Industry Intelligence Report

A Mid-Year Review of the Banking Sector

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Synopsis

Last year marked an important shift for credit markets in the United States. After having been moribund since the Great Recession began, overall private sector borrowing finally began to grow again, with both households and non-financial businesses increasing their debt loads. In addition, the Federal Reserve finally began to reduce their stimulative efforts by tapering off quantitative easing through the end of the year.

Within that context, this report begins with a retrospective of what happened last year, which includes an analysis of where new credit is coming from and where it is flowing. Historical data will be examined to understand whether the financial sector is starting to leverage-up again, and whether there are worrisome trends with which there is cause for concern. After presenting the historical analysis, the report will conclude with a discussion of the general trends occurring in 2014. The primary focus of the forward-looking section will be on where interest rates are heading over the short-run and what role inflation plays in those dynamics, including when the Federal Reserve will start to raise the fund rate.

Overview of Lending and Borrowing Environment in 2013

Economic Trends

Looking back, 2013 ended on a strong note from an economic perspective. The U.S. faced a variety of challenges last year—largely emanating out of Washington D.C.—including the "fiscal cliff" and sequestration to the government shutdown and debt ceiling stand-offs. Nonetheless, despite those headwinds, the economy improved at a decent pace in 2013 and saw acceleration during the second half of the year:

Real Domestic Product: After a lackluster 1.1% growth during the first quarter of 2013, growth hit 4.1% and 2.6% respectively in the third and fourth quarters of the year. Perhaps more importantly, netting out volatile inventories and federal defense spending, growth averaged 2.3% during the last 9 months of 2013. This is also true of the modest contraction in real GDP posted in the first quarter of 2014, when consumers and businesses also continued to expand and were offset by inventories and trade.

Consumers Move Past Tax Hit: Despite the year-end income tax increase pinching consumers' wallets and decreasing their disposable income, U.S. consumers still "shopped till they dropped" to end 2013. Whereas early in 2013 the total U.S. retail sales hovered between $416 and $424 billion, the year finished at a high point with the total U.S. retail sales in December 2013 reaching $428 billion. And though retail sales stabilized in April and May of 2014, they remained 4.3% higher in May 2014 than they had been a year before ($438 billion).

Fueling much of May's retail sales growth was auto sales. Consumers sprinted to the auto dealers and unleashed their pent-up demand for these durable goods after the abnormal polar vortexes passed and the summer season kicked off. Auto and auto parts sales rose by 10.4% from May 2013 to May 2014, to $88.8 billion, accounting for 47% of the growth in total retail sales. Also helping drive retail sales growth was non-store retailers (i.e. electronic shopping and mail-in houses). Non-store Retail Sales rose to $39.5 billion – a 7.4% increase from May 2013, accounting for 15% of growth in total retail sales. Non-store Retail Sales will continue to grow and become an increasingly significant portion of total retail sales because online shopping is gaining immense popularity.

While some individuals are disappointed that May 2014 retail sales missed expectations, Beacon Economics "sees the cup half full". In total, U.S. retail sales have grown 3.3% since the beginning of 2014, suggesting that consumers are continuing to spend despite the 2013 income tax increase and irregular weather in 2014.

Business Earnings Reach Record Highs: The private sector is back and better than ever. Annual corporate profits have been trending upward ($1.9 billion in 2011 and $2.0 billion in 2012) and have reached new record highs in 2013 at $2.1 billion, according to the Bureau of Economic Analysis. Unfortunately, the abnormal snowstorms and polar vortexes that plagued most of the nation in the beginning of 2014 damaged Q1 GDP and corporate profits. From 2013 Q4 to 2014 Q1, corporate profits declined by a seasonally adjusted annual rate of 9.8%; year-over-year, corporate profits declined 3.0%. But weather delays business, it does not cancel it – watch for corporate profits to rise from its ashes and soar later this year.

Global Economy Gaining Traction: Life is never dull on the global stage. In 2013, Europe marked the end of its recession and the beginning of its recovery. Last year China experienced an economic slowdown: the country's growth rate reportedly slowed from double digits to high single digits. Meanwhile, Japan's economy began to rebound with a growth rate of 1.7% thanks to "Abenomics". Overall, 2013 was an encouraging year for the global economy: global growth of 3% would have been better were it not for weak economic growth in most emerging markets (EMs), developing markets and developed markets.

