THE MARKETS THEN, NOW AND GOING FORWARD

by Steve Brown

The typewriter was once a mainstay of the office. A prototype was introduced in 1714 by Henry Mill and the first mass- produced typewriter surfaced back in 1868. The peak for production came in the 1950s (Smith-Corona sold 12mm of the machines in the last quarter of 1953). However, it appears that the typewriter has largely gone the way of the floppy disk and the buggy whip. The last company to exclusively produce the typewriter, Godrej and Boyce, has recently shut down production. As we bid farewell to the typewriter, we consider what other products may be pressured to extinction. While we don't believe that fixed income investments (bonds and fixed rate loans) will go the way of the typewriter, it is worth considering the pressure fixed income investors face in the near and medium term. As investors have been accelerating the purchases of bonds and fixed-rate loans, these instruments have been making increasing highs in the last three decades. You have to wonder how long the 32Y bull market in bonds can continue. While rates are low today, a consideration of the last 30Ys of rates illustrates the profound extremity in the interest rate cycle. QE3 was announced last week, which may signal the end (or at least nearly the end) of the artificial demand for fixed income investments. Once rates rise, Treasury bonds and other fixed rate investments could prove to be poor investment choices for many institutions, as the mark to market negatively impacts capital levels (even more so under Basel III). The biggest concern with fixed income securities overall, is price risk or market risk. Duration is the measure of price sensitivity to movement in interest rates. For example, if you own a 10Y fixed rate security (or loan) and rates rise by 100bps, the price of that instrument will decrease by 8%. That is a very large negative impact for a relatively small interest rate rise (given the historically low starting point today for interest rates). Put another way; that negative impact represents more than 4Ys of income for the bond and approximately 2Ys of income for the loan. The reason for concern is that trends that have supported overvaluation of fixed income investments are likely to reverse in the coming years. Bonds have benefited from substantial and continual buying over the last 5Ys, banks have been awash with funding seeking a home and banks have been forced to reinvest into lower and lower yielding investment options. The Federal Reserve's monetary actions are designed to bring inflation (or just the fear of inflation), which will eventually serve to punish fixed income investors (particularly those that have extended duration or taken on significant structure risk). If fixed income investments are overpriced, the only alternative for many banks is discontinuing making fixed-rate loans, buying bonds and moving to cash. There are two foreseeable ways that interest rates could increase. One is when the economy is stable or improving, leading to higher rates through monetary tightening. The second can occur when the world refuses to buy U.S. debt, adding pressure to rates because of supply and demand. It is always hard to call the top of a bull market, but many are still trying to do so. A strong contrarian view is supported by the extreme opportunity cost of holding cash (instead of bonds and fixed rate loans), but that investment thesis also cannot endure for much longer. So our advice is to stay safe, sane and simple in this environment to make sure your bank has the most options going forward.

BANK NEWS

Affluent

A survey of affluent people (with $100k or more of household and investable assets) by Phoenix Marketing International finds the most trusted financial institutions are local community banks (47%) and mutual funds (25%), while the least trusted are large national banks (13%) and credit card companies (11%).

M&A

Columbia Banking System ($4.8B, WA) has agreed to by West Coast Bancorp ($2.4B, OR) for $506mm in cash and stock or 1.45x tangible book. The combined company would have about $7.2B in assets and more than 150 branches in WA and OR and would rank #1 in deposit market share among community banks in the two states.

Worst in History

The Business Roundtable survey of CEOs found their view of the economy took its sharpest drop in the 3Q from 2Q in its history. More CEOS now say the economy is deteriorating and more plan to lay off employees over the next 6 months (34% vs. 20% last quarter).

More Cyber Attacks

Hackers went after PNC Bank and U.S. Bank websites, slowing them down as they continued cyber attacks on major U.S. financial institutions.

TARP Repayment

Zions Bancorp ($53B, UT) has officially repaid the final $700mm in TARP capital it had outstanding with the Treasury. As a result, the Treasury reported it has recovered $266B vs. the $245B originally invested in the program.