

DON'T HOLD YOUR BREATH FOR RECOVERY

WEB BUZZ 2008.12.01

All interest rates along the yield curve (from 30 days to 30 years) are very important to the financial industry. For example, one of the primary ways banks make money is borrowing short and lending long. As the old banker's saying goes, "Borrow at 2, lend at 6, and be on the links at 4."

Such is not the case with the real economy—Main Street. The most important interest rate for them is the long rate, which includes their borrowing rate (6% and above) and market rates (notes and bonds). The reason the Federal Reserve toys with the short rate is to influence the long rate.

In economic periods such as this—recession or possibly worse—the spread between short and long rates tends to widen due to fear of default and because of the internal needs of the banks. Also, the spread between government and other notes and bonds widens. This is exactly what has been taking place over the last six months or so. Long-term ex-government bond rates have become historically high. The Federal Reserve, then, is faced with a real problem: how are they to get the long rate down? To help Main Street, they must get those rates down or a recovery becomes almost impossible to achieve. When fear grips the marketplace, it is nearly impossible to engineer lower rates by normal means. One thing they can do, however, is buy long-term government notes and bonds in their own portfolio. Also, they can buy other near-government debt, such as Fannie Mae and Freddie Mac mortgage backed securities, to accomplish the same thing. It would appear that the latter is taking place as this is being written. We believe the last time this occurred was in the early '60s, when the Federal Reserve sold short-term government notes and bought long-term government bonds—a procedure they called Operation Twist.

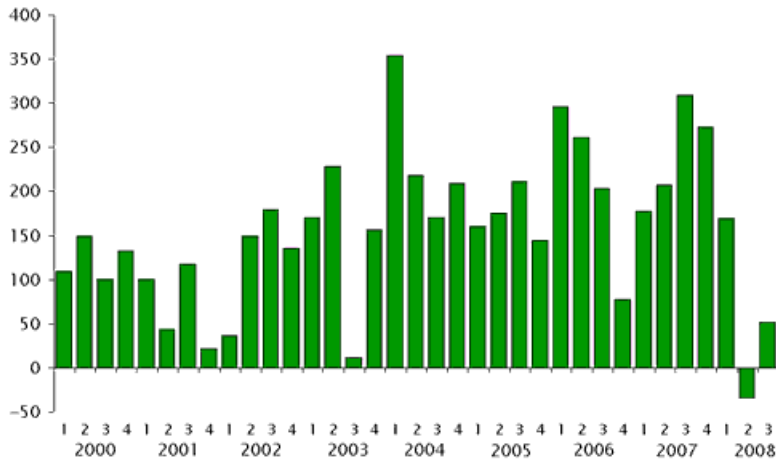
Please note the first chart, which depicts the addition to assets held by FDIC-insured banks for the various quarters of the 2000s. As one can see, the last several quarters have seen little—if any—growth in interest-bearing assets. They are frozen in their

tracks and hoarding cash. Why? Look at the second chart, which reflects the amount of loan charge-offs.

Economic recovery will not start until these two charts reverse their trends.

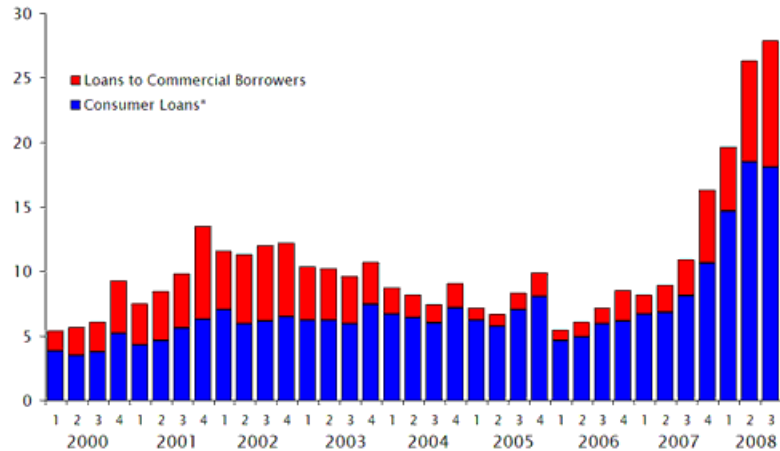
Earning Asset Growth Has Slowed Substantially

Quarterly Change in Interest-Bearing Assets
(\$ Billions)



Consumer Loans Account for Two-Thirds of Quarterly Charge-Offs

Quarterly Net Charge-Offs
(\$ Billions)



* Consumer loans include residential mortgage loans, home equity loans, credit card loans, and other loans to individuals.

Charts adapted from Mish's Global Economic Commentary