So far, 2014 has been just as eventful, but slightly rosier. Macro events like EMs' volatile currency fluctuations and the Russian/Ukrainian conflict continue. The International Monetary Fund just revised its global growth projections: global growth will be 3.7% for 2014 and 3.9% in 2015. Yes, the IMF revised its predications downward, but the trend is still upward. Helping global growth reach 3.7% in 2014 and 3.9% in 2015, Europe is hoping to recover and grow. As the U.S. winds down its stimulus, the European Central Bank (ECB) is cranking up its stimulus in 2014. As this report was being written, ECB's president Mario Draghi took unconventional actions by lowering the ECB benchmark interest rate to 0.15%, lowering the deposit rate for banks to -0.1%, and offering commercial banks long term loans at cheap rates until 2018. In sum, the global economy is slowly and steadily recovering and gaining traction.

Production and Capacity Improve: Industrial production (IP) throughout the U.S. continued to grow in 2013, as the Federal Reserve's IP index reached an all-time high at the end of 2013. In 2014, production growth continued to reach new levels, registering a 103.3 mark in March 2014 and a 102.7 mark in April 2014, whereas a value of 100 represents IP in 2007. Year over year, the IP grew 3.5%. Meanwhile, capacity utilization expanded to 78.6% utilization in April 2014 – indicating that businesses will soon need further investment in order to expand.

State and Local Governments Starting to Rebound: While the federal government continues to contract, state and local governments have started to rebound. Their contribution to GDP in 2013 was -0.02 percentage points (of the 1.9% growth), though an improvement from 2012 when they had contributed -0.08 percentage points (of the 2.8% growth). Employment levels have progressed as well. Jobs at state and local governments throughout the U.S. grew by 0.5% from May 2013 to May 2014, providing 98,000 new jobs. These trends are even more pronounced in California, where state and local government employment grew by 0.9% from April 2013 to April 2014, providing 20,100 new jobs. More than anything, the mere fact that state and local governments are not shedding jobs is an improvement from recent years.

California is a Driver of Growth: Despite a series of federal headwinds emanating from Washington D.C. during 2013, the California economy continued to move forward —though the rate of growth was impacted by these developments.

The state's economy grew by 2.0% in 2013, compared to the 1.8% growth throughout the nation. Employment growth through the first four months of the year indicate that the state's economy will grow even further, especially when compared to the national GDP, which contracted in the first quarter of 2014 due to the strong winter climate that hardly affected the golden state. From April 2013 to April 2014, nonfarm jobs are up 2.3%.

Unfortunately, the news isn't all good. The United States remains far from a full recovery —the economy has yet to catch up to its long-run trend line. From a cyclical standpoint, the stimulus (both fiscal and monetary) that was put in place during the recession to avoid a sharper contraction in the economy will continue to be unwound as broader conditions improve. Construction, although improving, remains well below "normal" levels of our economy, which has put more emphasis on consumers to bolster economic growth as their share of the economy has risen. Over the longer-term, many of the issues affecting the public sector at the national, state, and local levels have yet to be addressed, including plans for the future of Medicare, Social Security, Medicaid, CalPERS and CalSTRS to name a few of the well-known challenges. Inequality is also on the rise, and this trend is what Nobel laureate Joseph Stiglitz called the cause and consequence of our failed political system and a destabilizing force for the economy.

Still, despite these long-term challenges, the economy remains poised for ongoing growth over the short-run. In fact, Beacon Economics expects 2014 to be better than 2013 after it moves past the largely weather-related issues that plagued the first quarter and 2015 is expected to be better still.

Demand for Credit

As the economy has continued to gain momentum, the demand for credit has increased. After growing at roughly 5.5% in 2012, growth in lending averaged 7.8% at California-based banks last year. Lending at all U.S. banks also increased in 2013 by roughly 4.1% —a slight deceleration from the 5.1% average growth posted nationwide in 2012. Growth in California was particularly pronounced during the second half of 2013, where lending growth averaged 10.5%, while growth slowed at banks in the remainder of the United States. This is likely reflective of the severe weather that impacts many parts of the nation last year and during early 2014, while California was relatively unaffected. Importantly, 2013 marked a watershed year in which the volume of loans moved past their pre-recession peaks at both banks headquartered in California as well as at banks throughout the United States. With almost $340 billion in net loans and leases, outstanding bank credit at California-based banks reached an all-time high in the fourth quarter of 2013.

