

2012 U.S. Banking Outlook

European Contagion and its Impact

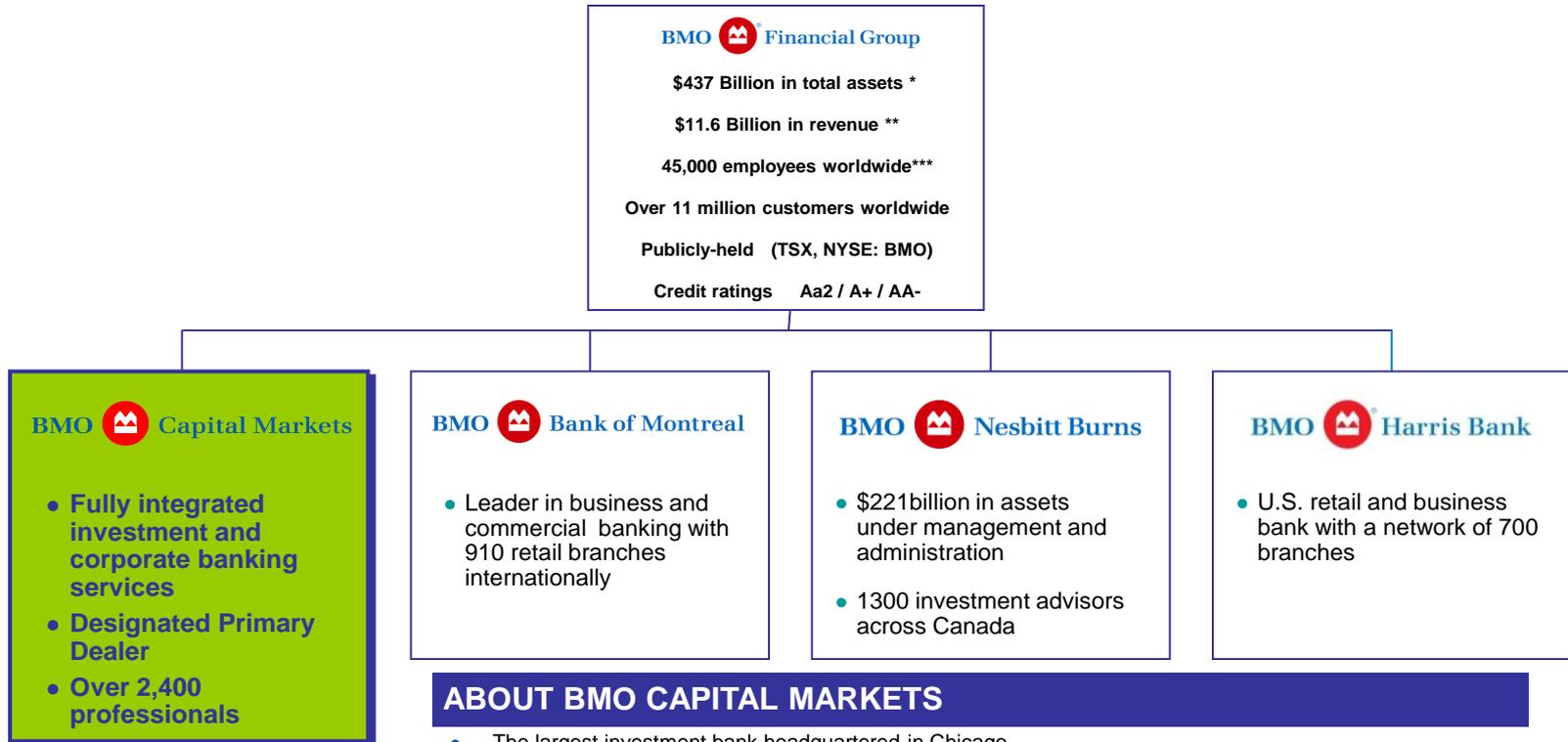
Strategies to Mitigate Risk and Stabilize Earnings

Justin H. Hoogendoorn, CFA
Managing Director of Fixed Income Strategy and Analytics
BMO Capital Markets GKST Inc.

BMO  **Capital Markets**

Your ambition achieved.

BMO Financial Group



All figures in US dollars

*As of April 30, 2011

** FY 2010

**As of July 6, 2011

Leading provider of financial services in North America

Debt Capital Markets

BMO's U.S. Debt Capital Markets practice is a premier fixed income securities resource (for issuers and investors) and a top-tier underwriter with deep involvement in both the primary and secondary markets.

Fixed Income Service Specialties

- New Issue Underwriting
- Negotiated/Competitive Municipal Securities
- FHLB and FHLMC Bullet, Callable & Step-Up Agencies
- Secondary Market Trading
- Municipal Public Finance
- Strategic Analytics
- Portfolio Accounting, Evaluation & Analysis
- Balance sheet analysis
- Insightful board reports
- In-depth securities analysis
- Asset-Liability Management
- Correspondent banking services
- Safekeeping

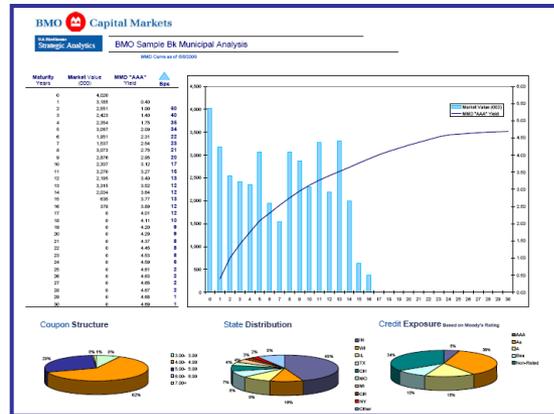
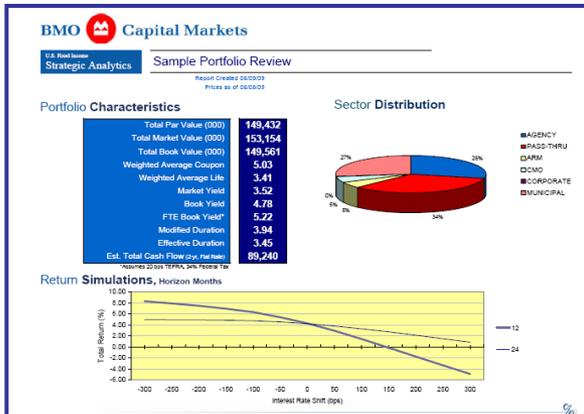


Product Specialties

- U.S. Treasury Securities
- Governmental Agency Securities
- Canadian Provincial Securities
- Certificates of Deposit
- Commercial Paper
- Municipal Securities
 - General Market Tax-Exempts
 - Taxable Municipals
 - Short-term
- Mortgage-Related Securities
- Repo
- Foreign Exchange
- Swaps/Interest Rate Derivatives

Strategic Analytics

- BMO's Strategic Analytics Group ("SAG") is a highly experienced and accomplished team of investment professionals dedicated to providing support to our buy-side customers.
- The team produces market research, relative value strategies as well as portfolio and security level analytics, which include:
 - Portfolio reviews and customized analysis
 - Fixed income market and macro research
 - Client conferences and research calls
 - Proprietary interest rate and security models
 - Trade strategies and sector analysis
- The SAG is used by a wide variety of banks to provide portfolio consulting services and in-depth portfolio analysis, trade ideas, market research, and customized cash flow analysis.



Critical Banking Research

- In-depth sector reviews
 - Rates
 - Municipals
 - Mortgages
 - Agencies
- Bank Strategies
- Relevant market ideas

Bond Market Outlook

BMO  Capital Markets

Municipal Analysis (continued)

November 2011

Justin Hoogendoorn, CFA

Municipal Credit and Revenues

However, we find three headline grabbing credit challenges in the market that provide an avoidance template for investors. Harrisburg, Pennsylvania, which filed for Chapter 9 bankruptcy protection this past month due to a failed incinerator project, causes concern. However, the headline grabbing problems of the city have clearly arisen out of a

... suffers a similar fate from a ... contracts. This non-systemic ... that looked to ultimately end in ... or goes to print. Central Falls, ... of a problematic municipality. ... of right sizing pension promises, ... stors that credit risks remain a ... tands.

... n at about 78% of 2010 levels. ... te financial health trends have ... cording to a recent Rockefeller ... t 3). U.S. Census Bureau data ... quarter data. The growth ranged ... recently found North Dakota oil ... Preliminary 3rd quarter data ... ll constitutes attractive revenue ... ear HPI declines accelerated in ... tively stable (albeit at negative ...

Bond Market Outlook

BMO  Capital Markets

Rates Analysis

November 2011

Euro-zone Mission Accomplished? Probably Not

Dimitri Delis, Ph.D

Over the past two years, US markets have rallied several times on European plans to fix the sovereign debt problem only to see that optimism slowly fizzle away. Not surprisingly, a plan announced by euro-zone policy makers last month was once more embraced quite enthusiastically causing the S&P 500 index to rally by 3.4% on the day of the announcement. The plan had three main elements which include increasing the borrowing capacity of the European Financial Stability Facility (EFSF) fund, recapitalizing Europe's banks, and applying a private "voluntary" restructuring of Greek debt. While all three initiatives may improve the tone of the US markets near term, we believe they fall short of providing the necessary debt relief as well as addressing the core issues of the crisis. First, the leveraging of the EFSF bailout fund from 440 billion to 1 trillion euros falls on the low end of expectation that has a debt of nearly 2165% to 120% by 2020 by tightening measures in place of growth. Finally, the barrier to the losses arising from the

Community Bank Strategies

U.S. Fixed Income Strategic Analytics

Now is the time to buy "Interest Rate Risk Insurance"

September, 2011

Your bank has Directors and Officers Insurance (D&O), as well as other types of business insurance. Now is the time to buy some insurance against the long-term risk that rising interest rates will cause the bank's Cost of Funds to rise significantly. Why now? How does it work? How much does it cost? What are some of the benefits?

Why now?

