

September 28, 2009

Hello CFG clients . . . Brian here. Considering all the banking related emails I write, a few of you have asked Val if you should be doing anything at this time in light of the increasing number of bank failures. I just want to reiterate why I tend to focus on the banking industry and try to answer the question of what (if anything) you should be doing.

Prior to teaming up with CFG, I spent 20+ years in the banking industry. In that time, I came to understand the critical role banks play in the overall economic system. Not only in their intermediary role of taking in deposits and lending them back out again, but also their role in carrying out monetary policy (the supply, availability and cost of money). In past emails, I've likened the banks' role to that of the heart in a human body. The money they pump through the economic system is like the blood . . . and money truly is the lifeblood for many businesses and consumers!

The flow / availability / supply / and cost of money is truly at the heart of keeping our economic system functioning. And the banks are in control of these four functions. If the banks feel they are not healthy, they will curtail their lending (for autos, credit cards, home mortgages and loans to businesses), the flow of money throughout the system is reduced and the economic engine begins to slow and sputter. Businesses then see reduced sales of product, so they cut or layoff staff, which leads to more and more people unable to make their bank loan payments and the cycle continues. Understanding this vital connection between the banking industry and the economy will better equip you to discern the headlines claiming the worst is behind us. **If the banks carrying out this important role are not healthy, then the overall economy will not be healthy.**

So, the primary reason I focus my emails on the banking industry is because of the bolded sentence above. Mainstream media outlets have been and continue to report on certain economic numbers that appear to be improving and, hence (headlines claim) we're in an economic recovery. The information and numbers coming out of the banking industry, however, are contrary and (in many instances) appear to be deteriorating!

To answer the question of "what should I or we be doing now", my response is this; (1) remain conservative with your cash . . . carefully consider major expenditures and purchases, (2) try to save cash by cutting or reducing personal expenditures (dinners out, dry cleaning bills, forego trips to the mall or stores that encourage impulse purchases, conserve utilities . . . and my wife even offers one up . . . "color your own hair"), (3) re-assess life / auto / home insurance needs (i.e. look for opportunities to reduce premiums via higher deductibles) (4) keep only the minimum necessary amount you need to live on in your bank account.

And now, on to this weeks email . . . and yes it's about the banking industry. And this week I'm borrowing an article written by John Mauldin. He is a recognized financial expert and investment author/analyst. He writes on various financial topics and his latest narrative centers on the banking industry. If you don't have time to read the whole article, please skip through and read the highlighted text . . . you won't find this information on Fox News, MSN or CNBC.

The Hole in FDIC

by John Mauldin

This week we continue to look at what powers the forces of deflation. As I continue to stress, getting the fundamental question answered correctly is the most important issue we face going forward. And the problem is that we cannot use the usual historical comparisons. This week we look at one more factor: bank lending. **I give you a sneak preview of what will be an explosive report from**

Institutional Risk Analytics about the problems in the banking sector. Are you ready for the FDIC to be down as much as \$400 billion? This should be an interesting, if sobering, letter.

Outrageous! - Artificial Deflation!

Speaking of deflation, let me mention something I find totally outrageous. Normally, I actually take up for the bureaucrats who are stuck with the task of trying to monitor inflation. It is a tough job, and like Monday-morning quarterbacks, everybody thinks you should have done it differently. I can understand the rationale for hedonic measurements, housing rent equivalents, etc., even if I don't agree with them. You have to set some rules and live with them. But the latest imbroglia is disgraceful.

It seems the US Bureau of Labor Statistics, in the CPI next week, will treat the subsidy received by those 800,000 car buyers who bought a car in the "Cash for Clunkers" program as if the price of a car fell by \$4,500. Really? My tax dollars account for nothing?

This does several things. It will decrease the inflation used to adjust the GDP for this quarter. Not the end of the world, but annoying. But what really matters is that the CPI is used to calculate Social Security increases and interest paid on TIPS.

If I tried to defraud one of my clients using such accounting legerdemain, I would be shut down, sued, and taken to court (at the minimum) by the host of regulators who look over my shoulder. And I should be! You don't make such changes in the rules to your own benefit. But that is what the Bureau of Labor Statistics did. This policy should be overruled immediately. There are enough deflationary forces in the world without having to artificially create some more. OK, off the soapbox and onto the banking system.