With the exception of credit cards and other revolving credit plans, lending grew across the board at California-based banks in 2013. Loan volumes for multi-family mortgages did decline by roughly 4.2% nationwide at the end of 2013, despite continuing to rise in California. Still, every other major category of lending grew at FDIC-insured commercial banks last year. Amongst California-based banks, mortgage lending for single- and multi-family real estate loans saw the sharpest increases last year, reflecting in large part the strength and improvement of the state's real estate markets. The solid uptick in home prices in particular has helped to motivate new buyers into the market for both homes and condos. For example, multi-family lending increased by 17.8% at California-based banks last year after a solid year of growth in California condo sales of over 3% (at much higher prices).

Loans and Leases Outstanding by Type - California vs U.S. ($ 000s)

Loan Type	2012	2013	Change (%)	U.S. 2013	U.S. Change (%)
Number of Institutions Reporting	222	206	-7.2	5,876	-3.6
Net Loans and Leases	30,247,107	338,386,637	12.0	7,119,507,731	3.2
Construction and Land Development	6,734,325	7,398,274	9.9	195,476,033	3.5
Commercial Real Estate	78,878,544	86,727,237	10.0	1,013,757,594	3.7
Multifamily Residential Real Estate	16,806,526	19,797,845	17.8	203,769,500	13.6
1-4 Family Residential	101,157,422	113,278,717	12.0	2,046,194,816	-4.2
Farm Loans	5,319,189	5,743,638	8.0	68,122,989	5.5
Commercial and Industrial Loans	63,425,959	68,777,650	8.4	1,538,847,593	6.0
Loans to Individuals	16,034,418	16,894,565	5.4	1,249,044,874	1.2
Credit Cards	293,838	252,001	-14.2	621,626,940	-2.0
Other Revolving Credit Plans	615,863	582,365	-5.4	57,452,376	-4.1
Automobile Loans	4,585,121	5,116,877	11.6	331,916,153	10.2

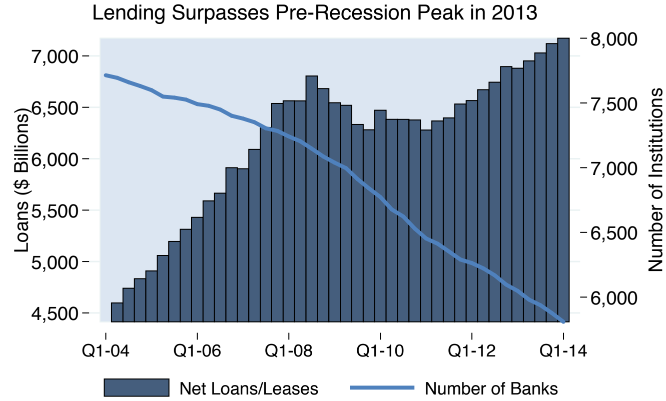
Source: Federal Deposit Insurance Corporation (FDIC)

Single-family mortgage lending in California also increased by nearly 12% last year —less growth than on the multi-family side of the market, but a robust increase nonetheless. Interestingly, the fact that single-family lending did not see the same uptick in lending as multi-family mortgages is reflective of the fact that single-family homes actually saw fewer sales in 2013 than in 2012. However, with defaults and foreclosures down significantly, many of the 340,000 sales of existing single-family homes in 2013 were comprised of owner-occupants who tend to utilize mortgages. In comparison, in 2011 and 2012, there were many more investors or cash-only buyers who relied to a smaller extent on mortgage financing. Fortunately, the improvement in the residential real estate markets has already precipitated a surge in new construction activity. And, while construction currently covers a smaller share of our GDP compared to "normal" economic conditions, there has been a significant number of new single- and multi-family building permits issued in both California and the remainder of the U.S. Construction and land development loans have seen a corresponding increase.

However, the improvement in lending was not limited to the real estate market, but was as broad-based as the economic recovery itself. For example, auto loans at both California-based banks as well as at all U.S. FDIC-insured commercial banks increased by double-digit percentages last year. This provides a solid boost to the economy overall by generating demand and supporting jobs in the retail sector and by stimulating state and local governments with much-needed revenues via sales tax receipts. However, these sales also serve as an important bellwether for future economic activity in that car sales represent long-term,

Net Lending and Number of Banks, 2004 to 2014

Lending Surpasses Pre-Recession Peak in 2013



Source: FDIC

durable goods purchases that tend to be postponed or foregone entirely during times of economic uncertainty. That consumers are increasingly willing to make these long-term investments points to a confidence amongst California and U.S. households that economic conditions will continue to improve as well.