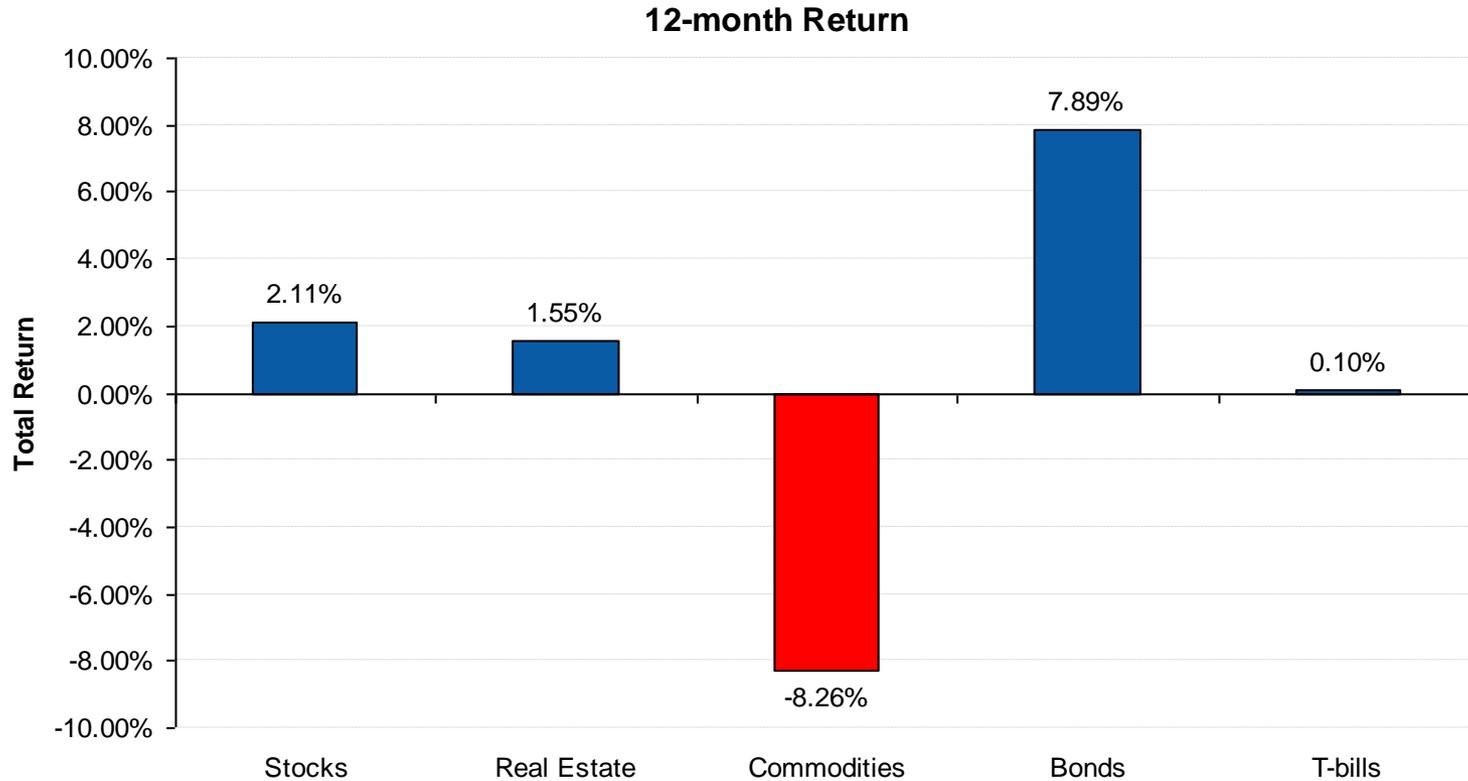
First of all, interest rates are currently at historic lows and, in the long term, have nowhere to go but up. Whether that increase is slow and modest or quick and dramatic, it could pose a problem for your Cost of Funds (COF). If you wish to buy insurance against the potential damage that rising rates could cause, it is better to buy that insurance now, while rates are still bumping along the bottom, rather than later, when rates actually do begin to rise and the cost of that insurance starts to skyrocket.



Roy Hingston

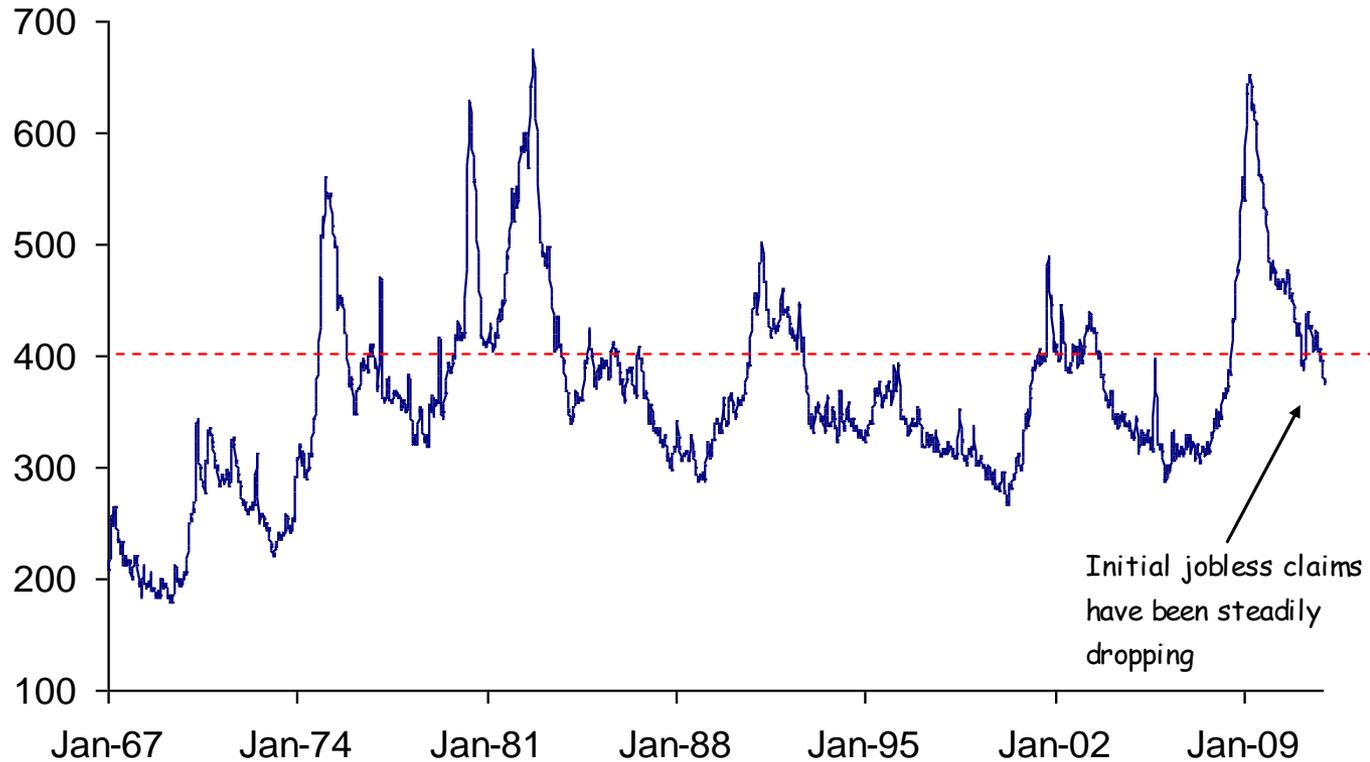
This is the fourth in a series of articles intended to address the

2011 Returns The Good News



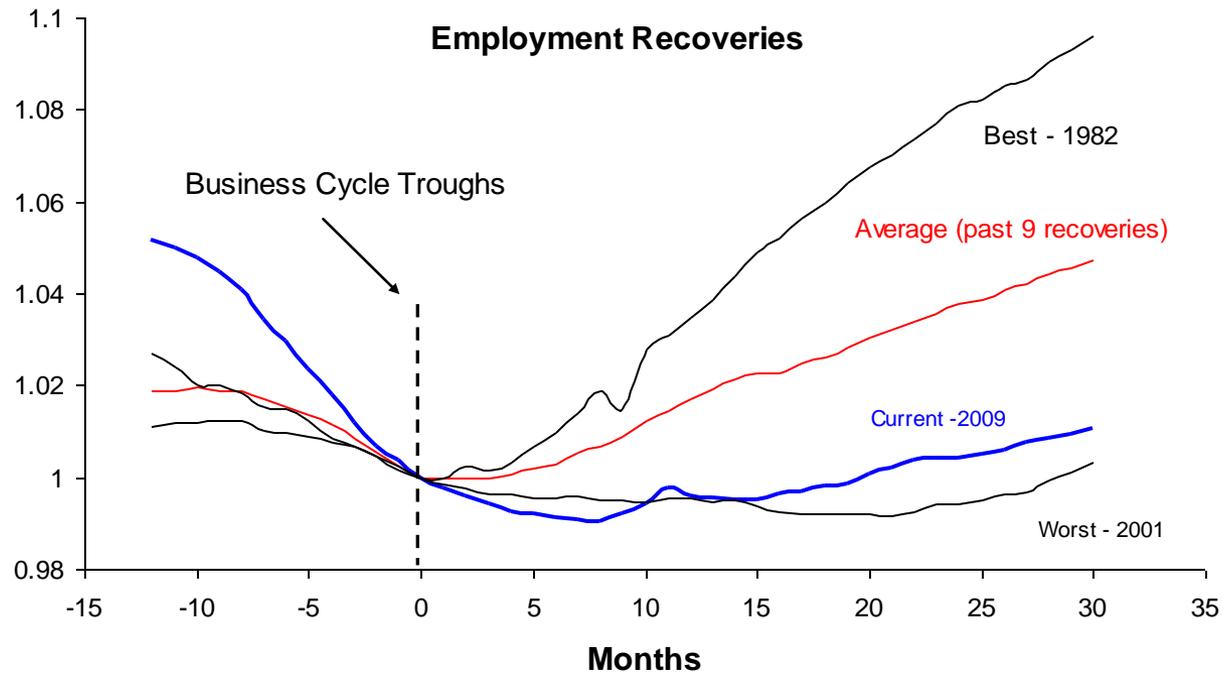
Source: Merrill Lynch, S&P, Dow Jones, Bloomberg
As of 9/30/11
*Municipals adjusted for 35% tax advantage on income

Employment conditions improving...



- 400K in initial claims is consistent with a GDP of about 2%

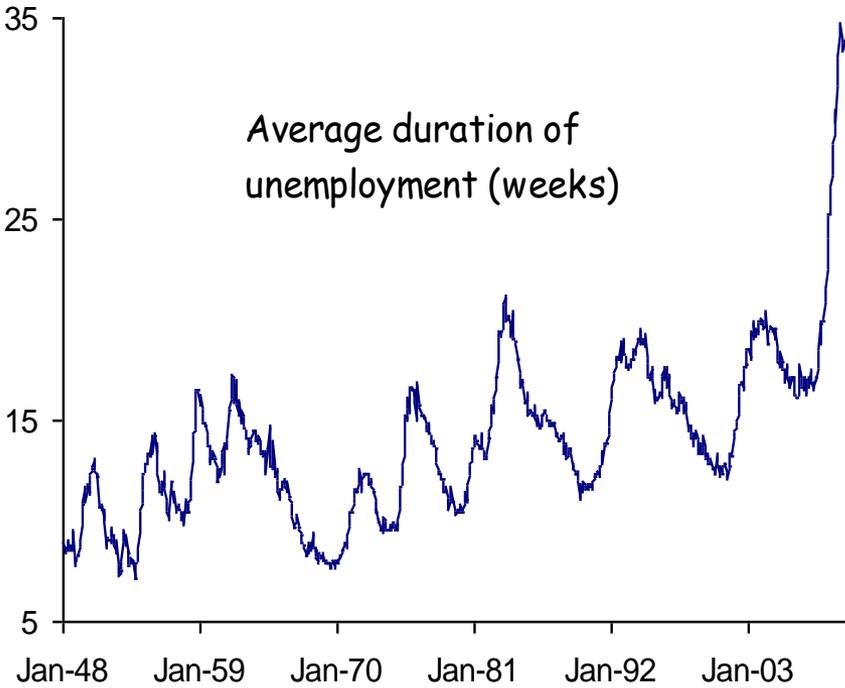
...but jobs recovery lackluster.



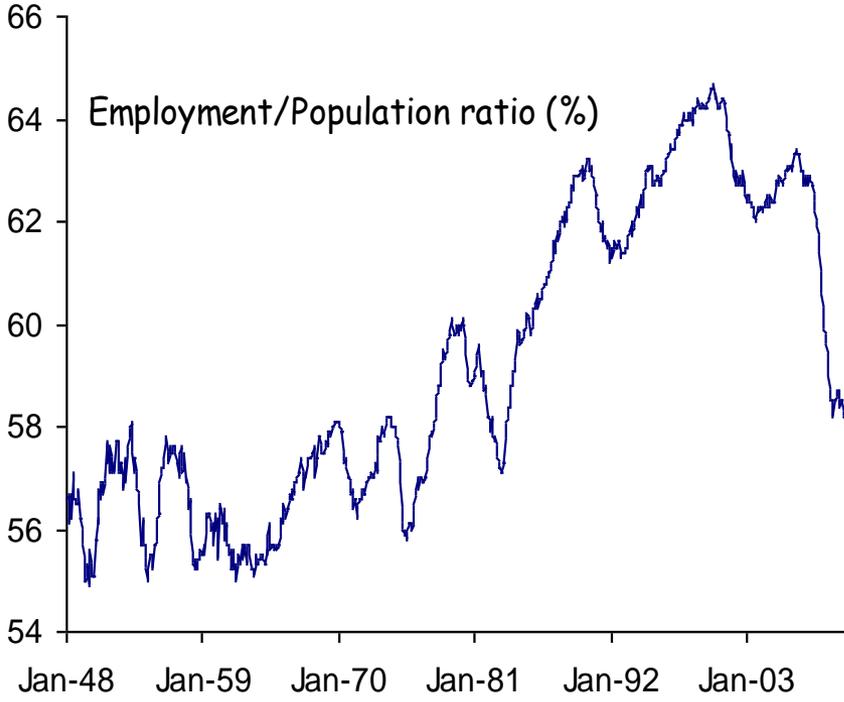
Source: Federal Reserve

- 400K in initial claims is consistent with a GDP of about 2%

No labor recovery...