The Hole in the FDIC

Let's look at a huge hole that is looming at the FDIC. **Institutional Risk Analytics (IRA) is maybe the premier bank-analyst service in the country.** They charge over six figures for their flagship service. Good friend and Maine fishing buddy Chris Whalen runs the show and was kind enough to send me some of his new data, which they have not yet released to the public. You get it here first. (www.institutionalriskanalytics.com)

IRA takes the data from the FDIC and crunches it with their own set of risk parameters. **While the FDIC has a little over 400 banks on its current "watch" list, IRA gives 2,256 banks an "F." They project that over 1,000 banks will either fold or be taken over during the current cycle.** To date in 2009, a total of 92 banks have failed across the country, compared with 25 for all of 2008, according to the FDIC. 900 more to go. Ouch.

Period	A+	A	B	C	D	F
2009 06	3,518	1,449	417	421	72	2,256
2009 03	3,959	1,431	452	437	88	1,820
2008 12	3,918	1,705	119	390	98	2,003
2008 09	4,498	1,325	283	356	63	1,793
2008 06	4,884	1,248	404	326	66	1,458

Source: FDIC/IRA Bank Monitor

How much money are we talking about? The banks rated F have total insured assets of \$4.46 trillion. So far in this cycle banks that have been taken over by the FDIC are showing losses of 25%!

IRA Bank Stress Index Distributions
(Assets of FDIC insured banks, \$B)

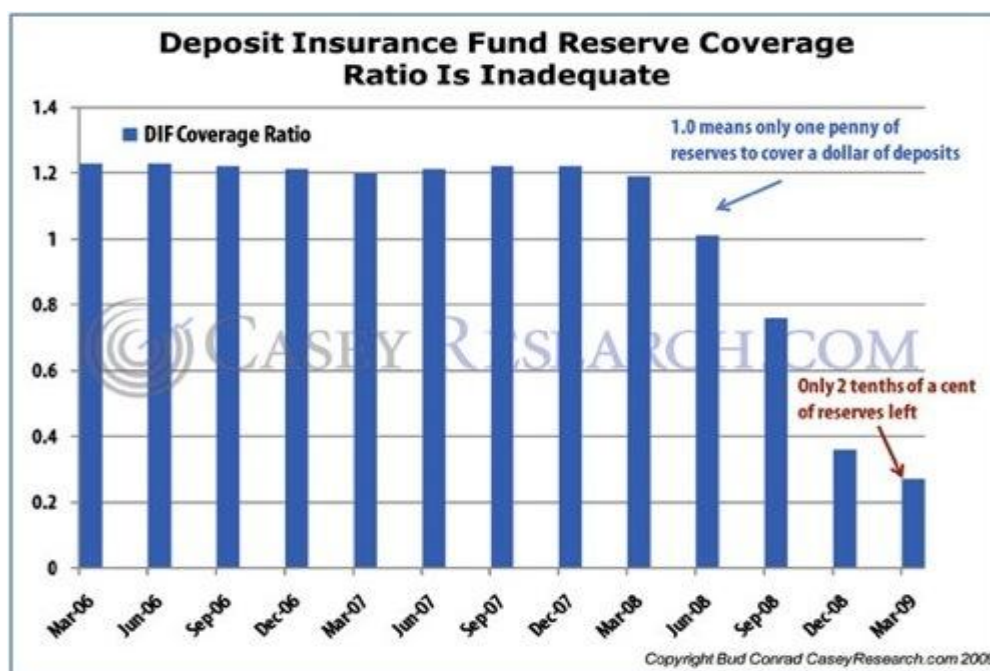
Period	A+	A	B	C	D	F	Total
2009 06	\$2,005	\$2,097	\$4,132	\$518	\$68	\$4,458	\$13,278
2009 03	\$3,202	\$3,131	\$3,587	\$729	\$86	\$2,784	\$13,519

Source: FDIC/IRA Bank Monitor

Turning to a note from IRA: "An important point in the analysis is that estimated losses for failed bank resolutions by the FDIC are running around a quarter of failed bank assets, a level much higher than between 1980 and 1995, when failures cost an average 11 percent. Our firm's long-held view of the likely loss rate peak for the US banks in this credit cycle is 2x 1990 loss rates or, as noted by the IMF, around 4 percent of total loans. Since total loans and leases held by all FDIC-insured banks was some \$7.7 trillion as of Q2 2009, the IMF estimate implies a cumulative loss of over \$300 billion.

