



AMBASSADOR FINANCIAL GROUP, INC.

FMS- NY/NJ Chapter

The Economy, The Fed & Interest Rates

Presented By:

Matthew T. Resch, CFA– Managing Director

February 22, 2012



Overview

- I. The Economy
- II. The Fed & Monetary Policy
- III. Interest Rate Environment
- IV. The Issue
- V. Strategies and Recommendations

I. The Economy

The Economy

- U.S. economic data remains mixed, but has improved over recent months... much work remains
- Monetary, fiscal & government uncertainty
 - More stimulus/QE3?
 - Deficits
 - Regulations
- Double dip, **new normal** or sustained recovery

Economic Indicators Most Sensitive to Bonds

1. Employment Situation Report
2. Consumer Prices
3. ISM Report—Manufacturing
4. Producer Prices
5. Weekly Claims for Unemployment Insurance
6. Retail Sales
7. Housing Starts
8. Personal Income and Spending
9. ADP National Employment Report
10. GDP

Globalization & Global Imbalances



The world has gotten smaller due to globalization

Globalization & Global Imbalances

1. European Sovereign debt and banking crisis
2. BRIC economies, namely China, slow down
3. Currency Devaluations
4. Massive amounts of global debt
5. Natural disasters and weather events
6. Geopolitical risk

II. The Fed & Monetary Policy



The Fed's Dual Mandate

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production, so as to promote effectively the goals of **maximum employment and stable prices.**

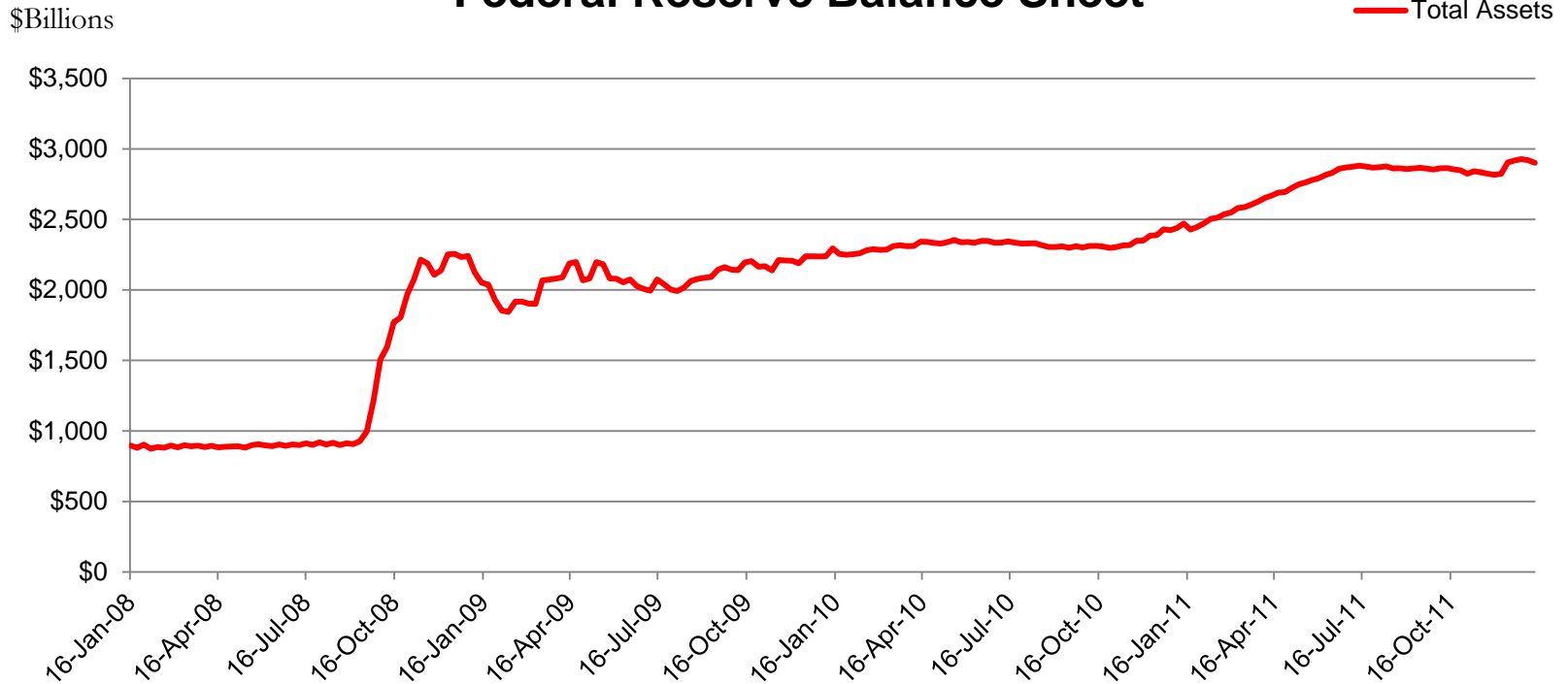
Monetary Tools

- Traditional
 - Open market operations
 - Adjusting the reserve requirement ratio
 - Adjusting the Fed's discount rate