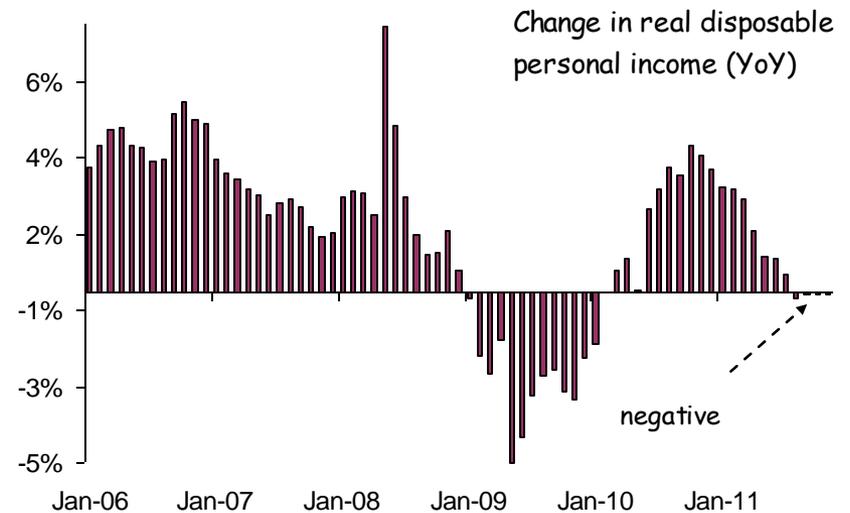
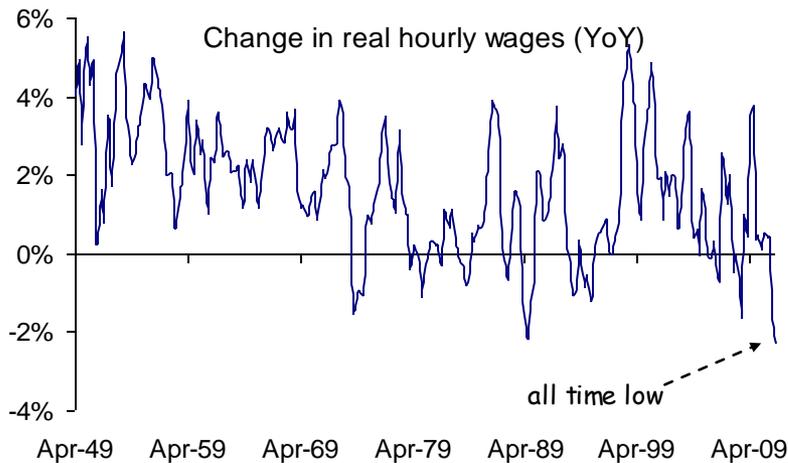


Source: BLS



Source: BLS

...as hourly wages and personal income shrink.



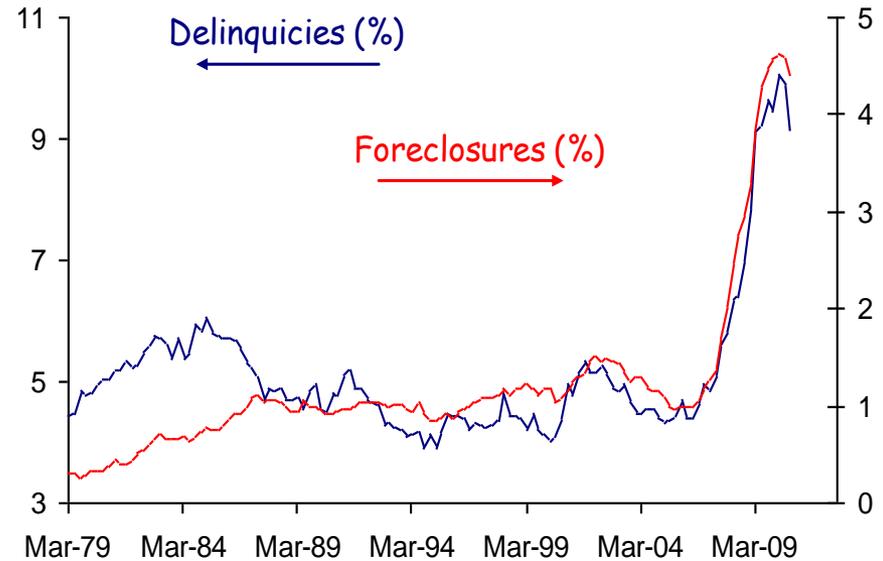
Source: BLS

Downside for housing remains



Source: National Association of Realtors

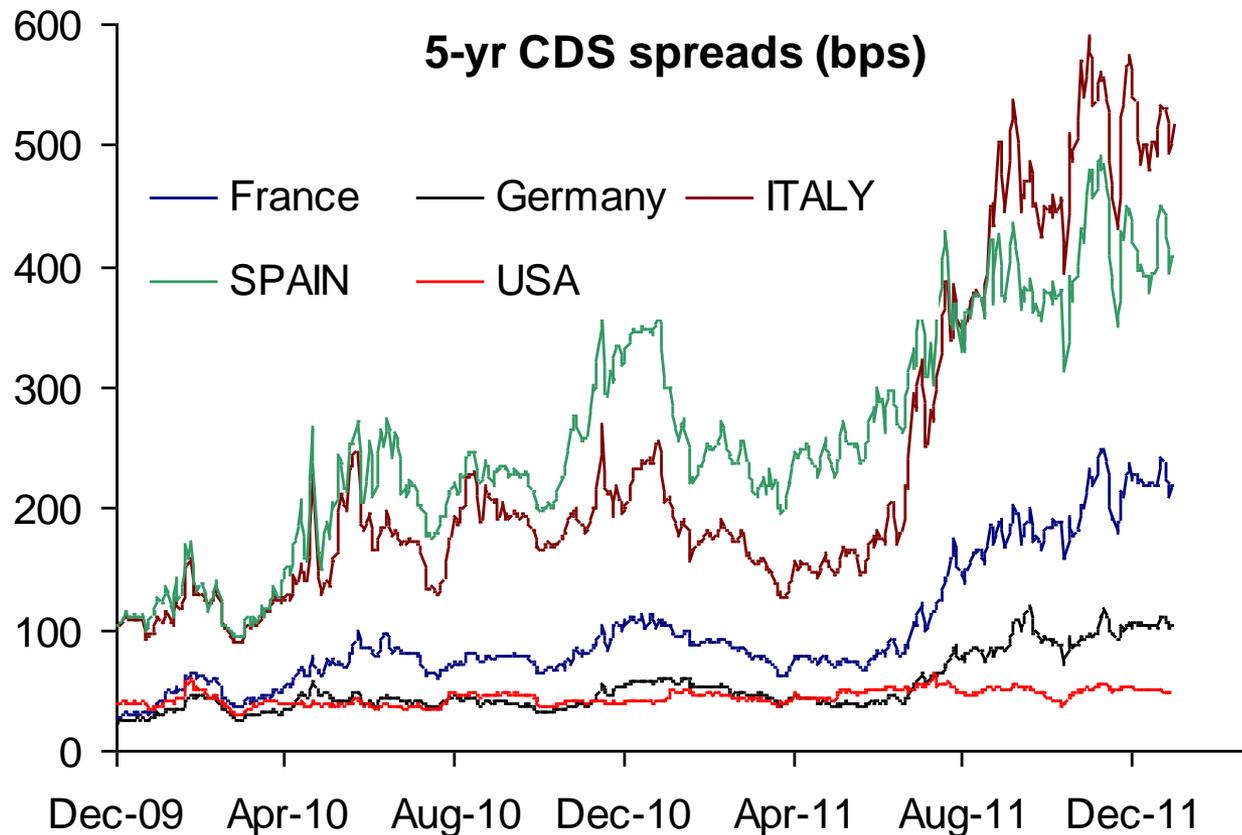
It still takes twice as long to sell a home (new or existing) than it did during 2005-09



Source: Mortgage Bankers Association

Elevated levels of delinquencies and foreclosures suggest that more homes will be added to the housing inventory

European sovereign debt crisis brewing...

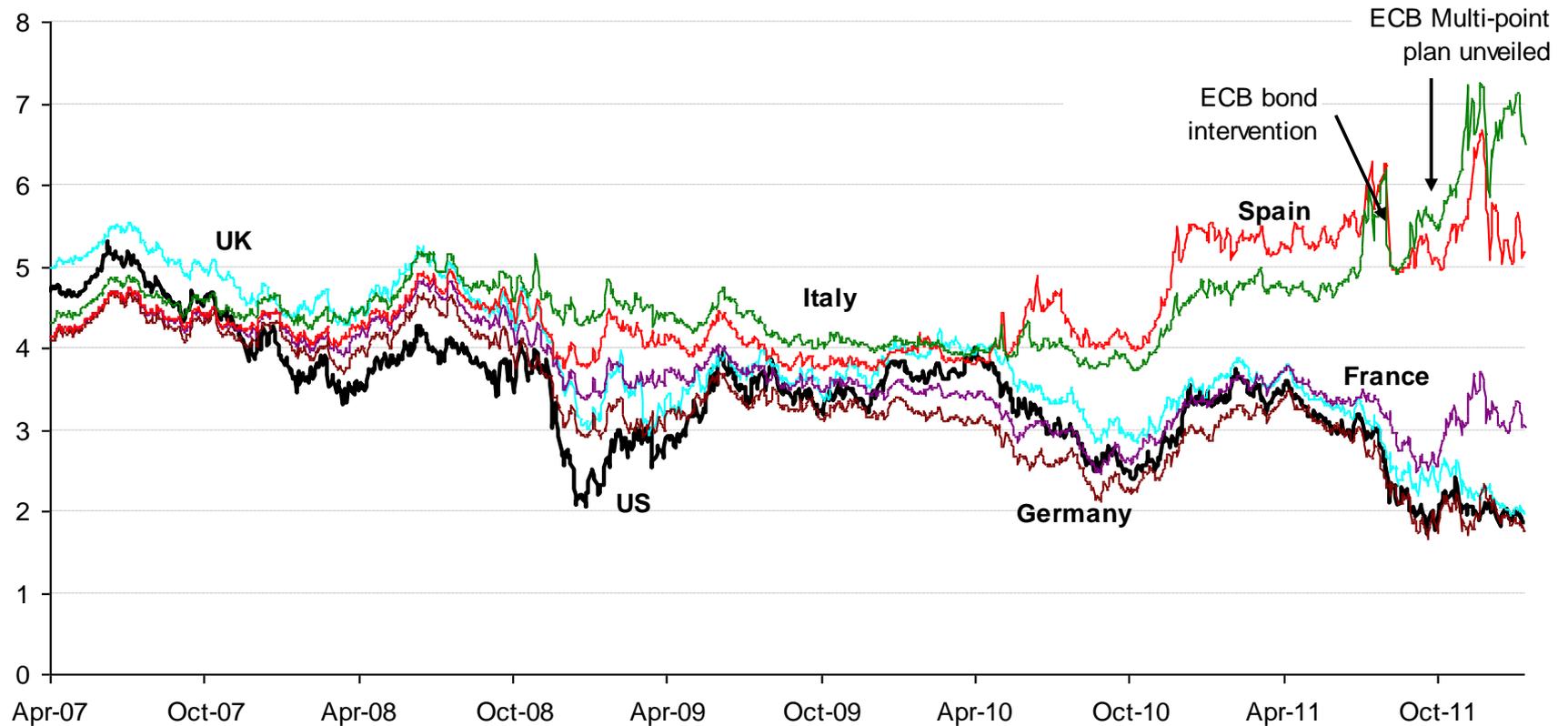


...as ratings downgraded.

