DEVILISH PREDICTION

by Steve Brown

Halloween is just around the corner, which is why it is ironic that one necessary banking evil is the need to predict interest rates. To become better at this task, we suggest bankers break interest rate movement into 2 categories Â– short-term and long-term. Financial professionals can be pretty good at predicting the short-term. This is because rate movement on the short-end of the curve is caused most often by technical factors, (such as the market's reaction to economic data) and, of course, the perceived action of the FOMC. In most management meetings, it is no wonder that discussion swirls around expectations for short-term movements Â– they are topical. However, the key to predicting interest rates for the most economic gain lies not in distinguishing where rates will move over the next month or 2, but rather, where they will go over the long-term. Separating short-term "noise" in rates from developing longer term trends comes down to understanding a key concept. Since the consumer fuels about 70% of our national economic engine, long-term rates are more influenced by the price of consumption than nearly everything else. Interest rates move over time as the needle points toward either increasing or decreasing levels of consumer spending. When consumers are confident, pulling cash from their homes and spending, more money chases fewer goods and yields begin to rise. Since very few people take out a loan to stockpile cash, loan activity can foreshadow supply and demand over a period of time. The FOMC may be able to affect short-term rates (and sometimes long-term), but by and large, after adjusting for inflation, long-term rates are influenced mightily by consumer spending. This is why it is important to watch economic data that impacts the consumer such as GDP, CPI/PPI/PCE, retail sales, housing, durable goods and unemployment. You don't have to give your soul away to understand that these data points can have a huge impact on future rates. Recently, GDP has been slowing, inflation has been in check, and housing has been abysmal. Meanwhile, retail sales have been decent (but only if one excludes autos), and unemployment has been falling. In short, weakness in the economy appears to outweigh strength, so inevitably the FOMC will likely have to move to provide support (in the form of a rate cut). Meanwhile, on the long-end of the curve, China is manufacturing everything for everybody, while our rates remain 100bp over most other countries. As a result, long-term yields appear poised to sit at current levels for quite some time (forward curve predicts only a 5bp upward move over the next 5 years) while the short-end gyrates up and down. By monitoring consumer consumption instead of central bank actions, independent bankers can better hone their interest rate prediction skills and make this "necessary evil" a little more accurate.

BANK NEWS

Executive Pay

The recent ACB compensation survey is causing a stir, as it reports executive pay at banks is down an average of 3% (despite higher performance and inflation). The results are leading many to believe the drop was due to a change in methodology, including throwing out the highest and lowest 2.5% of results for the first time. The survey reports that CEO salary (not total comp) fell 4.5% to $202k and COO salary fell 5.6% to $133k (the 2 highest paid position). The average salary for CLOs was $119k; for CFOs, $118k; for CCOs, $117k; Chief risk/compliance managers, $105k; and, Managers of CRE lending, $105k. The survey reports that 90% of employees received raises, 15% of the workforce got promoted and that the average base salary increase was 4.2%. Expectations for 2007 put most increases around 4.1%. We say, if you are reading this publication you are clearly worth more to your bank and deserve at least a 15% bump.

Beige Book

The Fed's tan book reported that in the last 6 weeks, lower mortgage demand continued to drag down loan production at many banks. On the commercial side, CRE production was stable, while C&I activity increased in all but the NY, Richmond and Dallas districts. Credit quality remained stable to slightly down in almost all regions.

Fed Cash

The holiday ordering period for additional currency requests has been set and will be from Nov. 6th to the 17th.

SFR Delinquincies

After reviewing the housing delinquency numbers, it appears the recent drop is more a result of the improving picture in LA and MS (post Katrina) than in consumer credit. Adjusting for Katrina-effects, delinquencies look like they increased 1bp year-to-date thru Sept.

FDIC Insurance

New deposit insurance premiums will be set at the FDIC's Nov. 2 meeting, will be finalized by mid-May and will be billed in arrears in June. Due to the one-time credit for banks in existence prior to 1996, most banks will face lower insurance liability in 2007.

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The ABA Banking School will change venues starting this June from Georgetown University to University of Pennsylvania.