that catastrophe. Having said that, we cannot foresee any “new dawn” plan that could quickly and cleanly resolve the issues, and we suspect that the financial markets will remain nervous and excitable for some time. Furthermore, the process of lifting several European economies back into something resembling healthy conditions will

require their accepting distasteful medicine and a long-lasting commitment to better practices. And finally, there is at least a chance that governments might succumb to the temptation of reflating out of this conundrum, even though Germany in particular seems firmly anti-inflation. In sum, developments in Europe leave us convinced that a trend of continued but very modest economic growth throughout most of the world (including the U.S.) is likely to remain in place for some time, probably for a few years. As we have said previously, such an environment could present fertile opportunities for strong banks, but will not give much of a boost to problem banks.

Third Quarter Banking Results – Not Bad

Closer to home, we saw pretty decent numbers for third-quarter bank industry earnings – not robust, but well ahead of the comparable quarter last year. As the report from the FDIC said, “insured banks and savings institutions reported an aggregate profit of \$35.3 billion in the third quarter of 2011, an \$11.5 billion improvement from the \$23.8 billion in net income the industry reported in the third quarter of 2010. This is the ninth consecutive quarter that earnings registered a year-over-year increase”. The report also stated that lower provisions for loan losses were responsible for most of the earnings gain, as asset quality continued to improve and charge-offs declined 39% year-over-year. Loan balances increased slightly – just 0.3%. Deposit growth looked to be pretty healthy, although the majority of this occurred in the 10 largest insured banks, and may be relatively temporary.

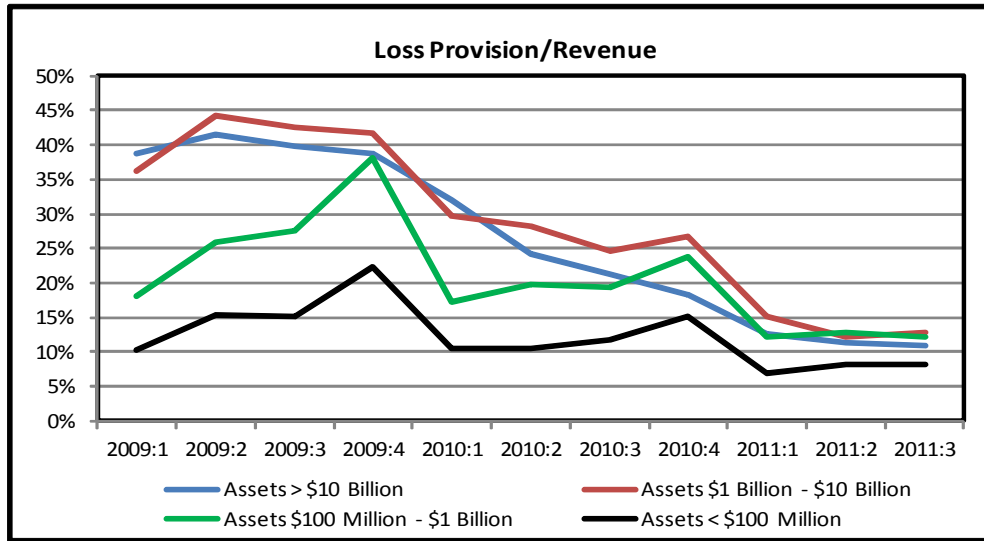
We note, however, that the 48% year-over-year profit gains look so dramatic in part because last year’s earnings were so mediocre. As the following chart shows, the return on assets has actually tended to flatten out during 2011, and (unfortunately) at levels that we could also describe as less than stellar, especially for the smaller banks. So while we’re no longer where we were, we’re not where we want to be, either. We suspect that it will take some considerable time before we see typical ROA’s back at or above 1.00%.



Source: FDIC

And as indicated by the FDIC’s comments, and as we have seen in the past several quarters, earnings gains are being created not by revenue gains but by reduced credit costs – a very welcome trend in itself, but not a trend that is likely to be maintained for a whole lot longer. As shown in the following chart, the earnings burden from credit costs has dropped sharply over the past couple of years, and while there still looks to be some further room to go, the bulk of the

improvement has probably already been achieved – especially if the economy remains sluggish, and asset quality improvements tail off.



Source: FDIC

In other words, “core” earnings growth has been and is likely to remain pretty flat for some time, with only minimal growth in loans and fee income while net interest margins struggle to remain flat. This is likely to push bank managements to focus on market share gains in order to achieve earnings growth, involving some intensified pricing competition, attempts to lure away other banks’ customers and most valuable employees, and increased incentive for potential acquirers and bank sellers to negotiate merger/acquisition transactions. In addition, cutting costs will move to the front burner, and in fact already has according to a very recent Wall Street Journal article. While these strategies are all appropriate for the current conditions, and can prove successful if executed carefully and rigorously, they can also lead to sub-par results if managed sloppily. As we have said quite a few times, the next couple of years should be a period when the winners separate themselves from the losers and the also-rans. Things do seem to be getting better, but don’t drop your guard and don’t ease up in your drive toward top-tier performance.

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