Country	Ratings				Default Spreads		
	Aug S&P	Jan S&P	Aug Moodys	Oct Moodys	Aug 5Yr CDS	Jan 5Yr CDS	Bps +/-
Germany	AAA	AAA	Aaa	Aaa	74	104	30
United States	AA+	AA+	Aaa	AAA	56	49	(7)
France	AAA	AA+	Aaa	Aaa	145	217	72
Portugal	BBB-	BB	Ba2	Ba2	919	1188	269
Italy	A+	BBB+	Aa2	A2	387	521	134
Ireland	BBB+	BBB+	Ba1	Ba1	774	670	(104)
Greece	CC	CC	Ca	Ca	1691	7020	5,329
Spain	AA	A	Aa2	A1	405	411	6

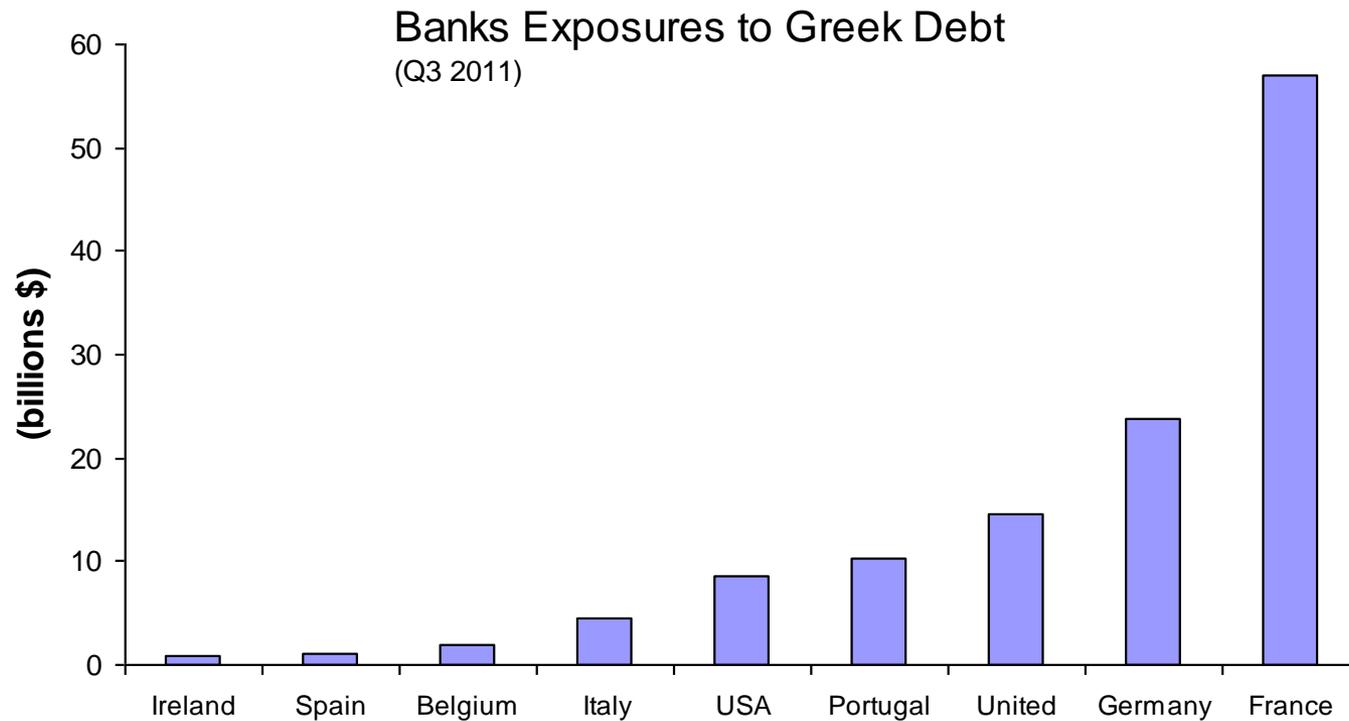
Government bond yields diverge

Country Borrowing Rates (10-year Sovereign Bonds, %)



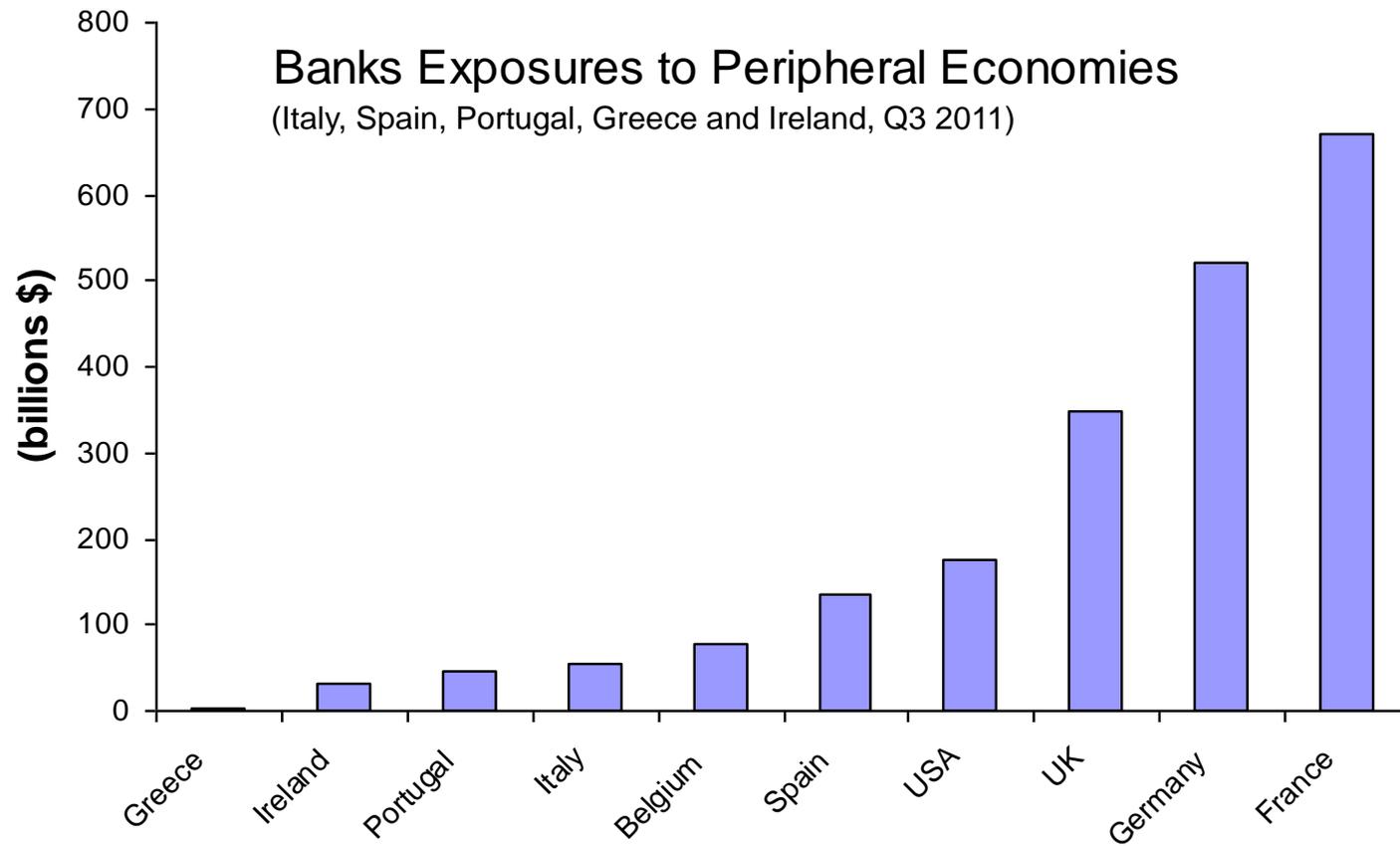
Source: Bloomberg

Minimal U.S. exposure to Greek debt, but...



