INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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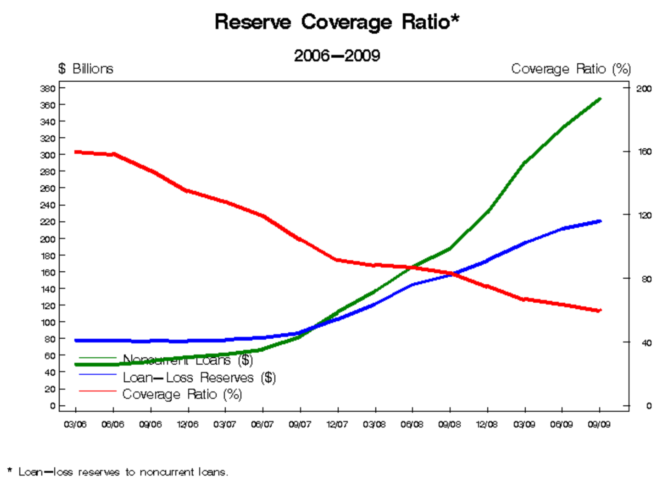
Not Out of the Woods

I've shared this first graph before, and noncurrent loans (green line) and bank loan-loss reserves (blue line) keep diverging. The steeper slope of non-current loan growth suggests that's not about to change. Not reserving for losses now can cause them to hit the financial statements in bunches down the road; this only shifts banks' stated credit outlook from bad to a delusional version of better.

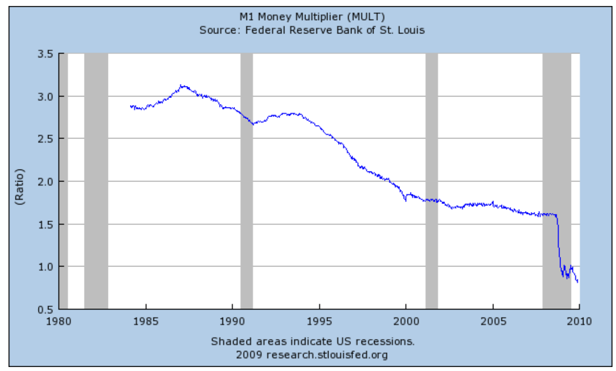


Source: FDIC 3Q09 Quarterly Banking Profile

Some other points from the most recent FDIC Quarterly Banking Profile concern us:

- Year-over-year **charge-offs (recognition of loan amounts as uncollectible) rose most among commercial and industrial borrowers (+117%)**, those who do the hiring (or lately, *don't* do the hiring);
- Credit card and home equity line charge-offs both rose 78% – **comeuppance for two drivers of the consumer spending spree mid-decade**;
- Banks' average regulatory capital ratios improved to their best level in 19 years… yet 75% of the increase in total equity capital derived from Accumulated Other Comprehensive Income – mostly due to appreciation in securities' market value, an **improvement of unreliable durability**;
- Total loan and lease balances posted their largest percentage decline on record; **relentlessly shrinking credit has never been recovery's companion**.

Now let's introduce a graph showing change in the M1 Money Multiplier, which shows the ratio of physical currency and demand deposits to adjusted monetary base:



Source: Federal Reserve Bank of St. Louis

At first glance, the current multiplier of 0.81 seems sure to delight the most dismal deflationist: for every new dollar added by the Federal Reserve, only 81 cents hits the basic money supply. But make no mistake: M1 still has spiked higher, even if it hasn't kept up with the ballooning monetary base – this graph shows their relative relationship, not the absolute growth in either series.

This worries us not so much because of what it says about inflation vs. deflation, but because of what it says about the relevance of conventional Fed measures going forward. We seem to have reached a critical threshold where the extremity of prior Fed actions dampens the impact of future Fed actions.

Say what you want about the wisdom of bank bailouts in particular or central bank intervention in general – no matter your perspective, the notion that Bernanke now has to conjure $1.23 to get a dollar's worth of bounce should be troubling given the ongoing erosion in credit illustrated in the 3rd quarter bank numbers. To ramp up money supply yet further, the fractional multiplier will require an increasingly disproportionate swelling of the monetary base.

The law of diminishing returns as applied to central bank efforts may spell not just diminished returns on financial portfolios broadly, but severely diminished capital for the riskiest.