- Non-traditional
 - Quantitative easing
 - Interest in excess reserves
 - Term auction/deposit facility
 - Other programs

The Fed—Monetary Policy

Federal Reserve Balance Sheet



Cash Index

ALCBCASH NY 28DEC11 00:00 1534.2 Billion

ALCBCASH INDEX Save Chart Hide GP - Line Chart Page 1/16

Range 01/03/01 - 12/28/11 Upper Mid Line Mov. Avgs Currency USD

Period Weekly Lower None Mov. Avg Events



Current Monetary Policy

- Rates to stay “exceptionally low” through ~~June 2013~~ at least late 2014
- Progress toward objectives has been “disappointingly slow”
- Operation Twist
- Reinvesting cash flows into securities
- More transparency

Remaining Monetary Bullets

- Actions
 - Q.E. III, IV, V.....?
 - Modify language in policy statement
 - Reduce the rate paid on excess-reserves, possibly even charging banks interest
 - Expansion of operation twist
 - Cap longer term yield
- Fed reality—policy has not mattered as economic issues are structural

III. Interest Rate Environment

Quantitative Easing & Operation Twist

- Quantitative Easing 1 (Nov. 25 2008 - March 31, 2010)
 - Fed initiated purchases of \$500 billion in MBS
 - Fed announced purchases of up to \$100 billion in debt obligations of Fannie Mae, Freddie Mac, Ginnie Mae and Federal Home Loan Bank
 - Fed expanded the mortgage buying program and said it would purchase \$750 billion more in MBS
 - Fed announced it would invest another \$100 billion in agency debt and \$300 billion of long-term Treasuries