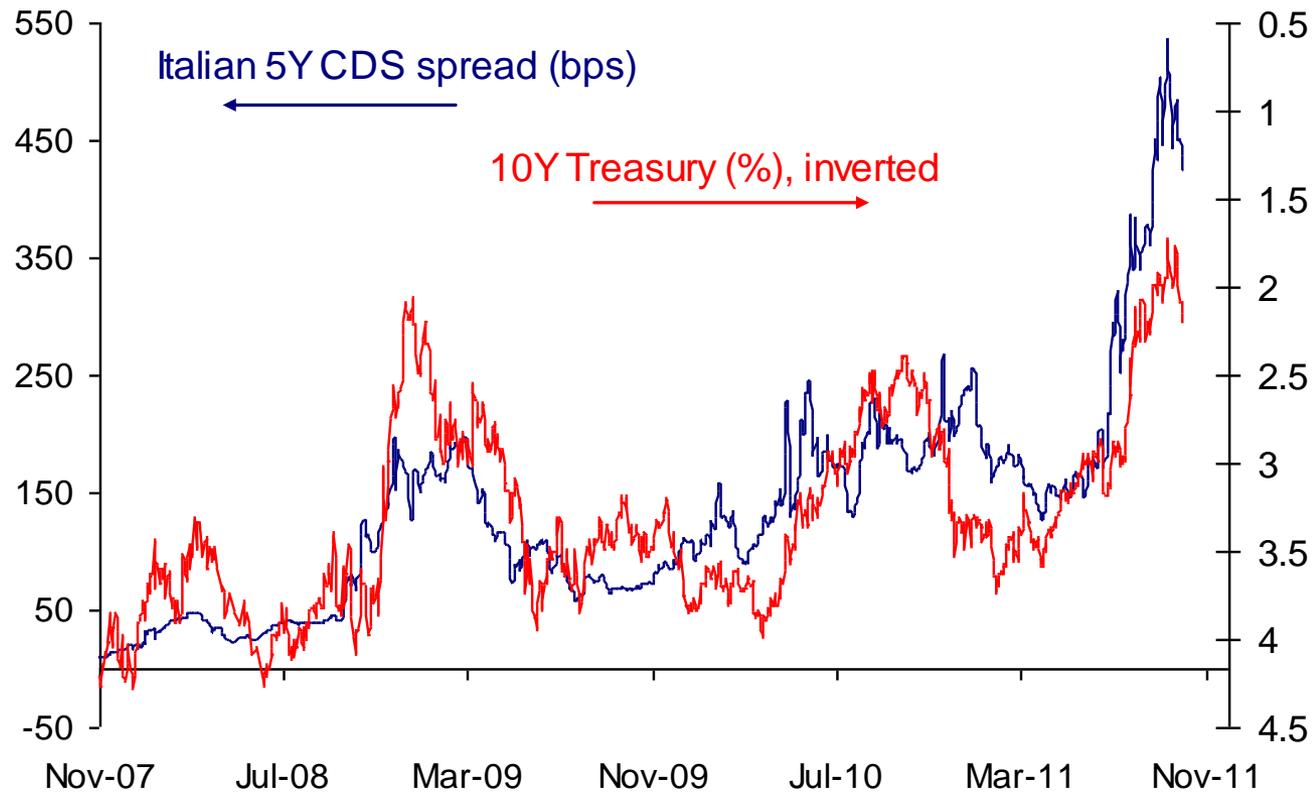
Source: BIS

...sizable exposure to peripheral debt



Source: BIS

Eurozone flare-up = Lower Rates



Source: Bloomberg

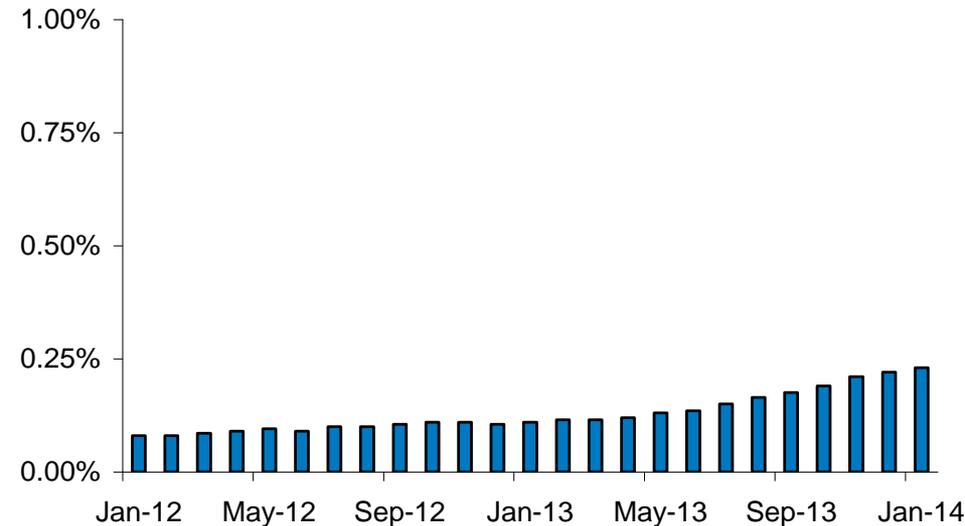
...as Fed remains accommodative

Key Points

- Rates low
- Little fiscal support expected
- Fed focused on keeping rates low until at least mid-2013
- Operation twist pushing long-end lower
- Fed disenchanted with QE (QE3 presents risk to outlook)
- European problems not going away
- U.S. growth outlook weak
- Expect high volatility and correlations

Fed Fund Futures

U.S. Fed Fund Futures (%)



Source: Bloomberg

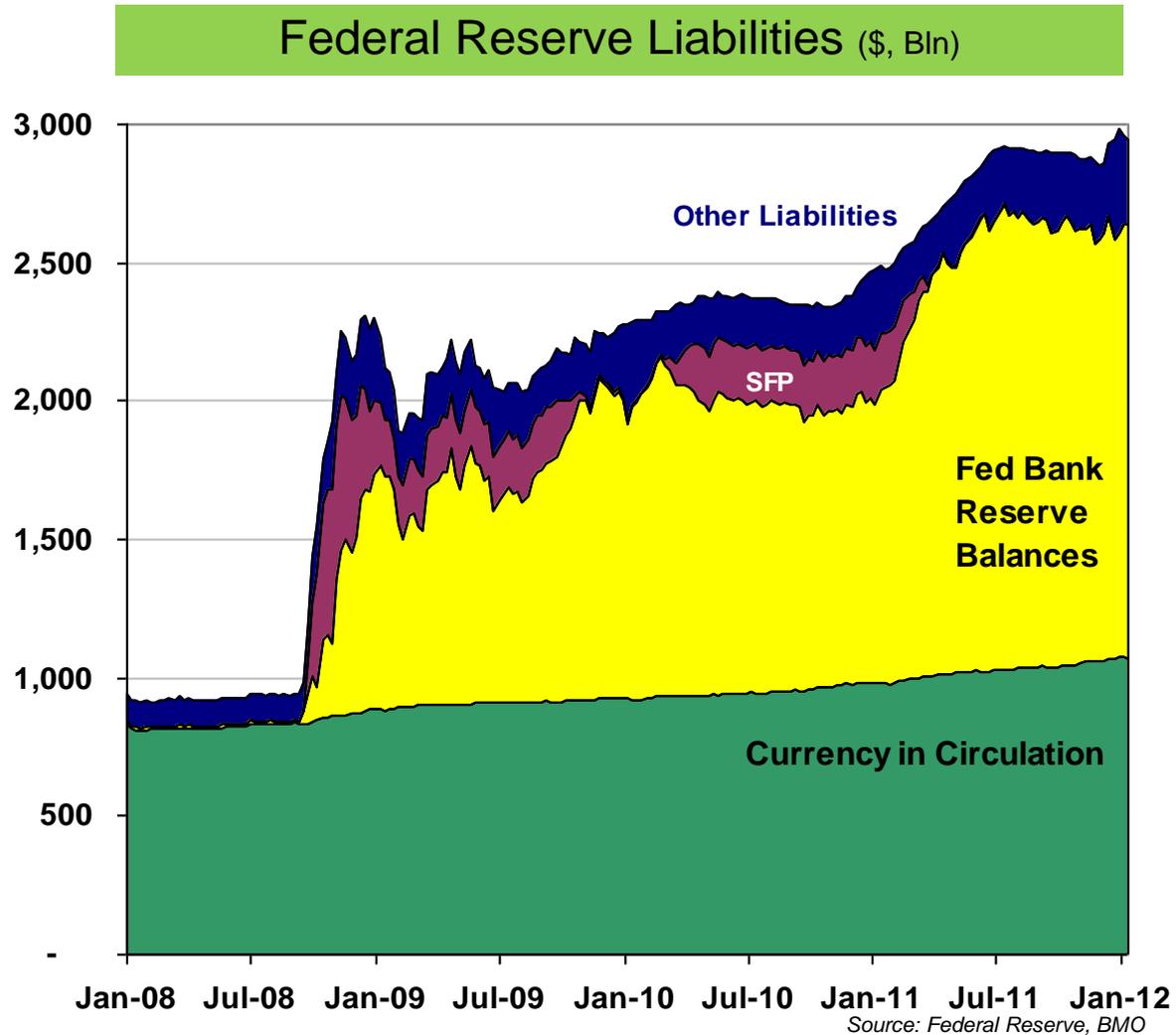
Excerpt from August 9th FOMC Statement

percent. The Committee currently anticipates that economic conditions -- including low rates of resource utilization and a subdued outlook for inflation over the medium run -- are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. The Committee also will maintain its

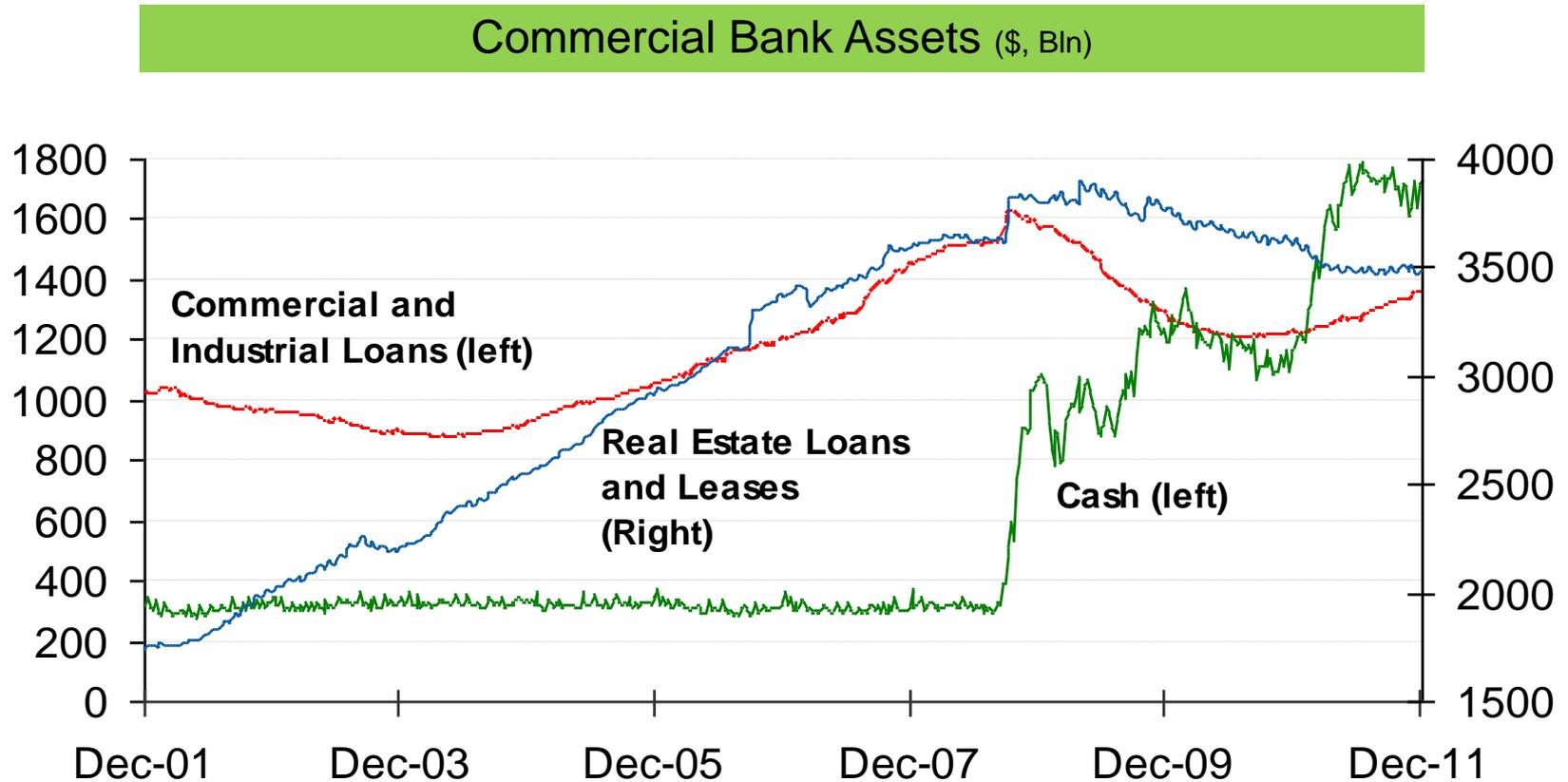
18

Source: Bloomberg, BMO Capital Markets

Ample Fed liquidity for U.S. banks...

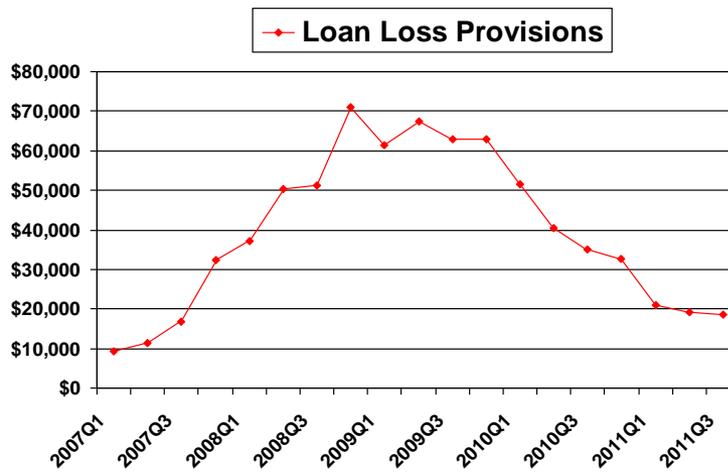


...but building excessive liquidity at banks...

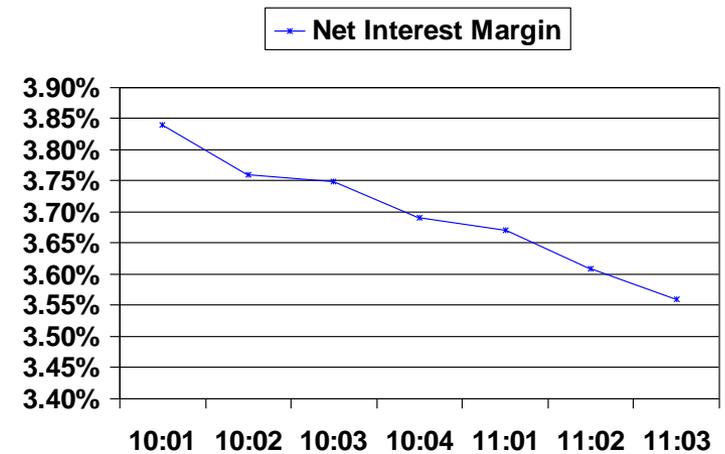


Source: Federal Reserve

...leads to shrinking net interest margins.



