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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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Bank balance sheets continue to shrink

A puzzling attribute to the current financial environment, in our judgment, is the continued shrinkage in bank balance sheets. Indeed, the second half of the calendar year has been characterized by a sharp erosion in bank asset positions, especially for loan portfolios. The absence of bank credit growth over recent months appears attributable to several factors, some of which seem at odds with the prospects for a vigorous and sustained recovery in the U.S. economy.

The slump in bank assets began during the second quarter and has continued through the first week of October, the latest period for which data are available. Over this period of nearly five months, total bank credit has declined by $350.0 billion, representing nearly an 11.0% annual rate of contraction. The entire drop has been centered in loan activity, with this asset grouping tumbling by $424.0 billion since an interim peak was reached in May. Offsetting part of this roll-off has been an increase of about $75.0 billion in securities portfolios.

Lending to the business sector has been particularly weak in relative terms since the spring time. In particular, commercial and industrial loans have slumped by $138.0 billion over this period or at a 26.0% annual rate. C & I loans now total just $1.386 trillion and comprise only 15.4% of aggregate bank assets, off from 16.7% as recently as late April. The persistent weakness in business lending undoubtedly reflects the renewed ability of many companies to tap the capital market for funding purposes. Indeed, commercial paper issuance has stepped-up of late and corporate bond placements have accelerated dramatically since the second quarter. Clearly, some share of these funds has been employed to pay down previous borrowings from the banking system, thus accounting for the recent weakness in C & I loans. Nonetheless, the fact that the business sector is not tapping their commercial bank credit lines is a potential indication that corporations remain very cautious about the overall economic outlook and are still reluctant to bolster working capital positions via external funding.

Equally surprising is the ongoing contraction in real estate lending over recent months. Since May, real estate loans have fallen by $136.0 billion or at 10.0% annual rate. The decline has incorporated home equity borrowings as well as residential and commercial loan portfolios. For sure, some of the drop reflects an increase in property foreclosures, a development that oftentimes encourages institutions to write-off an outstanding loan. In addition, many mortgage loans are being refinanced and are incorporating reduced loan balances for the borrower. Considering that the cost of housing credit is hovering at all time lows, it is apparent that many banks are earning visibly less income from mortgage-related lending activity, especially as the volume of outstanding loans continues to move lower.

Several other lending categories have also contributed to the downturn in total bank credit since May. Money market activities by banks are being aggressively curtailed over recent months, perhaps reflecting the low return on these loans. Fed fund sales to both banks and non-bank

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financial institutions have eroded by nearly $200.0 billion over the last five months. Bank managements also appear judicious about extending additional credit to households as consumer loans have dropped by about $15.0 billion since May, with minimal impact being evident on such lending activities from the "Cash for Clunkers" program. Amazingly, banks remain committed to maintaining record holdings of cash. According to the latest Fed report, cash assets tallied nearly $1.1 trillion in early October and represented 12.1% of total bank assets. One year ago, cash comprised just 4.2% of total bank credit. The huge volume of cash is obviously a restraint on bank earnings and reveals a determined effort by many large institutions to sustain a highly liquid profile as the year-end statement date approaches.

As bank assets decrease, the need for deposit liabilities lessens accordingly. The downturn in liability positions since the second quarter has been associated with an abrupt deceleration in money supply growth. Specifically, in mid-May, when commercial bank assets reached their recent high water mark, the three month annualized rate of expansion in the M2 definition was pegged at 6.7%, while over the previous six months, the increase tallied a hefty 11.7%. As bank lending activities have slumped since the second quarter, the M2 series has lost a tremendous amount of momentum. Indeed, in the six months that ended in early October, the annualized increase in this broader aggregate had declined to only 1.2%. For the current three months, M2 is now registering a -0.3% annual rate of contraction. Whether the pronounced decline in monetary expansion will have any bearing on the economy's performance over the period ahead is certainly open to debate. However, the sharp deceleration has unequivocally been associated with a decline in lending by the banking system and, from that perspective, could be a hint that the available pool of liquidity to support a robust economic recovery is still not in place. ■

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