As noted, businesses are also seeing a robust recovery. Not only have the equity markets bounced back above their pre-recession highs, but corporate profits also set new records in 2013. Earnings were very solid as we entered 2013, but perhaps more importantly, capacity utilization was also on the rise. As firms consume greater proportions of their available productive capacity, future investments in capital are required in order to meet rising demand. This has already affected the demand for commercial and industrial (C&I) loans in both California and the United States as a whole. Indeed, C&I loans at both California-based banks and at banks across the nation improved by 8.4% and 6.0% respectively last year. The uptick in employment is also stimulating the demand for additional commercial space. Indeed, commercial real estate lending expanded by 10% at California-based banks and by 3.7% nationwide.

Balance Sheet Fundamentals and Banker's Outlook

In addition to rising loan volumes, the fundamentals of banks' balance sheets are also much improved over the past year. For example, the percentage of loans that were 30 or more days delinquent or in non-accrual status declined from roughly 2.74% at California-based banks at the end of 2012 to just 2.05% by the end of 2013. Similarly, net charge-offs were virtually non-existent last year with roughly 0.03% of total lending charged-off at California-based banks and a similarly small 0.15% at the national level. Thus, not only have loan volumes improved alongside the state and national economies, but banks were much healthier in 2013 than at any point since the Great Recession.

By asset-size, banks with over $100 billion in assets demonstrated the biggest improvement in the quality of their balance sheet in 2013. At the end of 2013, 2.39% of outstanding loans at banks in this asset-size were past due, compared to 3.41% at the end of 2012. As many of these banks took over failed banks that were plagued by high levels of faulty loans, the past due share topped 4% in mid-2010, while banks with less than $100 million in assets peaked at just above 2% and the past due share at the remaining banks was under 2%.

Finally, optimism and the outlook is improving amongst bankers themselves. The most recent Senior Loan Officer Survey (SLOOS) in April 2014 reveals that "banks eased lending policies for commercial and industry (C&I) and commercial real (CRE) loans and experienced stronger demand for both types of loans over the past three months." From the previous quarter, 11% of banks eased standards on net for C&I loans to large and middle-market firms and 7% of banks eased standards on net for C&I loans to small firms. These easier standards were similar last year, when 19% and 23% of banks eased standards on net to large and middle-market firms and to small firms. Lending standards for auto loans, credit card loans, home equity lines of credit, and commercial real estate loans were treated similarly.

Yet the SLOOS reveals that not all loan types are experiencing easier standards. The recent implementation of Dodd-Frank related rules that affect mortgage lending are creating much tighter standards for risk-prone residential real estate loans. In the April 2014 survey, 43% of banks reported tightening standards on net for subprime mortgages, whereas 17% of banks had reported tightening standard on net in April 2013. Simultaneously, 24% of banks reported tightening standards on net for non-traditional mortgage loans. The uncertainties created by the new policies even affected the prime-mortgage market, where 1.4% of banks surveyed reported tightening standards on net for prime mortgage loans, compared to 7.8% of banks reporting eased standards just a year before.

Senior Loan Officer Survey (Net Percentage of Domestic Banks Reporting Stronger Demand For)

Series Description	2013Q2	2014Q2
C & I Loans from Large and Middle-Market Firms	5.9	13.9
C & I Loans from Small Firms	7.7	8.5
Auto Loans	18.3	10.9
Credit Card Loans	12.0	9.8
HELOCs	-13.8	-7.1
Consumer Loans Excluding Credit Card and Auto Loans	3.1	0.0
Non-Traditional Mortgage Loans	0.0	-16.2
Prime Mortgage Loans	39.1	-25.7
Subprime Mortgage Loans	16.7	-14.3
Comm. RE Loans with Construction and Land Development Purposes	N/A	45.7
Comm. RE Loans Secured by Multifamily Res. Structures	N/A	25.0
Comm. RE Loans Secured by Nonfarm Nonres. Structures	N/A	25.0

Source: Federal Reserve Board of Governors

Senior Loan Officer Survey (Net Percentage of Domestic Banks Tightening Standards For)

Series Description	2013Q2	2014Q2
C & I Loans from Large and Middle-Market Firms	-19.1	-11.1
C & I Loans from Small Firms	-23.1	-7.0
Auto Loans	-10.3	-7.8
Credit Card Loans	-7.4	-9.3
HELOCs	-3.1	-1.4
Consumer Loans Excluding Credit Card and Auto Loans	-3.2	0.0
Non-Traditional Mortgage Loans	0.0	24.3
Prime Mortgage Loans	-7.8	1.4
Subprime Mortgage Loans	16.7	42.9
Comm. RE Loans with Construction and Land Development Purposes		-4.2
Comm. RE Loans Secured by Multifamily Res. Structures		-5.6
Comm. RE Loans Secured by Nonfarm Nonres. Structures		-8.2