"If you start with the internal assumptions used by our firm that roughly half of the banks currently rated "F" or some 1,000 banks will fail and/or be merged with another institution and that the loss to the FDIC bank insurance fund will be approximately 20-25% of total assets, then the cost of these resolutions to the FDIC through the full credit downturn could be in excess of \$400-500 billion. Keep in mind that in making this alarming estimate we ignore other banks currently in ratings strata above "F" and that some of these institutions may indeed fail as well. Also, our overall "worst case" or maximum probable loss ("MPL") for large US banks above \$10 billion in assets is \$800 billion through the current credit cycle."

From almost \$60 billion last fall, the FDIC's reserves have been drawn down to only about \$10 billion today (after set-asides), a 16-year low. A quick look at the FDIC's own data shows us how inadequate those reserves are compared to the deposits they are now insuring. The FDIC only has about two-tenths of one cent for every dollar of assets it covers. Look at this chart from my friends at Casey Research.

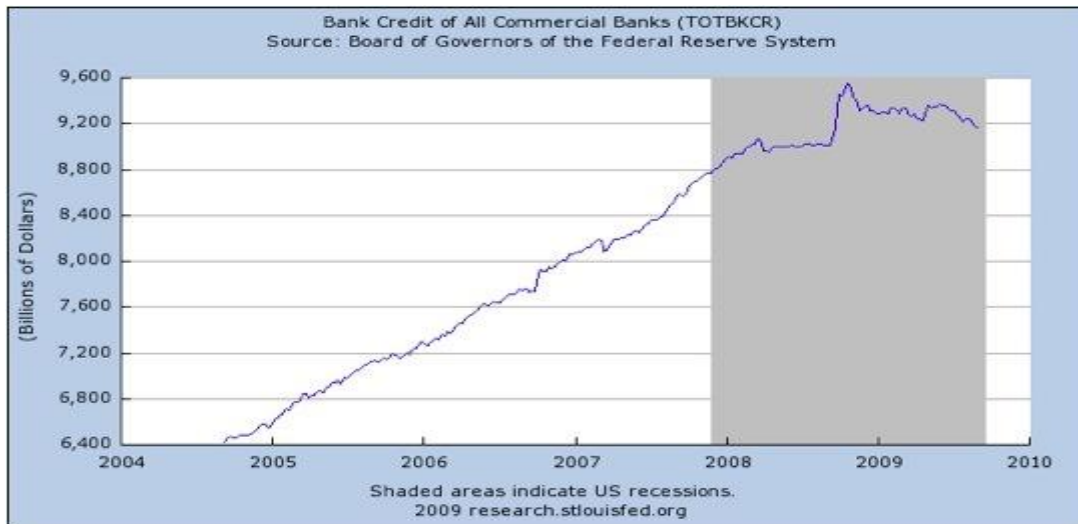


The FDIC can borrow \$100 billion in an emergency line of credit, and through 2010 it can get another \$500 billion. But if and when that money is borrowed, it will have to be paid back. Remember the money that was lost in the savings and loan crisis 20 years ago? The FDIC had to borrow a mere \$15 billion. We are still paying that 30-year loan back.