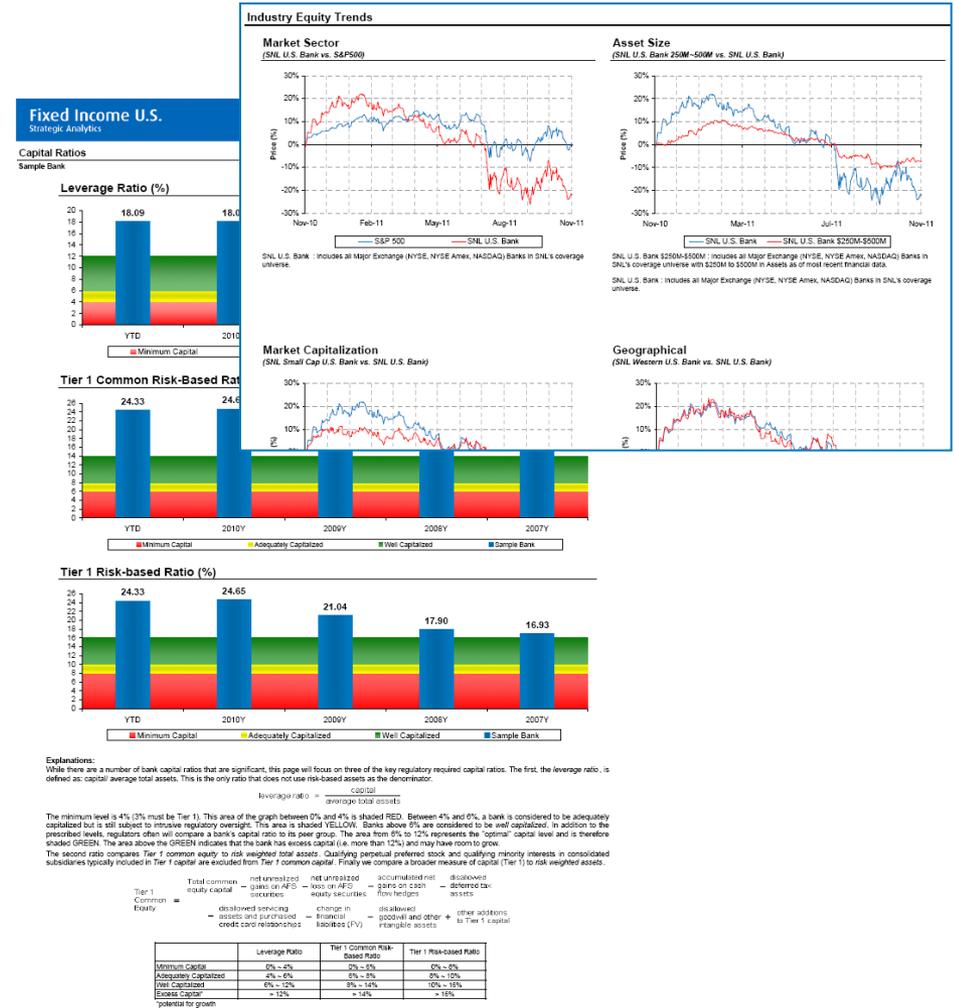
Source: FDIC Quarterly Banking Profile



Source: FDIC Quarterly Banking Profile

BMO creates community bank reports, adding vision... Financial Institutions Vision Analytics (FIVA)

- Industry Equity Trends
 - Comparisons for sector, asset size, market cap, geographical
- Bank Capital Ratios
 - Leverage
 - Tier 1 and common risk based ratios
- Key Financial Ratios
 - ROA, ROE, NIM
- Customized comparisons** creates unique results
- Comparisons versus industry peer groups and normalized levels** allows for decision making and outcome driven results
- Points toward underutilized capital or other ways for banks to **meet long-term goals**



...and Insights into Asset Allocation

- **Investments in context** of the entire balance sheet
 - Cash
 - Liquidity
 - Loans
 - Loan Substitutes
 - Other Assets
- **Comparisons versus optimal** positions allows for easy rebalancing
- **Benchmark comparisons** provide targets toward which bankers can strive

Sample Bank
October 31, 2011

Town, State

Actual Position

	Book Value	% of Assets	Book Yield	Effective Duration
Cash:	18,781	10%	1.29	0.01
Liquidity:	59,049	32%	2.34	1.59
Loans:	85,306	46%	6.23	
Loan Substitutes:	15,276	8%	3.22	2.27
Other Assets:	8,694	5%	0.00	
Total Assets:	187,106	100%	3.97	

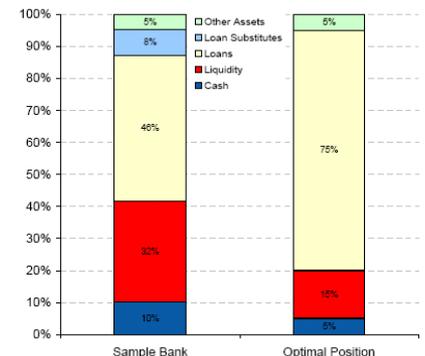
Optimal Position

	Book Value	% of Assets	Book Yield	Effective Duration
Cash:	9,355	5%	0.09	0.16
Liquidity:	28,066	15%	0.58	1.80
Loans:	140,330	75%	6.23	
Loan Substitutes:	0	0%	3.63	4.49
Other Assets:	9,355	5%	0.00	
Total Assets:	187,106	100%	4.76	

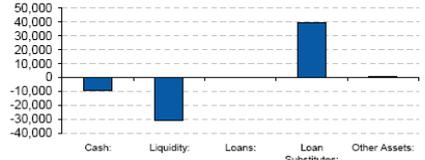
Variance from Optimal

	Book Value	% of Assets	Book Yield	Effective Duration
Cash:	-9,426	-5%	1.20	-0.15
Liquidity:	-30,983	-17%	1.76	-0.21
Loans:	0	0%	0.00	
Loan Substitutes:	39,748	21%	-0.41	-2.22
Other Assets:	661	0%	0.00	
Total Assets:	0	0%	-0.79	

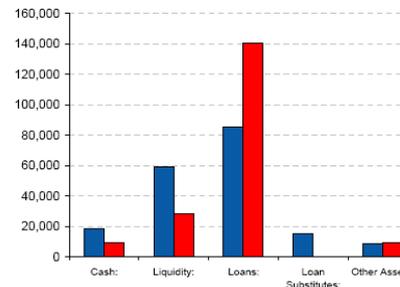
Asset Allocation, Sector Percent by Total Assets