Source: Federal Reserve Board of Governors

Senior Loan Officer Survey

Net Percentage of Domestic Banks Increasing Spreads of Loan Rates Over Banks' Cost of Funds

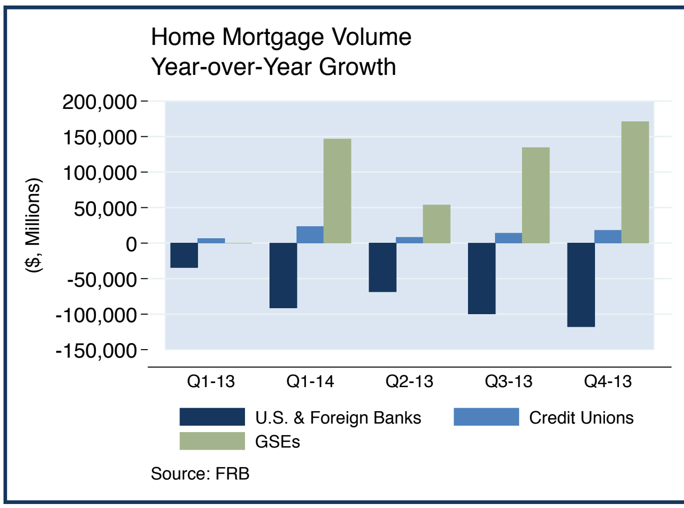
Series Description	2013Q2	2014Q2
To Large and Middle-Market Firms	-63.2	-59.7
To Small Firms	-57.8	-52.1
On Auto Loans	-20.7	-21.9
On Credit Card Loans	-4.2	2.0
On Other Consumer Loans Excluding Credit and Auto Loans	-11.1	-8.6

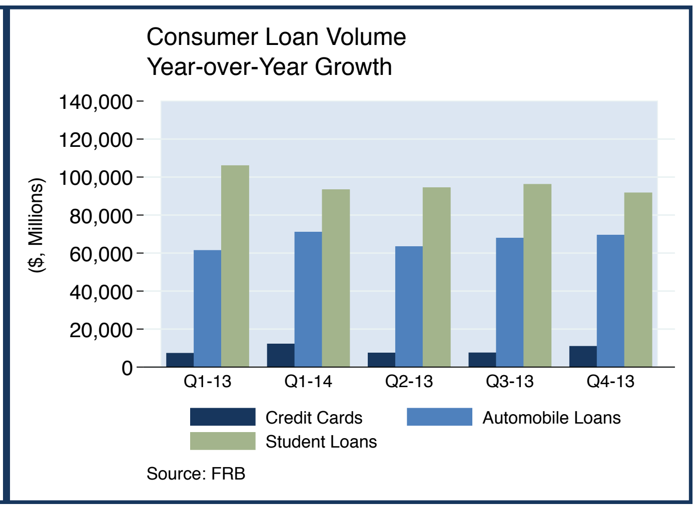
Source: Federal Reserve Board of Governors

Banks in Perspective: Role in the Broader Debt Markets

While banks increased their loan portfolios last year, households took on more debt from both banks and other sources. In 2013, households increased their total outstanding liabilities by 1.0% from 2012 to 2013. Today, mortgage debt obligations and consumer credit make up the bulk of these liabilities for households: 68.2% and 22.5%, respectively. Despite the uptick in outstanding credit and notwithstanding the resurgence in home prices, household mortgage debt obligations fell by 1.0%, following the declines seen over the last five years. Despite this, households are still borrowing more, with individual loans forming a significant portion of the credit expansion. Indeed, credit card and automobile obligations increased by 1.3% and 8.6% respectively in 2013, which helped offset the declines in mortgage lending. Student loans are also contributing to the uptick in the debt load for households, with federally held student loan liabilities increasing by 8.1% from 2012 to 2013 for households.

The holders of most household mortgage debt nationwide are government sponsored enterprises (GSEs) like Fannie Mae and Freddie Mac, which hold 60.6% of household mortgage debt. These institutions have increased their mortgage assets by 2.9% over the last year. Similarly, credit unions saw their mortgage assets increase by 5.5% over the last year. In contrast to the increased lending from GSEs and credit unions, banks have seen their mortgage assets decline over the last year, falling by 4.6% from 2012 to 2013. However, banks were not alone in falling mortgage assets as asset-backed security (ABS) issuers, finance companies, and REITs have also decreased over the year, shrinking their mortgage assets by a combined 14.6% from 2012 to 2013.