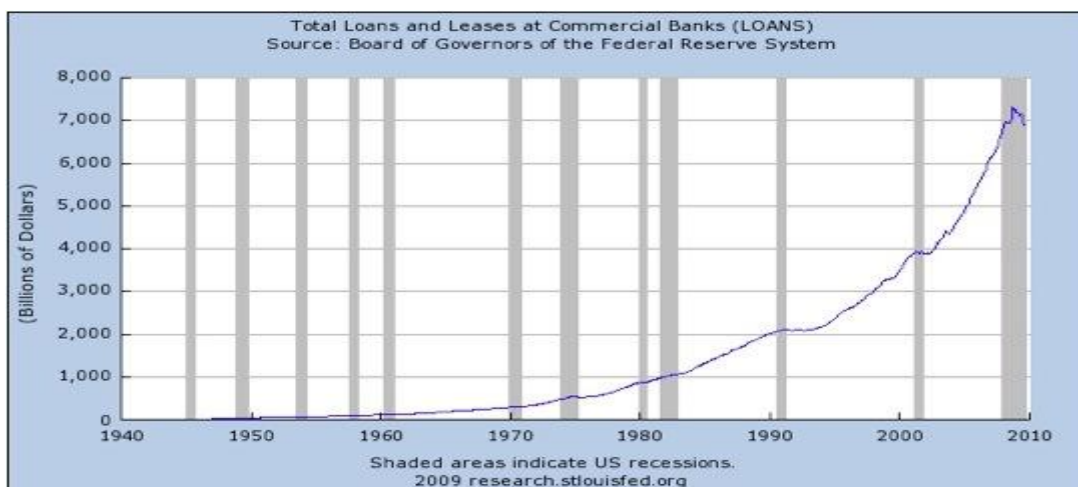
The FDIC has two options to replenish its insurance fund in the short run: it can charge banks higher fees or it can take the more radical step of borrowing from the US Treasury. It has already levied a "special fee" that garnered over \$5 billion.

Now, let's hold that thought, as we will come back to it in a minute.

A growing economy requires a growing credit market. If credit is shrinking it signals a receding economy. But banks are having to raise capital, and that means many banks are having to curtail lending. First, let's look at a chart of total bank loans for the last five years. Notice that there was a big jump in late 2008 as commercial paper became hard to obtain and businesses hit their credit lines. Since then banks have been cutting back.

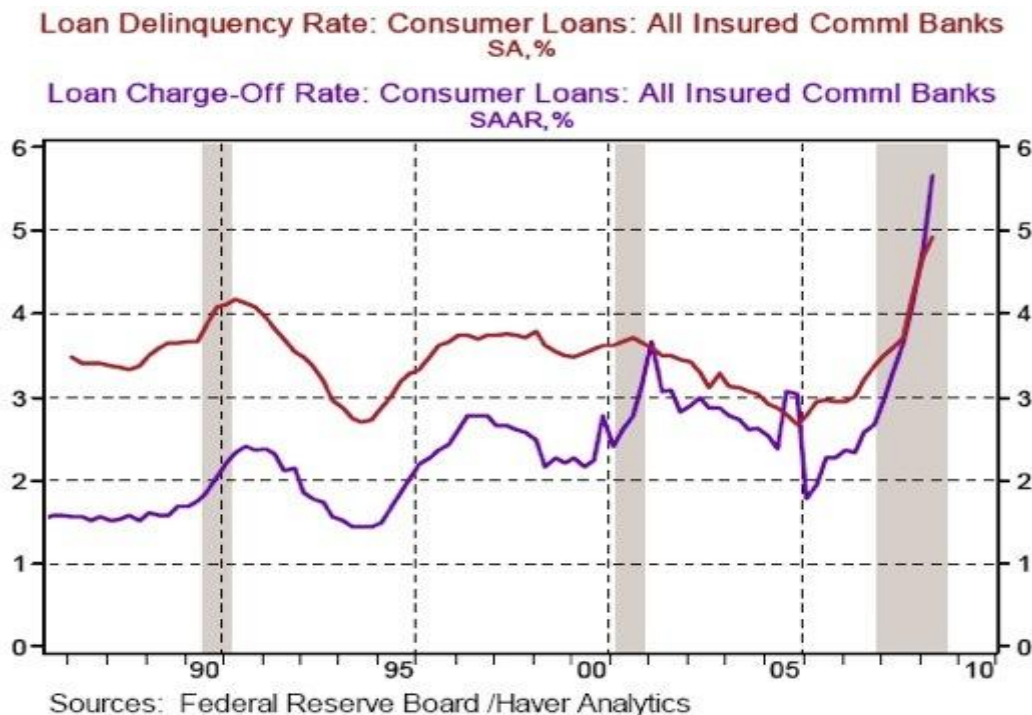


This next chart is again total bank loans but goes back to 1947. Notice that loan growth was relatively smooth with only a few sideways drifts during recessions and never dropping significantly, as it has in the last year. And the data suggests that banks intend to keep reducing their loan exposure as they try to increase their capital (at least the large number of banks that have problems).



