

October 2, 2008

BANKING 101



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Although we believe that the bailout bill is an important temporary patch for the psychological damage that the financial markets have suffered in the past year, we are certain that it will not change the downward trajectory of the US and global economy. Economies are just starting on the downward slope, where projects that are coming on line do not live up to their billing, and become significant loss makers. Not only will these fail to pay back their loans, but their failure will mean that other projects will be cancelled. As bank managers are already aware that there are further losses ahead, the government's \$700 billion will be used to cushion the losses of capital expected in the next quarter or two, not for making new loans. Banks will only start making loans when the prospect of getting repaid is very bright, and that is a function of inflation (in property values and selling prices) and optimism. We are nowhere near that point in the economic cycle.

Not only do banks need capital to support their loans, which the bailout will add, but they also need the liquidity to make them. In the old days, that liquidity was supplied by deposits, both demand deposits and savings but the global banking system has grown far beyond its deposit base. Deposit gathering has been outsourced. Now the critical liquidity is found by buying it on a daily basis from the ether floating around the financial system. Buying liquidity on a daily basis is a scary process, as it depends entirely upon trust, something that is very hard to find these days. Old-fashioned banks like the Merchants Bank of Burlington Vermont have all of their loans supported by deposits. In fact, they loan out only 83% of their deposits and the rest they invest in government securities. All banks were like this and they were pretty hard to upset – even if

15% of the deposits were to flee from Merchants, it would just sell some government paper and continue on like a dreadnought. As depositors almost never withdraw their money, Merchants is safe, but Citibank doesn't have enough depositors. It has loans that are about 160% of its deposits, and is not safe like Merchants. To support its assets Citibank must buy money every day and recently that has been very difficult – and expensive too. When loan books turn risky, or when derivative books can't be valued, it becomes harder and harder to fund a large book of assets on a daily basis. The government's bailout will help fund what is there now, but only banks like Merchants can take the risk, using that money to make new loans.

Today's global banks are in a parallel position to those in the gold era 100 years ago that had taken in more deposits than they could redeem in gold. When depositors demanded gold, they had to give it to them, call their loans, and cause a sharp economic contraction. Today, banks without a deposit base must refuse to roll over loans that they no longer can fund. As credit outstanding drops, the economy slows and goes into a recession. As of the latest figures in August, commercial bank credit in the US was barely up at a 0.8% annual rate over the most recent three months, and we are sure that more recent numbers will show it declining. The global banks must continue to shrink to cut their risk. Banks that are vertically integrated with strong deposit bases will be the survivors, and those like the investment banks with no deposit bases at all will soon be extinct. Merging Citibank and Wachovia to gain deposits is a fine idea, unfortunately they both have more loans than deposits, and so their loans must be cut. We have a long way to go and a recession is in our future. ✖

CYCLICAL PERSPECTIVE

The one area in which the United States has a clear competitive advantage has been in global banking, and that advantage is a function both of the large number of sophisticated competitors in the field and of the fact that its currency, the dollar, is the primary vehicle in which this business is carried out. Because such a high percentage of global business transactions and financial flows are dominated in dollars, the health of the US banking and near-banking industry is deeply intertwined in the value of the dollar. When banks cut back on the volume of loans on their books, there is a shrinking of the total amount of global liquidity and when those loans must be repaid, the borrowers must pay those loans back in dollars. Stating this very generally, the dollar is a counter-cyclical currency, when the global economy is growing and bank balance sheets are expanding rapidly, the dollar usually drops as many of those dollar loans are turned into other currencies. If the world economy

were to shrink, bank balance sheets would too, and local currencies would be sold to pay back dollar loans.

Central banks and everyone else are happier when economies are growing and the world usually reaches that goal, which means that the dollar is weak most of the time. However, this is one of those few times when the world economy will be weak and the dollar will be persistently strong. The last time the dollar was very strong was between 1980 and 1984, but much of this economic weakness was a function of Paul Volcker's war on inflation. This time it is because of a collapse in the level of bank capital, which is causing the banks to drastically curtail their lending. On the chart we see that over 65% of US banks are scaling back small business loans. The dollar should continue the powerful rally of the past two months into December and probably next year. 

