JVB FINANCIAL

Weekly Commentary
by Bill Sullivan, JVB Chief Economist

ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

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Conflicting messages amid shrinking bank balance sheets

The financial markets are frequently viewed as a discounting mechanism in which asset valuations shift in advance of actual changes in the broad economy. While there are undoubtedly historical patterns that have contained predictive information, one of the weaknesses of this approach is that there can be conflicting messages from different arenas. Indeed, that appears to be the case as the summer of 2009 winds down. The equity market, given recent price action, seems to be anticipating a vigorous recovery process and a definitive improvement in corporate profits. Conversely, the market for U.S. Treasury securities, given the downward drift in yields of late despite record supply, appears to be signaling a continuation of recession-like conditions well into the next calendar year. Perhaps even more difficult to discern and interpret is the input that may be forthcoming from the gold market. In particular, is the run-up to a new high indicative of an eventual buildup in inflationary pressures or is the price appreciation a by-product of a renewed preference for quality and safety among global investors?

Clearly, the firming trend in precious metal prices can be utilized by stock market bulls as another indication that the U.S. economy is now in an expansion phase that should prove quite robust over time. From this perspective, the higher quotes for bullion are a function of stronger demand conditions as the manufacturing sector begins to recover. Similarly, given the huge volume of Government-provided liquidity within the system, there are genuine fears that any acceleration in economic activity will inevitably lead to a higher cost-of-living for consumers. Against that backdrop, the record price for gold is judged to represent a massive attempt by risk managers to hedge against an intensification of inflationary pressures during 2010 and beyond.

Of course, those investors who may sense a self-sustaining recovery process is a long way off can also seize on the current price of gold to justify their caution, thus supplementing the input that is allegedly being provided by the slippage in Treasury borrowing costs. On balance, the surge in gold could be reflecting some renewed anxieties about the credit environment as unemployment mounts, a development that could call into question the ability of many households to repay outstanding loans. As is widely known, over the last few years, gold market rallies have been associated with some unexpected stresses in the credit milieu, including last September's bankruptcy of Lehman Brothers. Effectively, the gold market could be forecasting an increasing likelihood that there will be some turbulence and volatility within the financial sector before too long. To protect against such an event, cash is now being directed to U.S. Treasury debt and precious metals, traditional safe-haven vehicles.

One potential surprise for investors could be the failure for financial company earnings to sustain their recent rebound. This consideration seems especially applicable to the commercial banking segment, where total loans and investments

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are continuing to shrink. Although the existence of a positive yield curve is considered a net plus for bank profitability, the influence is diminished when the asset base of these institutions is contracting, as currently is the case. Within the last three months alone, bank credit has dropped by nearly $200.0 billion or at an 8.5% annual rate. The decline has been paced by a huge roll-off in loan positions. Commercial and industrial loans, for instance, have dropped by almost $100.0 billion over this period while real estate lending is off by a similar amount. Consumer-related loans have fallen by $18.0 billion since late May. Effectively, there has been sharp erosion in a variety of lending activities that typically generate a strong flow of earnings for these companies. As if to exacerbate the loss of earnings power, cash assets – which provide little or no income – comprise a much larger share of bank credit than in the recent past. To provide perspective, Federal Reserve Board data in late August placed cash at $1.076 trillion, or 11.7% of total bank assets. One year ago, cash assets registered $318.0 billion, or just 3.5% of total bank credit.

Beyond the opportunity for reduced earnings, the shrinkage in bank balance sheets is, in our judgment, another obstacle in the way of a meaningful and self-sustained recovery process. The persistent downward movement in loan portfolios is emblematic of markedly tighter lending standards that will curtail access to credit and will therefore limit spending on durable goods as well as business fixed investments. Moreover, the decision to allow total assets to shrink is an indication that bank managements remain deeply concerned regarding capital adequacy and the concomitant ability to raise fresh funds. If bank loans were in an expansion mode, the need to raise additional capital could come to the forefront, and many institutions may sense it is premature to test the marketplace. In this context, the retrenchment in bank assets could lend some credence to the viewpoint that the downward drift in Treasury rates and the recent up-move in gold are driven by an increased focus on safety and liquidity that will ultimately challenge the equity market rally. ■

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