

## “Eye of the Storm meets Eye of the Tiger”

### I. Report Highlights

- This ‘Decession’ is unlike any other economic phenomenon in prior history. The securitization market increased the incremental spending dollars for consumers via home equity loans and mortgage refinancings, credit cards, auto loans, student loans, personal unsecured loans and investing on margin. Aided by relaxed rules on leverage (essentially creating money out of thin air), certain financial institutions provided consumers with new sources of disposable income outside of the usual cash flow source: Salaries and bonuses. From this analysis, our first order commentary is that businesses must prepare for a return to normalcy, wherein consumers won’t be robbing Peter to pay Paul; incremental consumer spending will return to prior levels. Our second consideration is regarding the health of the U.S. consumer: We fear that U.S. and European policy makers are listening to economists who don’t fully comprehend the deep implications of the current consumer driven Decession.
- **Eye of the Storm**  
The Dow Jones Industrial Average’s ascent to 9,000 prompted a number of media pieces discussing the economic meaning of the event. Furthermore, many of these articles pronounced that the U.S. has reached an economic bottom. We believe the U.S. economy is in the **Eye of the Storm**. Specifically, the recent public market performance has provided a brief respite to the continual onslaught of negative economic news. Unfortunately, certain commentators are overlooking the fact that *sustained* corporate profit growth requires *sustained* corporate revenue growth. We expect generally flat to negative corporate profit growth for the period Q3 2009 to Q1 of 2010 (See our next report regarding the need to motivate the customer).
- **Troubling Data**  
According to Bloomberg, during the week of July 20, 2009, 143 companies in the S&P 500 reported earnings and 73 of these companies missed analysts’ revenue estimates. Moreover, revenue for these 143 companies fell on average 10% from the year earlier period. Most recently, as reported by the Wall Street Journal on 27 July 2009, loan volumes at the 15 largest U.S. banks fell by 2.8% in Q2 2009. This report is concerning given that credit is the lifeblood of business; falling credit availability signifies weak economic growth for the near term. Martin Feldstein accurately assesses the situation in a recent Bloomberg interview, “There is nothing to sustain a really solid recovery.” Consumers will need Rocky’s **Eye of the Tiger** to make it through this fight.

## II. Consumer Considerations

### ■ **Consumer Driven Economy Requires Stimulation**

Given that 70% of the U.S. economy is comprised of consumer demand, employment is the most significant issue facing the U.S. today. For employment rates to recover, companies must exhibit sustained revenue growth to justify additional employees. To achieve sustained revenue growth, consumers must stop hoarding cash and begin spending. Our view is that consumer spending levels will continue to drift lower, finally exhibiting growth in Q2 2010. This forecast could be negated if the government were to embark on a second stimulus package and implement significant consumer stimulus measures.

### ■ **Consumer Bridge Funding Collapses Creating Funding Issues**

Our forecast regarding consumer spending is based upon the serious predicament a great number of consumers find themselves facing. Specifically, many consumers were lulled into a consumption coma fueled by a cornucopia of credit cards and home equity products. It is our belief that these consumers felt their salaries would be sufficient to cover basic expenses and certain basic debt payments, with the remaining 'gap' of debt payments being 'bridged' by cash flow from rising investment returns and real estate values.

Now that the party has ended, many consumers lack the savings, access to credit (credit cards, home equity loans) and cash from investments to fund their debt obligations and continue to spur U.S. economic growth.

### ■ **Continued Consumer Debt Unwinding Will Create Significant and Unexpected Losses**

It is our view that the continued unwinding of the consumer debt burden will cause greater harm to the economy than the massive build-up of debt. We fear that, given financial illiteracy which is rampant in the U.S., many consumers will pick and choose which debts to default on without regard to financial rationality. Moreover, we believe this continued drain on banking reserves will come as a surprise to many banking analysts and thus create further negative psychology in the marketplace.

- Credit card charge-offs closely correlate to the level of employment in the United States. Given the near universal expectations that unemployment will rise in the U.S., we can expect credit charge-offs to rise as well.
- The mounting anecdotal evidence illustrating consumers' abandonment of mortgage and credit card obligations causes significant worry. These instances of obligation desertion are driven by consumers feeling overwhelmed by a combination of under/unemployment and mountainous debt. Thus, consumers are surrendering without signaling retreat, depriving financial institutions of any meaningful foresight into account quality.

Compounding the issues of unemployment and certain consumer's irrational financial decisions, David Reilly Bloomberg News columnist, reports a troubling calculation: "Of the seven biggest banks by total assets, all but Citigroup Inc. saw the growth of nonperforming assets -- mostly loans likely to result in a loss -- grow at a quicker pace than the increase in the bank's loan-loss reserve, according to my calculations."

## III. Near Term Policy Considerations

- **Employment** is the most important economic issue facing the U.S. Employment will not improve until corporations achieve meaningful corporate revenue growth, which in our estimation will occur in Q2 2010
- **The U.S. government** must be more aggressive in its efforts to restore liquidity to the securitization market, which is one of the most significant sources of consumer liquidity. Specifically, the U.S. government must clearly communicate to the market that participating institutions will not be unduly punished for profiting from the public/private partnership programs
- **Short term gains/losses in the public equity markets** should not be viewed as a meaningful indicator of economic health. We view employment trends and quarterly revenue trends of the S&P 500 index as the two most meaningful trends
- **Will the U.S. consumer be better off financially by January 1, 2010?**
  - ✓ No, in general the U.S. consumer will be worse off. As a certain portion of consumers will be dealing with hundreds of billions of dollars of prime mortgages due to reset in 2010 and another portion will be further down the road of foreclosure, relocation, job search frustration and related travails
  - ✓ The recent general trend of consumers spending more than they save, coupled with decreased housing values and investment returns, has caused significant cash flow gaps for the consumer as well as a need for consumers to rebuild their equity base. The U.S. consumer is facing a situation wherein the lack of meaningful liquidity portends an increase in the number of future foreclosures and bankruptcies as consumers run out of cash sources to meet debt obligations and necessary living expenses
- **The U.S. government must pass a second ‘stimulus’ package which should include a broad mix of incentives and assistance**
  - ✓ Significant tax relief for all U.S. individual taxpayers in order to help create liquidity
  - ✓ Government spending on needed federal, state and local infrastructure projects
  - ✓ Corporate tax cuts for (1) enterprises employing environmentally friendly business practices, and (2) small businesses which increase employment levels
  - ✓ Increased, and some instances extended, unemployment benefits and food programs for the hardest hit states and municipalities
  - ✓ Extending Medicare program to assist the long-term unemployed. We do not believe a complete overhaul of the U.S. health care system that satisfies all needs is attainable on the first attempt due to the varying interests of all the parties at the table

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The Hickory Group, LLC | 300 Park Avenue, 17<sup>th</sup> Floor | NY, NY | 10022