While, mortgage liabilities for households fell over the last year, households did take on more debt in the credit card and auto loan market. The primary holders of household credit card and automobile debt are banks, which hold 53.4% of household credit card and automobile debt. Both banks (+4.3%) and credit unions (+9.0%) have increased their credit card and automobile debt assets over the last year, though lending at credit unions outpaced the uptick in lending at banks. Asset-backed security issuers and finance companies (30.7%) and Credit Unions (11.6%) also hold a significant portion of this household debt. However, unlike banks and credit unions, ABS issuers and finance companies have seen their credit card and auto loan assets decline by 0.9% over the last year. Banks therefore played an important role last year in the personal lending space, driving growth in both credit card and auto lending that helped to drive consumption and auto sales higher. In turn, these forces contributed to solid contributions to overall economic growth from consumers in 2013. Thus, while banks play a smaller role in the mortgage markets than GSEs, they are a major part of the individual loans that helped to bolster the economic recovery over the past 12-18 months.

The stronger uptick in lending by credit unions can be attributed to a variety of reasons, including the advantage that credit unions receive by not paying taxes or having any Community Reinvestment Act requirements. There has been record growth in membership at credit unions over the past few years, as credit union membership requirements are very low. Furthermore, the largest credit unions typically have even lower limits on membership, and at least two of the larger credit unions are offering mortgages without requiring any down payment or mortgage insurance.[1] The uptick in membership at credit unions and the more aggressive venture into the mortgage market for credit unions have both led to the increase in mortgage lending for credit unions.

However, these gains in lending by credit unions have been met with some headwinds, particularly as a result of new regulations affecting qualifying mortgages. These headwinds can be seen more easily in how they are negatively affecting lending in the mortgage market as a whole in 2013. For example, a 2012 survey of community bankers and credit unions found the recent Dodd-Frank Act to be a source of collateral damage on their core operations. More specifically, the survey found that 56% of community banks and credit unions planned to devote an additional one to three full-time employees to compliance over the next three years, while some other small banks will seek out outside consultants to comply with the new rules.[2] Consequently, these compliance costs may have already caused some banks to pull back on certain products and services they offered, or hindered expansion, prior to the additional rules on qualifying mortgages implemented in early 2014.

Overall, banks played a vital role in the expansion of credit that helped to drive growth in the U.S. and California economies last year and into the first half of 2014. However, banks serve as merely one source, albeit an important one, of liquidity to the U.S. economy. Alongside their counterparts at credit unions, ABS issuers, trusts, and GSEs, banks in the U.S. have helped to bolster the demand for goods and services throughout the nation, which has generated more jobs and income as the effects of the Great Recession continue to wane.

Interest Rates, Money Supply, and Federal Reserve Policy

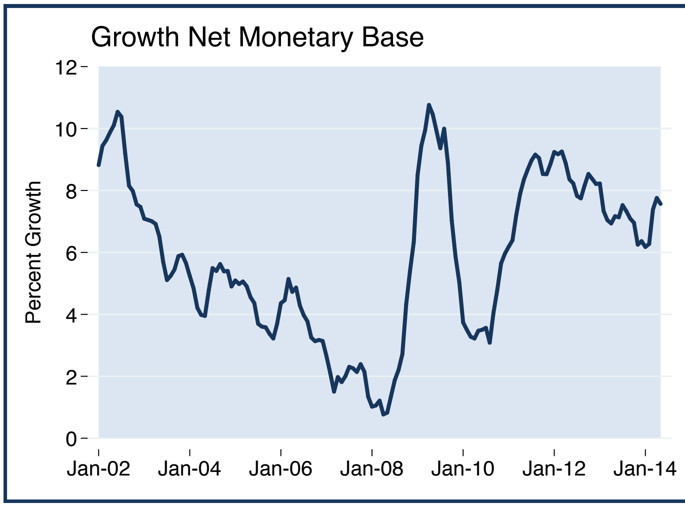
It has been said that the Federal Reserve's tools for managing the US economy is not unlike a small rudder on a large ship. It will turn the vessel, but you must have a lot of space to maneuver. Tight spaces are difficult. The Fed has been extremely aggressive in its policy actions over the last few years and Janet Yellen has been handed the reigns at a critical period of time when these past actions must be unwound without, hopefully, triggering any major economic turbulence that would spoil the nascent recovery. Fortunately for the Board of Governors, the seas are still wide open, allowing them to move slowly and deliberately to unwind past stimulative policies. As a result, Beacon Economics does not see interest rates moving up much over the next two years. Rather the Fed is on schedule to start slowly adjusting short term rates with a modest hike in the Federal Funds Rate early next year.

