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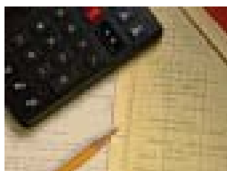

Economics & Financial Markets

United States Equity Markets

Philip L. Miller – 646-415-9141
Chief Strategist
pmiller@sisresearch.com
www.sisresearch.com

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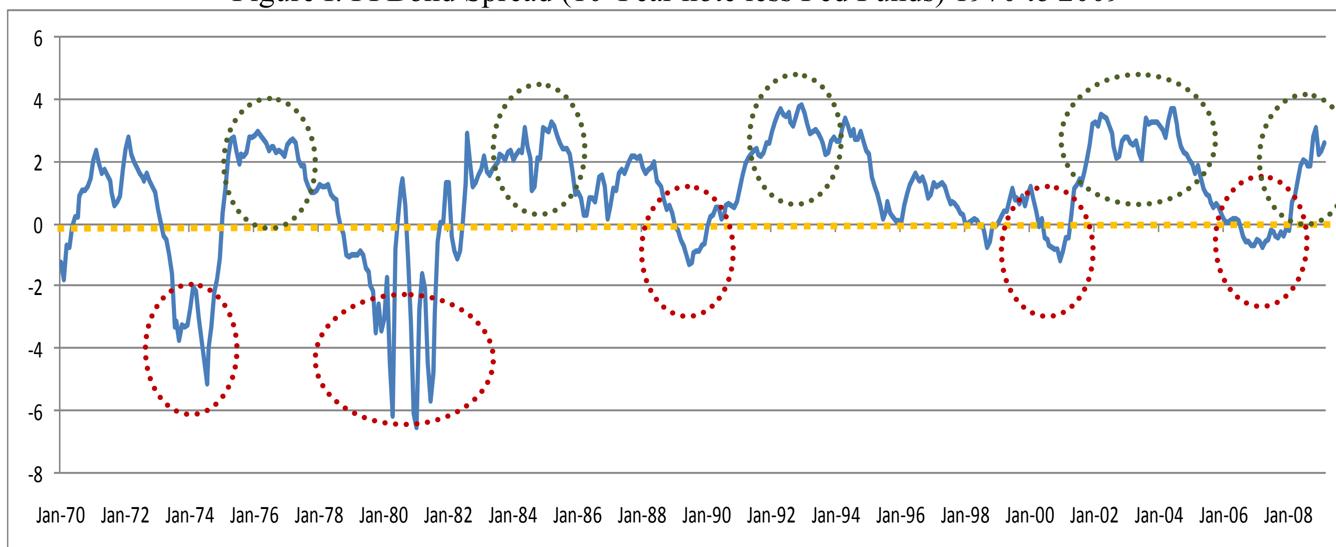
Citi, B of A, JP Morgan all Projecting Profitable – Reason FFBond (10 Year – FF) Spread at over 2.5%

Figure I: FFBond Spread (10 Year note less Fed Funds) 1970 to 2009



Source: Federal Reserve, SISR

In February and March of 2008 we argued that there are four principles that serve as necessary and sufficient conditions for market bottoms. In recent weeks we have focused on Principles #1 and #3 because Principle #2 had been holding since May of last year. Principle # 2 is the first step that the Federal Reserve executed when they realizes that there is a problem in the economy, and began to take serious steps to remedy those problem. With the announcement of expected profitability by Citigroup (C), Bank of America (BAC) and JP Morgan (JPM) this past week, the fruit of those efforts by the Federal Reserve have become apparent.

I. The Four Principles

The four Principles from our February 19, 2008 report (easily found on our website) on the recession are:

"Principle #1: In each recession the market recovery occurred only when there was sufficient evidence that the underlying conditions of the recession were resolved or perceived to be effectively concluded.

Principle #2: The FFBond relationship needs to be clearly in the positive for the financial institutions to be expected to recover, and in each recession this relationship went negative prior to the recession.

Principle #3: Traditional valuation metrics in a recession are virtually useless, as are traditional economic forecasting metrics for understanding when the economy will rebound. The necessary condition is the cause of the recession must be addressed and only those metrics that can speak to that issue is relevant for the market prior to a rebound.

Principle # 4: No two recessions are alike and the remedy for resolving the problem are all indeterminate but dependent only on the cause of the recession. The fed is often the cause, but the fed is only the reactive cause and not the true cause."

We have spent the last two weeks discussing principles #1 and # 3, in this report we will focus on Principle #2, because one of the primary reasons why these banks have become profitable is a direct consequence of the FFbond spread which makes for favorable lending. Principle #1 and #3 briefly imply that full recognition of the problem and the conditions must be in place for the markets to perceive that sufficient support exists to eliminate and stabilize the cause of the recession. For the past few weeks we have been arguing that the necessary conditions are in place to support the economy and abate the cause of the recession, with the possible exception of sufficient support for housing (please see our work of the last two weeks on this issue).

II. Principle # 2

With the expected profitability of these three referenced major banks, the markets soared last week and were up nearly 10% for the week. Viewing Figure I above we find that each time in the FFBond ratio went below the zero line for several months a recession was not far behind. This occurred as can be seen in 1974, 1979-80, 1990, 2000, and yes 2007 (the red circles).