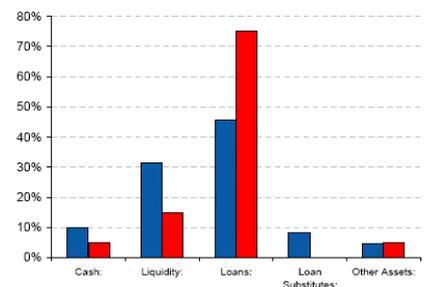
Sector Variance from Optimal, Dollars



Sector Allocation, Dollars by Total Assets

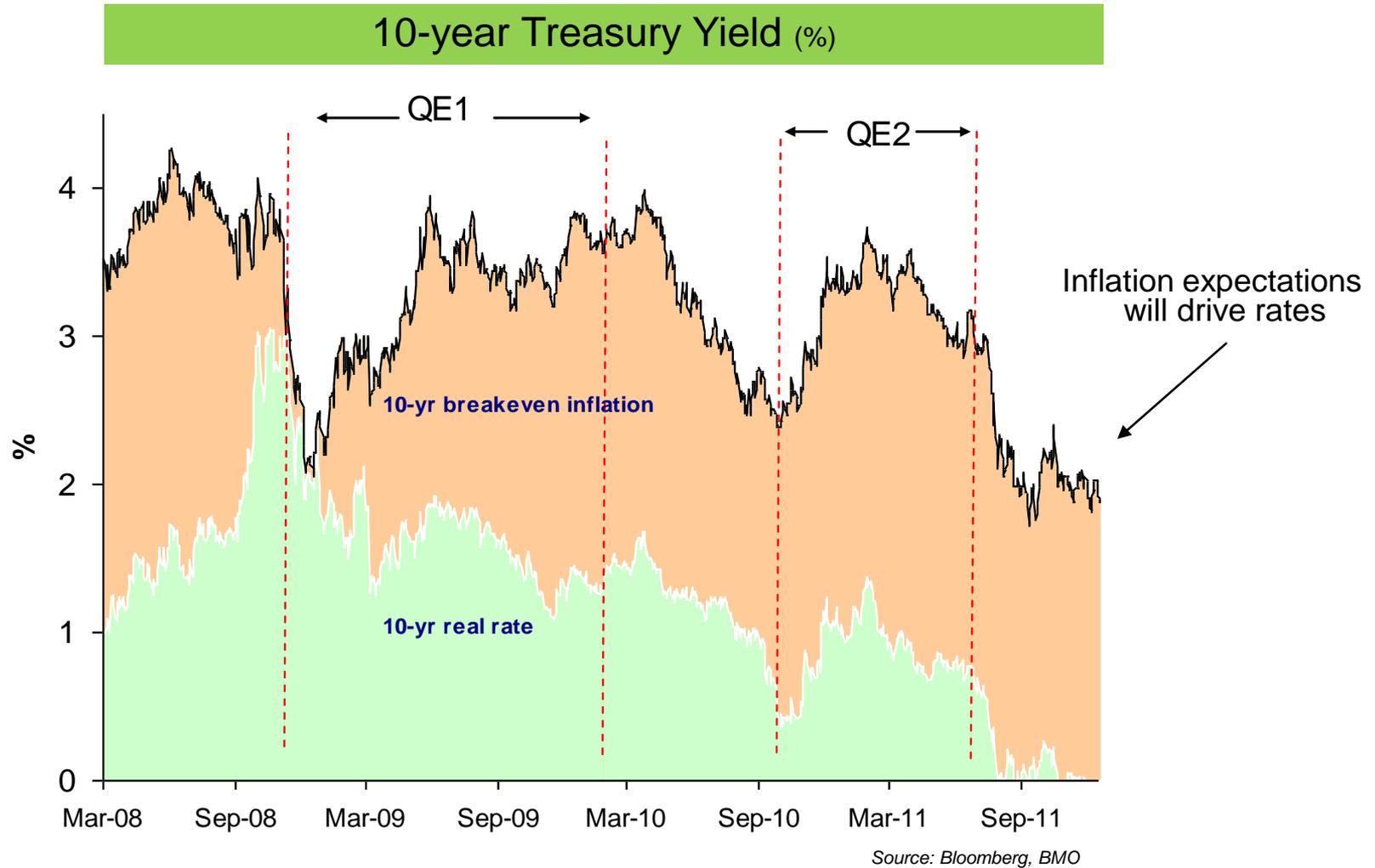


Sector Allocation, Percent by Total Assets



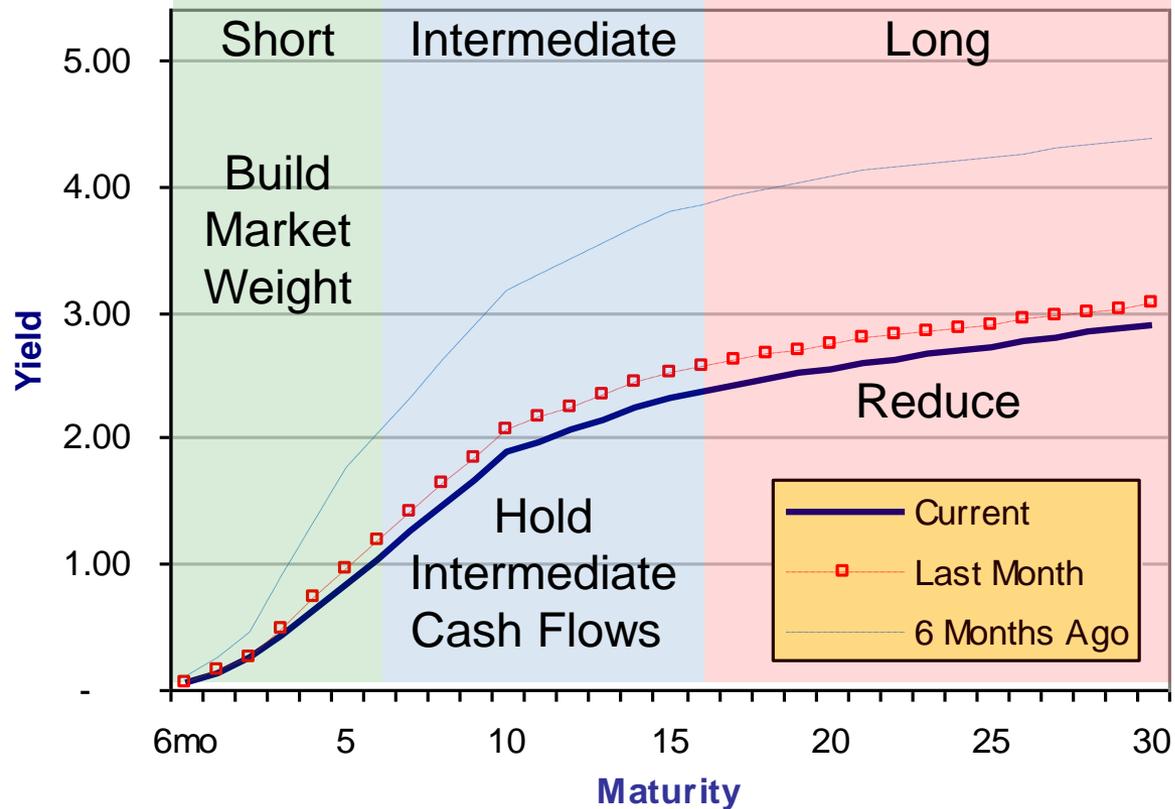
**Asset size as of most recent quarter end data. Any deviation of investment portfolio value is assumed to affect cash.

Pure (but low) inflation



Curve Positioning

Treasury Yields

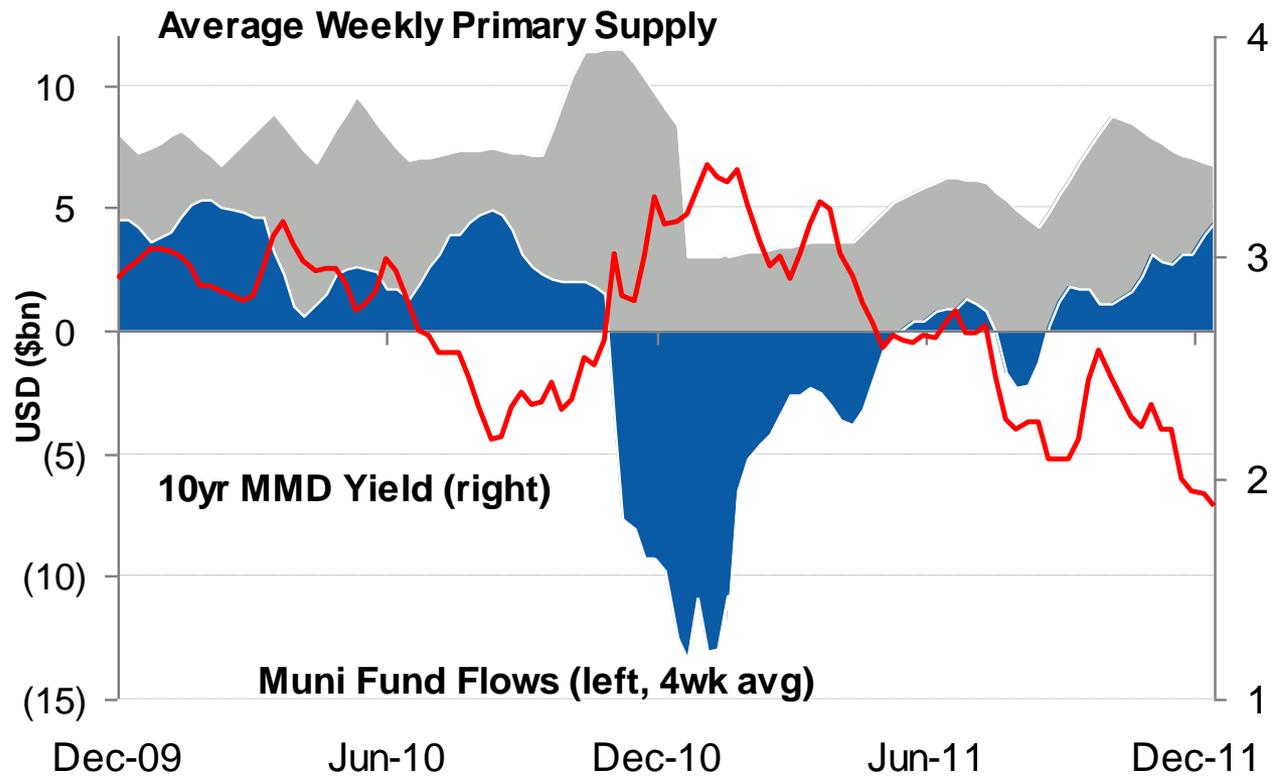


Intermediate Segment: Adding Bonds in the Mid-range of the Curve

STRATEGY FOCUS	
<p>Segment 1-12 Year Average Life</p> <p><u>Recommendation</u> Build Targeted Cash Flows</p>	<ul style="list-style-type: none">• Spreads on high quality paper offer attractive value• Focus sectors:<ul style="list-style-type: none">– Floaters– Taxable Munis– Covered Bonds <p>Goals</p> <ul style="list-style-type: none">• Find bonds that create roll down• Limit duration extension trades• Reduce near-term cash flows

Models suggest munis rich

10-year Muni Yield (%) Fund Flows and Primary Supply (\$, Bln)



Source: MMD, BMO Capital Markets

Structuring MBS cash flows

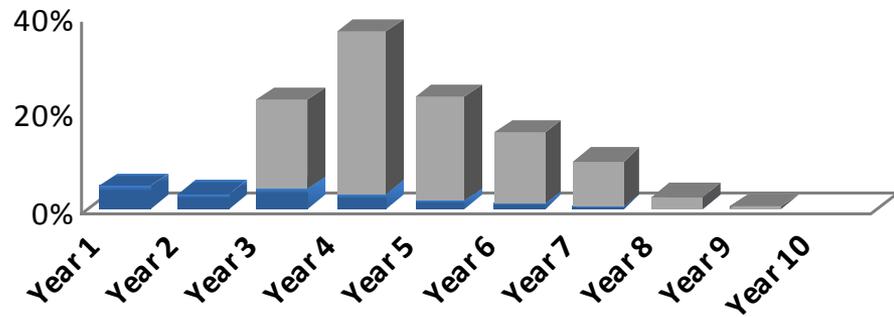
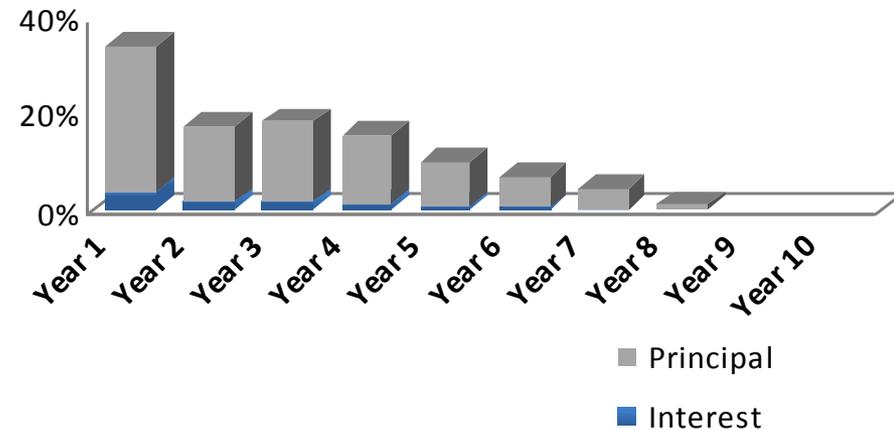
2005 Originated 15yr 4.5%

Pick ~50bps



Locked-out Principal CMO 4.5% 2005
Originated 15yr 4.5% LLB Collateral

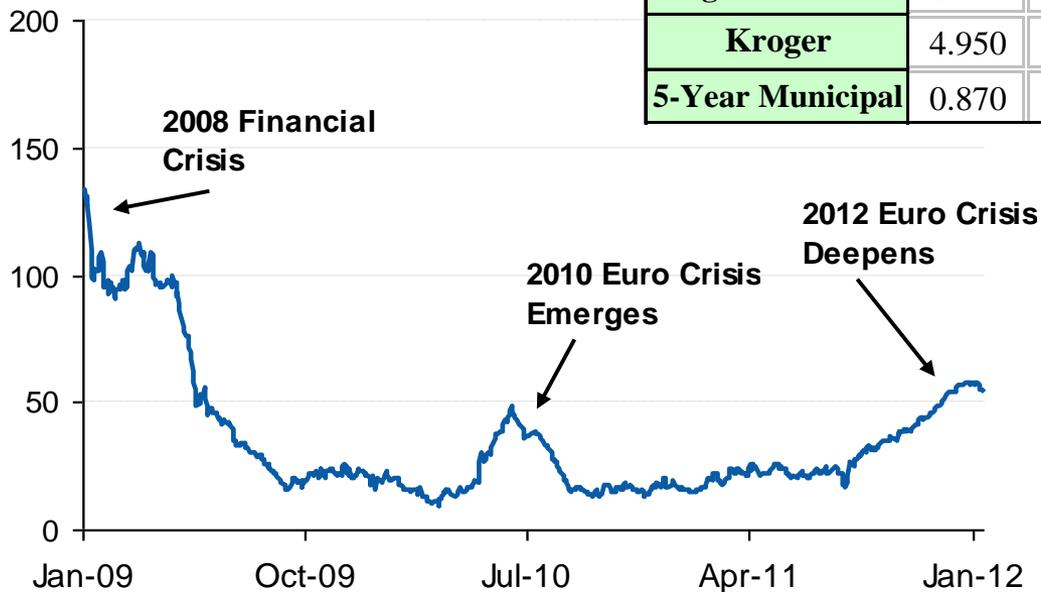
% Principal and Interest Paid, Base Case