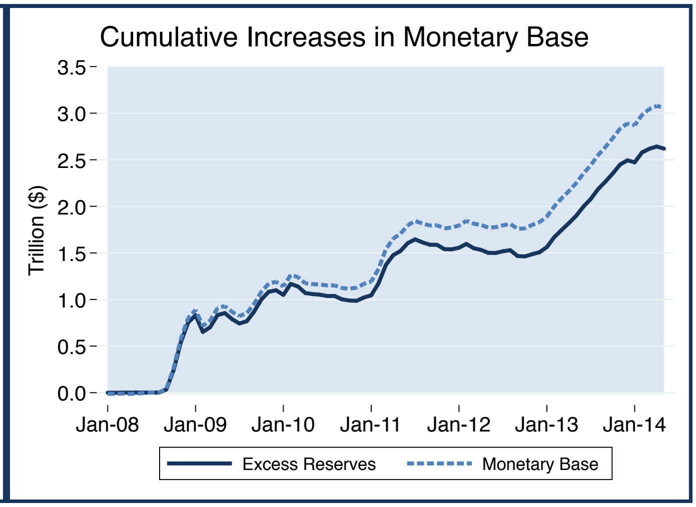
Falling long-term rates, already down to their lowest point in close to a year, are a function of the fact that supply of new debt, particularly Federal government debt, is slowing more than the demand for such credit instruments despite

[1] Please refer to the following webpages: http://www.cutimes.com/2013/03/14/two-credit-unions-offering-no-money-down-mortgages and http://www.stlouisfed.org/publications/re/articles/?id=2387

[2] http://mercatus.org/publication/regulatory-burdens-impact-dodd-frank-community-banking

the tapering off of quantitative easing bond purchasing programs. While we do not foresee any further decline in rates —rather a slow upward path that might have rates back close to 3% by the middle of next year —it is also true that predicting the short run movements of a bond market this liquid are always speculative.





The reason for our benign view stems from the fact that the vast majority of money injected into the money supply over the past few years of quantitative easing is not in the system —instead it sits in the banks in the form of excess reserves, held in turn at the Federal Reserve. Indeed, almost 86% of all cash injected into the system has been absorbed this way —not quite pushing on a string, but maybe al dente pasta. Slowing growth in the monetary base due to tapering is being matched almost lock step with a slowing in excess reserve accumulation. As such, the 'net' monetary base (monetary base minus excess reserves) is growing at 7.7% year on year —slightly higher than the fifteen year average, but not near the double-digit paces in the seventies or early eighties that presaged inflation.

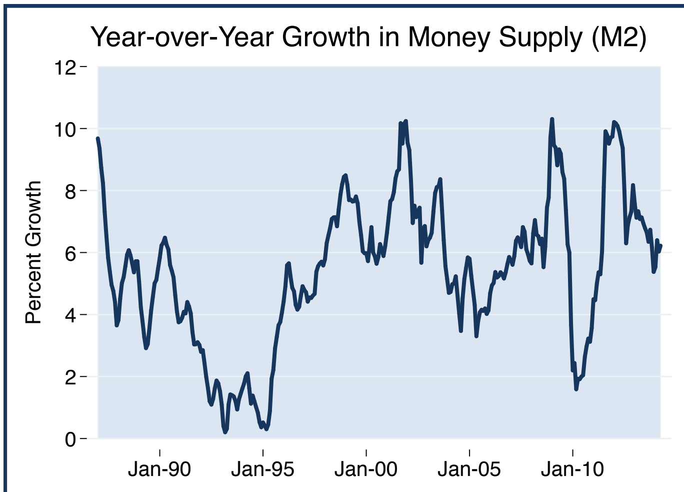
The pace of slowing suggests that quantitative easing will more or less be at a permanent end sometime at the end of the summer. It is equally believed on Wall Street that the Federal Reserve will start to increase the Federal Funds rate sometime in early 2015, and we have no reason not to believe this. But then again they have little need to worry about moving slowly, and every reason to believe that the economy still needs a stimulus push even if at a modestly slowing pace. Money supply growth (M2) is running roughly 6.0% year on year despite slightly faster net monetary base growth. Overall inflation is running a modest 1.9% overall and 1.7% core —numbers that are candidly below where the Fed would like to see them.