Similarly, in each period of recovery the FFBond ratio exceeded 2% during the recovery (Green circles) including 2008-9. This pattern works like clockwork, and it is clearly in play today. In many ways components of the 1990 recession provides a good analysis for the impact of the expanded FFBond ratio. The reason why it works so well is that banks borrow at the short rate and lend at the long rate, and if the spread is wide it enables the banks to reap a greater profit, exactly what is happening in the current situation, and why we had the savings and loan crisis in the late 1980's.

The S&L Crisis had its origin in the early 1980 when a sharp rise in interest rates caused what is identified as an "Asset-Liability Mismatch." This Asset-Liability Mismatch occurs when a financial institutions assets and liabilities do not materially correspond. The banks in the early 1980, for example,

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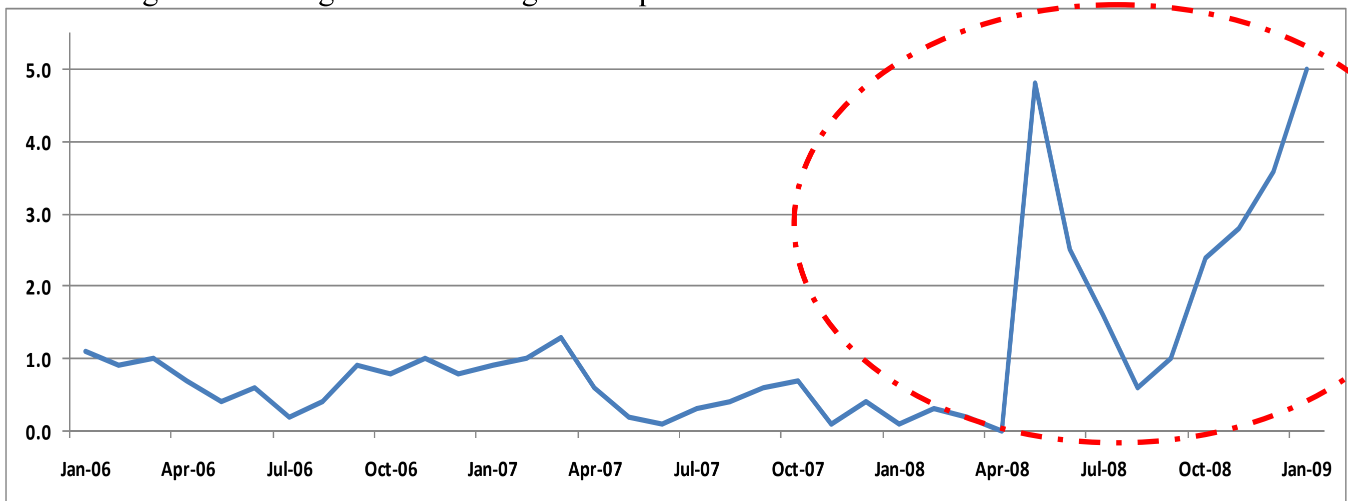
were selling CD's at very high interest rate, a liability and receiving income from their assets fixed rate long term mortgages, which was lower than the amount that they were paying out on the CD's. This mismatch is conventionally identified as the primary cause of the S&L crisis, and subsequently the housing crisis of the 1990's, but it was only when the short rate went below the long rate that the crisis began to come to an end and the banks again were becoming profitable.

The reason why the negative FFBond rate is so deadly for the economy is because as the short rates exceed the long rates the banks lose their ability to lend at a profit. Banks today are again becoming profitable because of this classic cycle pattern of an oversized spread between the 10 year notes and the fed funds rate following a recession.

There are 83 months out of 657 months since 1954when the FFBond spread was above the current monthly average of 2.65, and of these instances occurred in the months following a recession. This oversized spread enables the banks to begin to lend again at a profitable profit spread, which helped the banking system to regain their footing. This is the same pattern that is currently occurring in 2009, with the banks beginning to become profitable.

III. The Increased Saving Rate

Figure II: Savings as a Percentage of Disposable Personal Income Jan 2006 to Jan 2008



Source: BEA, SISR

On March 2, 2009 the BEA reported that savings as a percentage of Disposable income had increased to 5.0%. In our morning note we had raised concerns about this increase in savings given that much of the increased saving was a result of saving from fuel costs. More importantly the high savings rate was not helping the consumer sector with individual savings and not spending particularly during this period of high anxiety and lowered confidence.

The flip side of this equation is that the banks may be the beneficiary, with the banks receiving a good portion of these additional savings and paying the savers at the lower range of the interest scale, while lending this additional capital at the higher end of the interest scale. In the long run this will be a real positive if savings continues, because it will largely be lent out for capital improvements that will have a

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long run stimulus impact on the economy. This is in contrast to the quicker purchase of goods and services which does not have the same growth consequence in the long run, and result in a more simple replacement of inventories, but without additional capital investment. For present discussions however, this increased savings rate has been helping the banks return to some semblance of profitability and stability.

IV. Conclusion

What we have found in this report is that there are logical systems that have been put in place to support the banking system, particularly the work by the Federal Reserve to expand the FFBond spread that has enabled the banking system to become profitable on new loans, and new lending practices as they move forward and begin to lend again. The oversized FFBond spread has enabled the banks to gain those extra few percentage points that enhance their ability to regain profitability as their losses from prior lending become correctly valued on the books of the various banks.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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