HAPPY NEW YEAR

by Steve Brown

Now named the "Lost Decade" it is great to put 2009 and the "Double Oughts" behind us. What will 2010 bring? Will Washington have to sell Hawaii to pay down the deficit - maybe. Will Vice President Biden finally get to do what Tareq and Michaele Salahi did and attend a state dinner - doubtful. The truth of the matter is - we have no idea what lies ahead. For all we know, we might even get a health care plan before someone notices that the Winter Olympics has started.

While we can't predict the events that lie ahead, we can tell you some areas of concern that bankers are planning for. In a nutshell, as a result of our surveys, most bankers believe the economy will grow at a slower pace than the current market predicts, while rates will go higher. We don't disagree and here is our take on several important parts of that equation:

Inflation: Inflation hit a low 1Y ago and has been rising slowly ever since. We think inflation will continue to trend slowly higher, as monetary policy will remain accommodative, the dollar remains weak, gold remains strong, the yield curve is steep, commodities prices are high and credit spreads decline. We don't see significant inflation on the horizon, but we do believe that it will exceed the breakeven expectations implied in the pricing of TIPS, which are currently in the neighborhood of 2-2.5%.

Growth: The "new normal" of slower growth will become commonplace and corporations will start to feel more of the benefits of the Stimulus Package and cheaper labor. We predict a 2.5% to 3.0% rate for earnings. While above-average from an historical perspective, it will be a distinctly sub-par recovery given the depth of the recession (which ended about six months ago). Tight credit, the hangover from bloated Keynesian stimulus (i.e. "Cash for Clunkers"), regulatory burdens, reduced government spending and rising municipal deficits will all create the drag to prevent a robust recovery in 2010. Look for more corporations to accelerate revenue recognition into 2010, as by mid-year, higher taxes in 2011 will be a foregone conclusion.

Lending: Lending activity will remain slow and restrained for most of the year until banks can restore capital levels and the regulatory picture becomes clearer. Credit spreads should continue to decline, due to the continuation of cheap money and an improving economy. C&I sectors that are slated for the best performance are those in the healthcare, insurance and energy sectors. For banks looking for the best risk/return profile, CRE will offer the best total return, as we anticipate that probabilities of default will move sharply lower, as the sector hits bottom in the next several months removing significant risk.

Bank Earnings: Look for this year to be another tough one for community banks. While margins will improve by the end of the year (due to higher loan rates and stable deposit levels), softness in CRE will require higher ALLL levels. Banks will focus on relationship profitability as they seek to generate fee income. We predict a minor backlash against the TBTF banks and there will be more of a compelling case for households and businesses to take their business to community banks. By 2Q, look for earnings growth to slowly come back at banks across the nation.

A safe bet is to say 2010 will bring its share of challenges and volatility. After 2009, bankers are more hardened, focused, streamlined and ready to grab profitable customers from the larger banks. We are excited for the possibility of regeneration and look forward to both working and laughing with community banks across the nation.

BANK NEWS

M&A

Tower Bancorp ($1.4B, PA) entered an agreement to purchase First National Bank of Chester County ($1.3B, PA) for approximately $65mm in shares.

M&A

Horizon Bancorp ($1.3B, IN) struck a deal to acquire pieces of American Trust and Savings Bank ($123mm, IN). Horizon will pay a 3% premium (plus a potential $500k) for core deposits and assume $110mm in assets for $2.6mm, however excluding $12mm in loan participations.

New Regulations

Bankers are reminded Jan 1 was the effective date to comply with revised Real Estate Settlement Procedures Act provisions. Meanwhile, new rules go into effect in Feb as part of the Credit Card Act of 2009. The new rules will limit certain interest-rate increases, require more customer disclosure and prohibit banks from raising interest rates on current balances unless a customer is at least 60 days behind in a payment.

0% Risk Weight

Now that the Treasury Dept. will provide unlimited financial support for FNMA and FHLMC, shouldn't these be moved to 0% risk weight? We have seen nothing to support this, but hope it is forthcoming soon from regulators.

Branch M&A Off

Sterling Bancshares ($4.9B, TX) canceled a deal to buy First Banks Inc's ($10.7B, MO) 19 Texas branches. The original deal included $500mm in deposits for a 6% premium and $230mm in loans for a price of $30mm.

ID Theft Program

Associated Bank introduced a new optional service that provides business customers with additional account protection. The program, called Out-of-band Authentication, verifies the users of online banking applications by calling them on the phone to provide a personal ID number to use on the website.