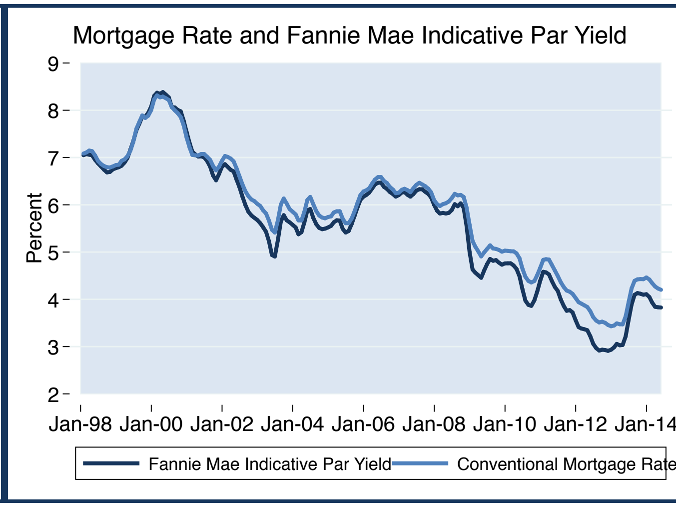
On the other side of the equation, Janet Yellen is abundantly aware of the fact that there are roughly 14 million distressed and discouraged workers in the US —still much higher than the 8 million pre-recession, but better than the 19 million worker peak seen in 2010. This number is slowly but steadily falling at a pace of roughly 1.5 million per year. That would suggest that the number will be half way back to normal levels in percentage terms by late 2015, and a good time for the Fed to start swerving back to neutral.

This benign view would most likely be upset by an increase in the pace of bank lending, pushing those excess reserves out in to the economy. However, to date the pace of bank lending has instead been quite slow nationwide despite the fact that growth at California-based banks last year was more robust. While lending from mid-sized banks has been growing solidly, the ongoing paring of credit at some larger institutions has offset it. The net result is that growth in outstanding bank loans and securities is running a moderate 4% year on year, up from the 2% earlier in the year, but still way below the long term average of 8 to 9%.

This isn't to say that credit has not been expanding in the United States. Actually, consumer credit has started to expand with increases in almost every form of debt. The rate of growth is moderate, but this is a big shift from the years of deleveraging. And businesses, particularly medium and large firms, have been availing themselves of an active and growing market for corporate bonds. Unlike Europe, which is much more bank-dependent for credit, the US has very active markets for non-bank credit. This explains why the Federal Reserve has not had to employ such aggressive tactics to promote bank lending as the ECB has recently begun pursuing.

Indeed, if there is any risk at all, it may be that some portions of the bond market are beginning to under-price risk, driven by a mini-credit bubble. Maybe, but without the leveraging up of the financial system itself as during the last credit explosion prior to the Great Recession, it is unlikely to have the potential macro-economic implications without this financial multiplier effect.





In the meantime, mortgage rates have also come down to low levels by recent year standards. This is being mirrored by a reduction in credit standards for GSE-backed loans as measured by the average FICO score for borrowers suggesting that the housing market will have another selling wave in the near future, driven this time by retail move-up buyers and new home demand. This will come with a nice boost in new-home construction that will in turn have a big impact on helping the recovery get past its current slow pace.

So look for rates to drift up slowly, while there is a flattening of the yield curve. But with asset prices in other categories already so high, it is hard to see how there could be any major sell off in the bond market that might cause rates to spike. And with the Fed slowly regaining the ability to deploy more stimulus as they may need, they have a lot of room to slowly unwind quantitative easing. One might think that the Fed will allow, at least in the short term, their balance sheets to slowly shrink as bonds pay off. After all, there is simply no reason to think about mopping up those excess reserves in today's lending environment.

About Beacon Economics

Beacon Economics is a leading provider of economic research, forecasting, industry analysis, and data services. The firm's internationally recognized forecasters were among the first and most accurate predictors of the U.S. mortgage market meltdown that began in 2007—and among a relatively small handful of researchers who correctly calculated the depth and breadth of the financial and economic crisis that followed. By delivering independent, rigorous analysis, Beacon Economics gives its clients the knowledge they need to make the right strategic decisions about investment, growth, revenue, and policy. The firm's clients span both the public and private sector, ranging from the California State Controller's Office to major universities to one of Wall Street's most successful hedge funds. Core service areas include economic and revenue forecasting, economic impact analysis, economic policy analysis, regional economic analysis, real estate market and industry analysis, and EB-5 Visa analysis. Visit Beacon Economics' website at www.BeaconEcon.com to learn more.

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