Source: Bloomberg, BMO Capital Markets

Rising case for LIBOR floaters

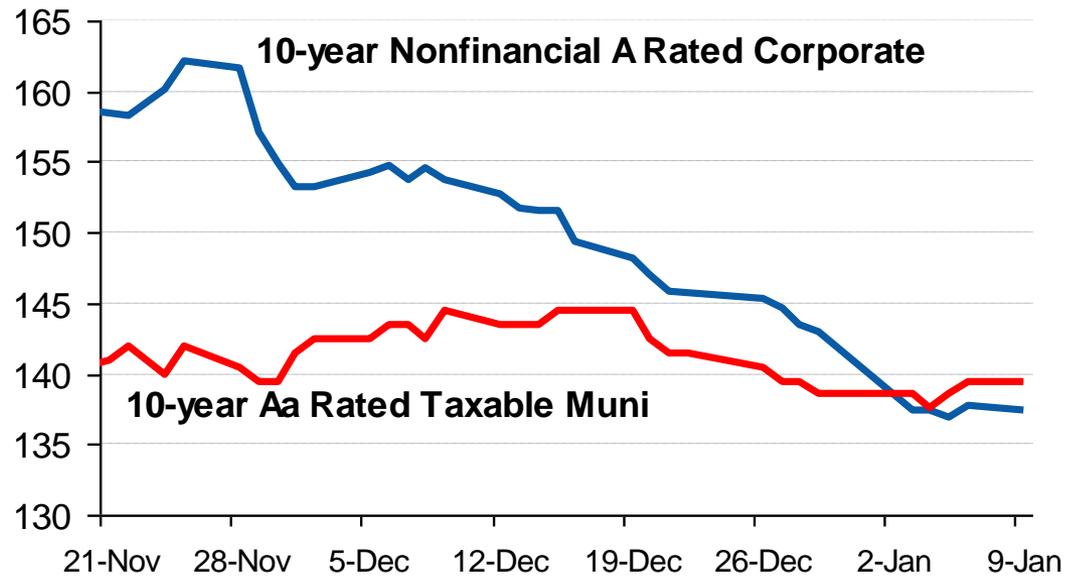
	Cpn	Maturity	Yield	Avg Life	Market Price	Eff Dur	Conv
GE Floater	0.806	09/15/14	2.06	2.67	96.780	0.25	0.00
GE Fixed	5.900	05/13/14	1.65	2.33	109.600	2.40	0.05
3-Year Treasury	0.250	01/15/15	0.36	3.00	99.672	2.99	0.05
3-Year Agency	0.750	12/19/14	0.51	2.92	100.708	2.90	0.05
FN 20-Yr	4.000	01/01/32	2.35	4.25	106.172	3.62	-0.53
Colgate Palmolive	1.300	01/15/17	1.42	5.00	99.411	4.85	0.13
Kroger	4.950	01/15/15	1.32	3.00	110.666	2.76	0.05
5-Year Municipal	0.870	01/07/17	0.86	5.00	100.049	4.90	0.13



Source: Bloomberg, BMO Capital Markets

Value in taxable munis

10-year Taxable Muni Yields vs. Lower Rated Nonfinancial Corporates (Bps)



Source: JP Morgan, BMO Capital Markets

Covered bonds offer AAA/Aaa ratings due to structure

WHAT ARE COVERED BONDS?

- Corporate/mortgage hybrids
 - Unsecured corporate bond

PLUS

 - Secured or “covered” by high quality assets (often residential mortgages) that investors can claim (bankruptcy remote) in the event of issuer default
- Dual recourse often provides AAA rating
- Used in Europe for centuries
- \$3.5 trillion global outstanding bonds
- U.S. issuance
 - \$30B 2010
 - \$35B YTD 2011

Covered bonds have withstood crisis

U.S. Case Studies

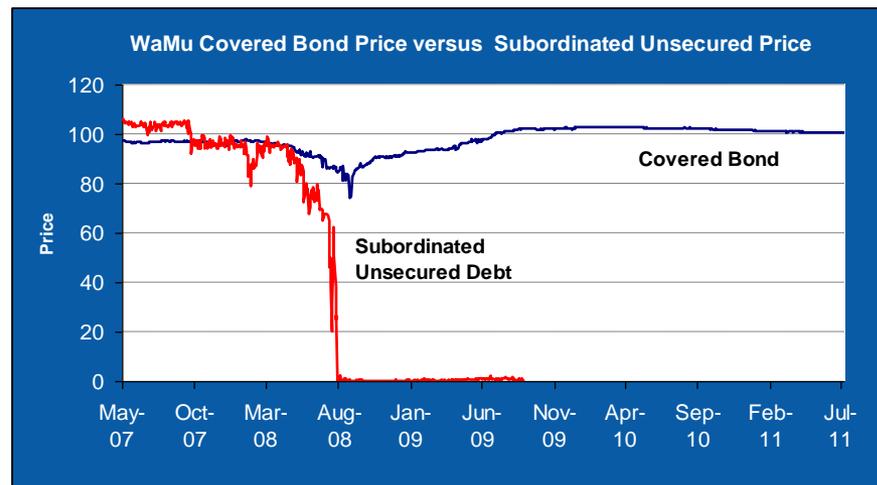
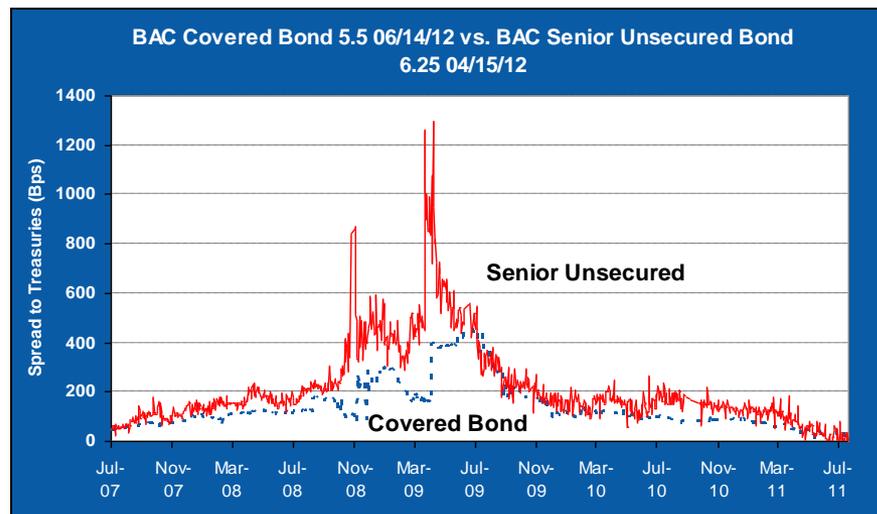
- Bank of America
- Washington Mutual

Benefits

- Diversification
- Highly rated

Current Opportunities

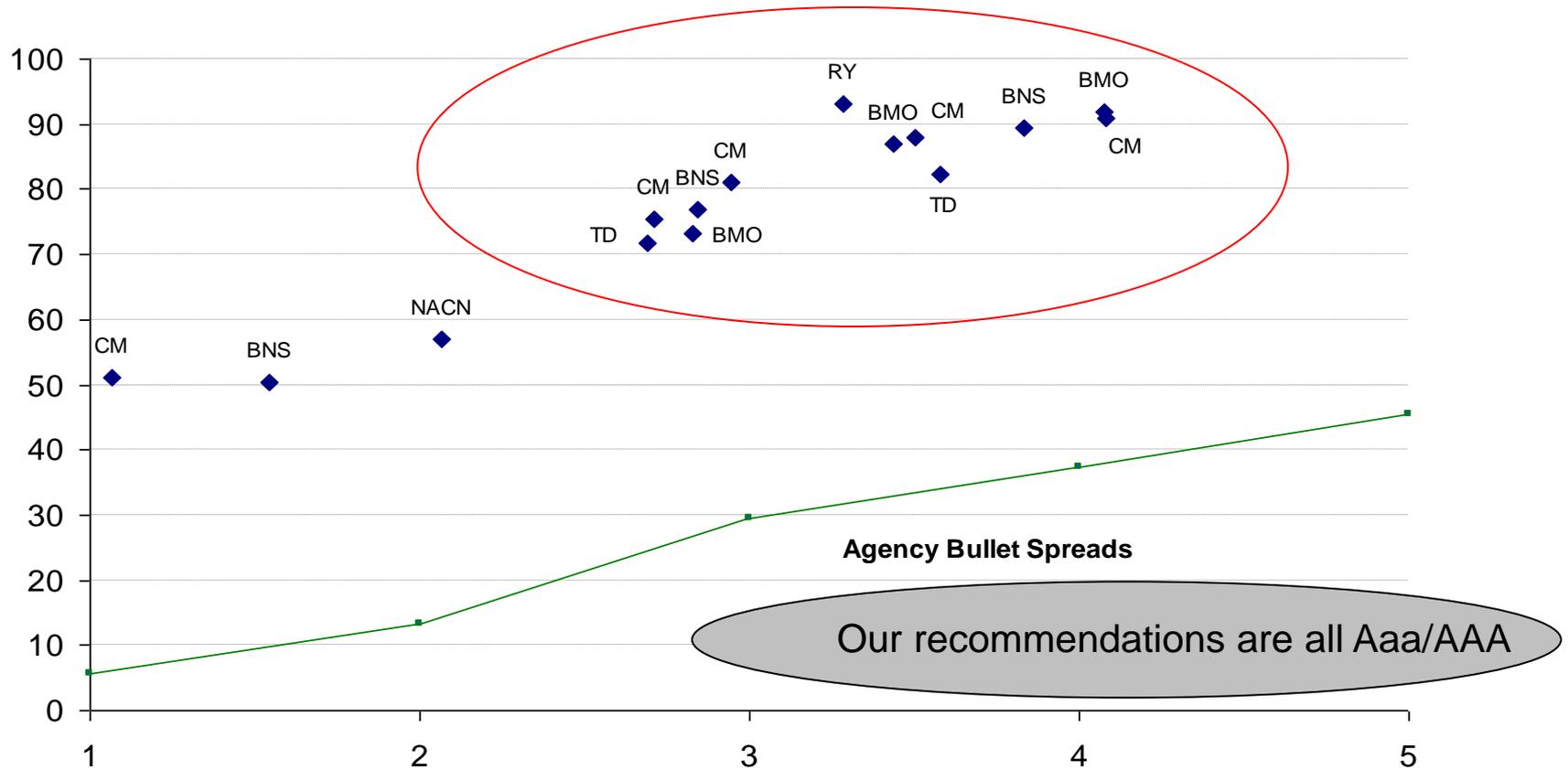
- Legislation in place in Europe
- Canadian banks have strong contractual framework
- U.S. legislative framework developing
 - June 22, 2011 House Financial Services approved (44-7) H.R. 940: US Covered Bonds Act



Source: Bloomberg

Covered bonds offer attractive spreads

Covered Bond Spreads to Treasury Yields vs. Agencies (Bps)



Conclusion and Recommendations

The Economy

- Sovereign and household debt problems weigh on the markets
- Housing will continue to act as a drag on economic growth
- Labor market trends underscore structural problems confronting the US economy
- European debt crisis weighing on global markets
- Rates are low and will likely remain low for at least the next couple of years

Bond Markets

- Exceptionally low long-term rates suggests building shorter duration positions
- Fed purchase program suggests continued low volatility for MBS, use targeted amortization bonds and mid-coupon pass-through paper
- Reduced agency issuance suggests that investors look for alternatives
 - Including: Covered bonds, CDs, Non-agency mortgages, DUS
- Covered bonds a rare triple-A/triple-A alternative to governments at better spreads
- Taxable munis offer value
- BQ paper source of funds

Disclaimer

The views expressed in this report accurately reflect the analyst's personal views. No part of the analyst's compensation was, is or will be directly or indirectly related to any specific recommendations or views. This report is intended for the private use of the institutional investor to whom it was sent.

The opinions, estimates and projections contained herein are those of BMO Capital Markets GKST Inc. ("BMO") as of the date hereof and are subject to change without notice. BMO endeavors to ensure that the contents herein have been compiled or derived from sources that we believe are reliable and contain information and opinions which are accurate and complete. However, BMO makes no representation or warranty, express or implied in respect thereof, takes no responsibility for any errors and omissions which may be contained herein and accepts no liability whatsoever for any loss (whether direct or consequential) arising from any use of or reliance on this report or its contents. Information may be available to BMO, which is not reflected herein. This report is not to be construed as an offer or solicitation to buy or sell any security.

BMO, its affiliates and/or their respective officers, directors or employees may buy from or sell to customers the securities of any issuers mentioned herein on a principal basis. BMO usually makes a market in the securities and actively trades these securities for its customers and as principal for its own account. BMO may act as financial advisor and/or underwriter for the issuers mentioned herein and may receive remuneration for same.

BMO is a subsidiary of Harris Financial Corp., which is a subsidiary of the Bank of Montreal. BMO is affiliated with Harris Bankcorp, Inc.