Consumer credit-card lending is down. Banks have cut their outstanding and unused bank lines to corporations. I can go on and on, but you get the picture. Remember the money that the Fed used to purchase toxic assets so that banks could lend? They are increasingly using that money to buy Fannie and Freddie loans and banking the interest in an effort to improve their profitability.

Why are they raising capital? Because their loan losses are high and rising. Look at this chart from Northern Trust. What it shows is consumer loan losses rising, and so far there is no sign of those losses topping out. The lines are still going up. The same can be said for real estate loans at commercial banks, which are now running over 9% delinquent. These are loans the banks kept on their books.



Everyone knows that commercial real estate loans are the next shoe to drop, and write-offs may be as large as \$400 billion. This will force some banks to go under, but other banks will simply have to absorb the losses.

Now, let's come back to the FDIC. Sheila Bair, who heads the agency, has emphatically said that the FDIC will not ask Congress for a capital infusion. That means, as noted above, that the FDIC will have to either use their credit lines or ask for more "one-time" special-fee contributions.

If the FDIC borrows the money, and it is highly likely they will, they are going to have to raise the rates they charge member banks for the government backing. And to pay back \$3-400 billion? Rates will have to be raised quite high, on the very banks struggling to raise capital and make a profit.

This is going to be a huge drain on future profits of US banks for a very long time. It is going to make it even harder for them to increase their capital – and they need to. But it has to happen. Zombie banks, those that are bound to fail, need to be taken out and put into stronger hands so that credit growth can once again start to rise. But this will not happen overnight. It is going to take time.

While I am writing about US banks, this is a problem all over the developed world. **Banks that have to raise capital and reduce loans are not growing credit and are a drag on growth. As credit shrinks it is a large deflationary force.** And that is not even taking into account the implosion of the shadow banking system.

Yes, we are seeing statistical growth in the economy this quarter and probably the next. But unemployment is rising and wages and incomes are falling. We will go into that next week.

We are in for a very poor, jobless recovery, and the risk of falling into a double-dip recession is quite high. The stock market is pricing in a steep V-shaped recovery in both GDP and corporate profits. I am not convinced.

How Can Just Four Stocks Be 40% of the NYSE Volume?

Before I hit the send button, **a brief comment on a very odd market happening. It appears that recently up to 40% of the volume in the NYSE is in just four low-priced financial stocks. "According to Reuters, four beaten-up financial companies - Bank of America (BAC), Citigroup (C), Fannie Mae (FNM), and Freddie Mac (FRE) - have accounted for upwards of 40 percent of the trading volume on the New York Stock Exchange."**

The stocks are basically churning in price. Why is this? There are a lot of theories, so let me offer one of my own. I think it has a lot to do with flash trading. As I [wrote in a previous letter](#), with high-frequency program trading hedge funds and sophisticated brokers can make as much as 0.5 cents buying and selling a share of stock at breakeven. Supposedly, the exchanges pay these premiums for adding liquidity. But we are seeing liquidity in stocks where none is needed.

The SEC announced this week that they are going to look into halting these programs. Good. It can't come too soon. Allowing certain funds and brokers to basically front-run the average fund or individual because they have their servers on the actual trading floor is just wrong. This must stop. And if program trading is actually driving the volume in these four names, it needs to be stopped as soon as possible.

Candidly, I have no way of knowing what the true reason for the volume is. Maybe it is something simple and innocent. But I am deeply suspicious. I doubt it's people buying Bank of America, which has seen its volume as high as 238 million shares, or Citi at 973 million shares, in ONE day! This for stocks that are severely financially impaired? Someone needs to be on top of this. As in Monday.

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