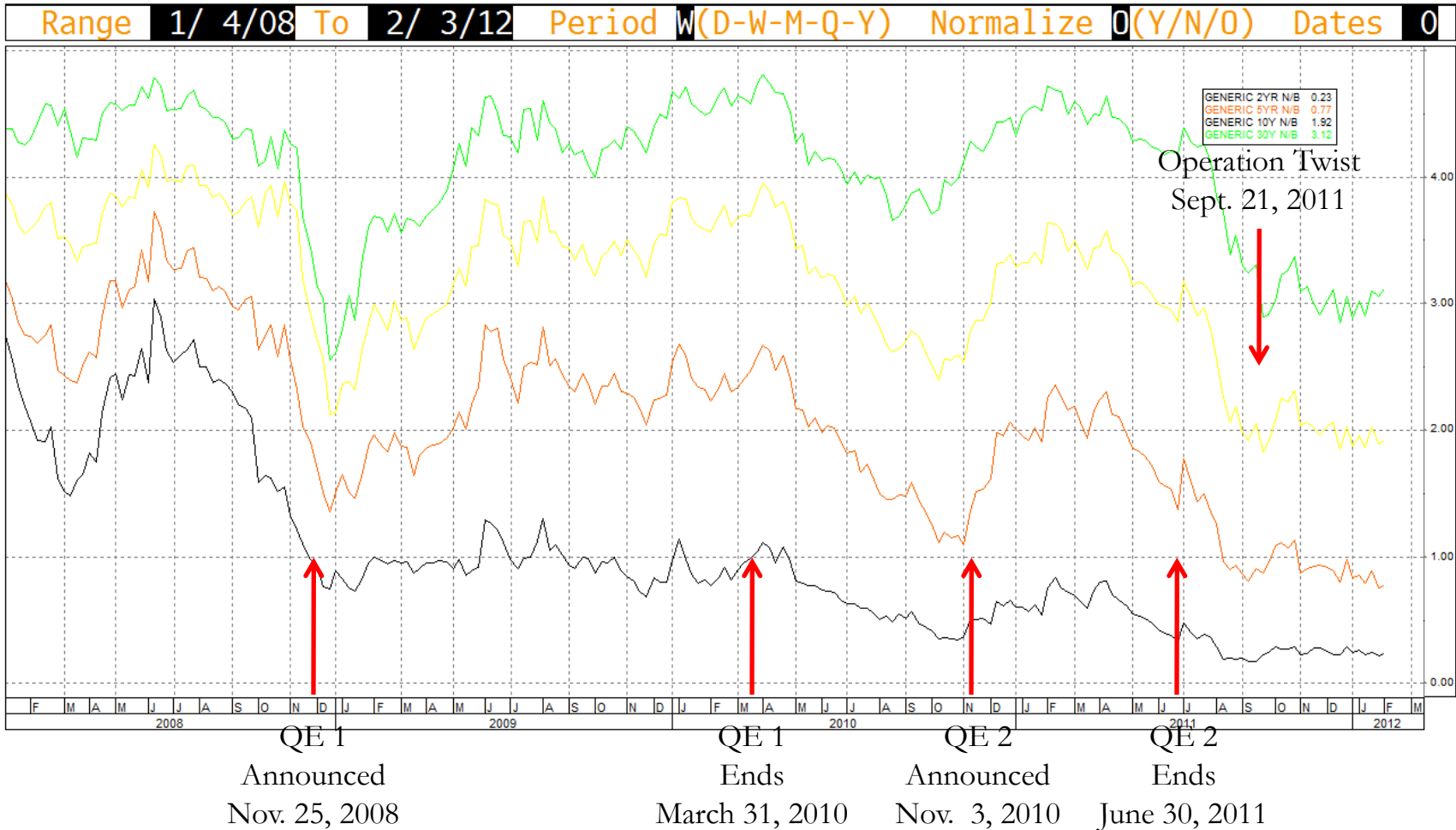
Quantitative Easing & Operation Twist

- Quantitative Easing 2 (Nov. 3, 2010 – June 30, 2011)
 - Fed announces purchases of \$600 billion of longer term Treasury Securities
 - Fed announces reinvestment of \$250-\$300 billion of cash flow into longer term treasuries
- Operation Twist (September 21, 2011-June 30, 2012)
 - Fed announces purchase of \$400 billion in 6 to 30-year treasuries, funded with \$400 billion in sales of 0 to 3-year treasuries.
 - Fed announces pledge to reinvest cash flows into agency MBS.

Quantitative Easing & Operation Twist

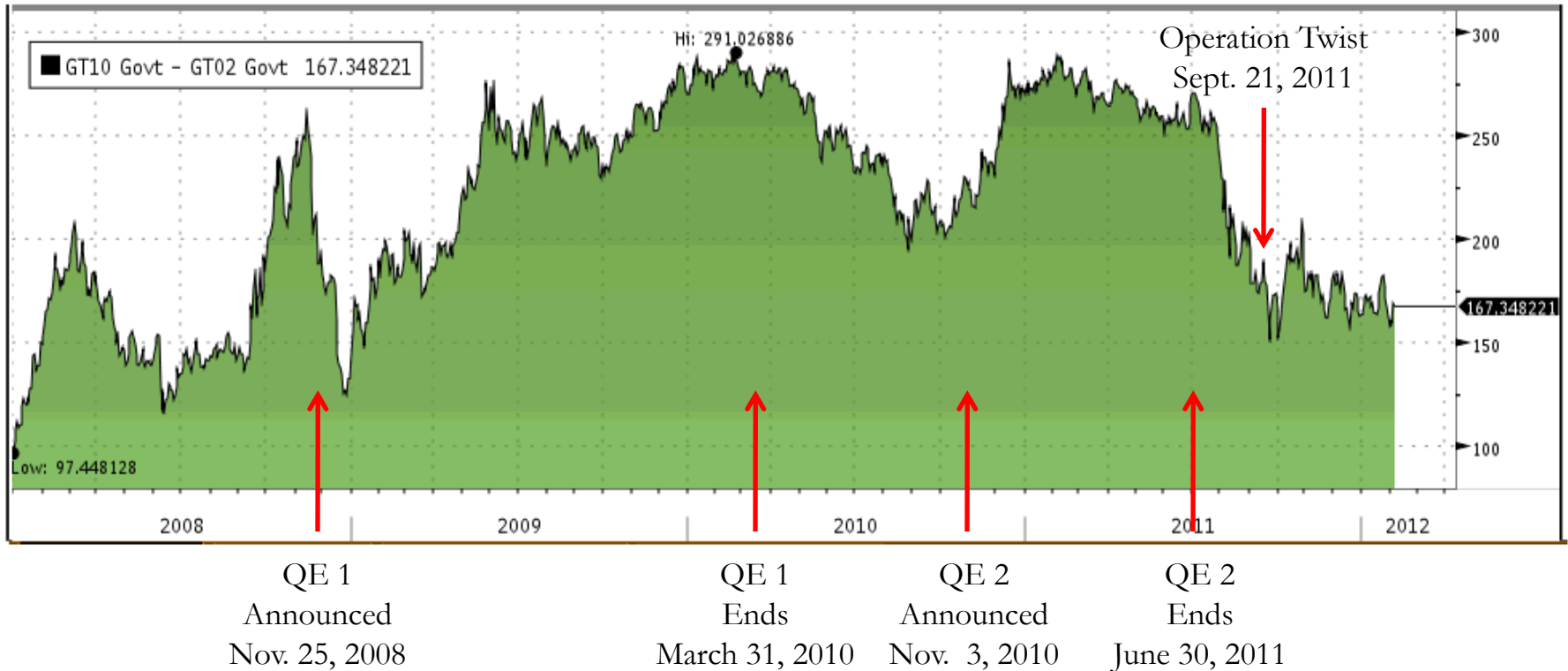
- Quantitative Easing 3 (QE3) ???
 - Size: Talk of \$1 Trillion
 - Timing: Summer 2012?
 - Concentrating on MBS purchases
- Additional twisting?

Timeline of Quantitative Easing

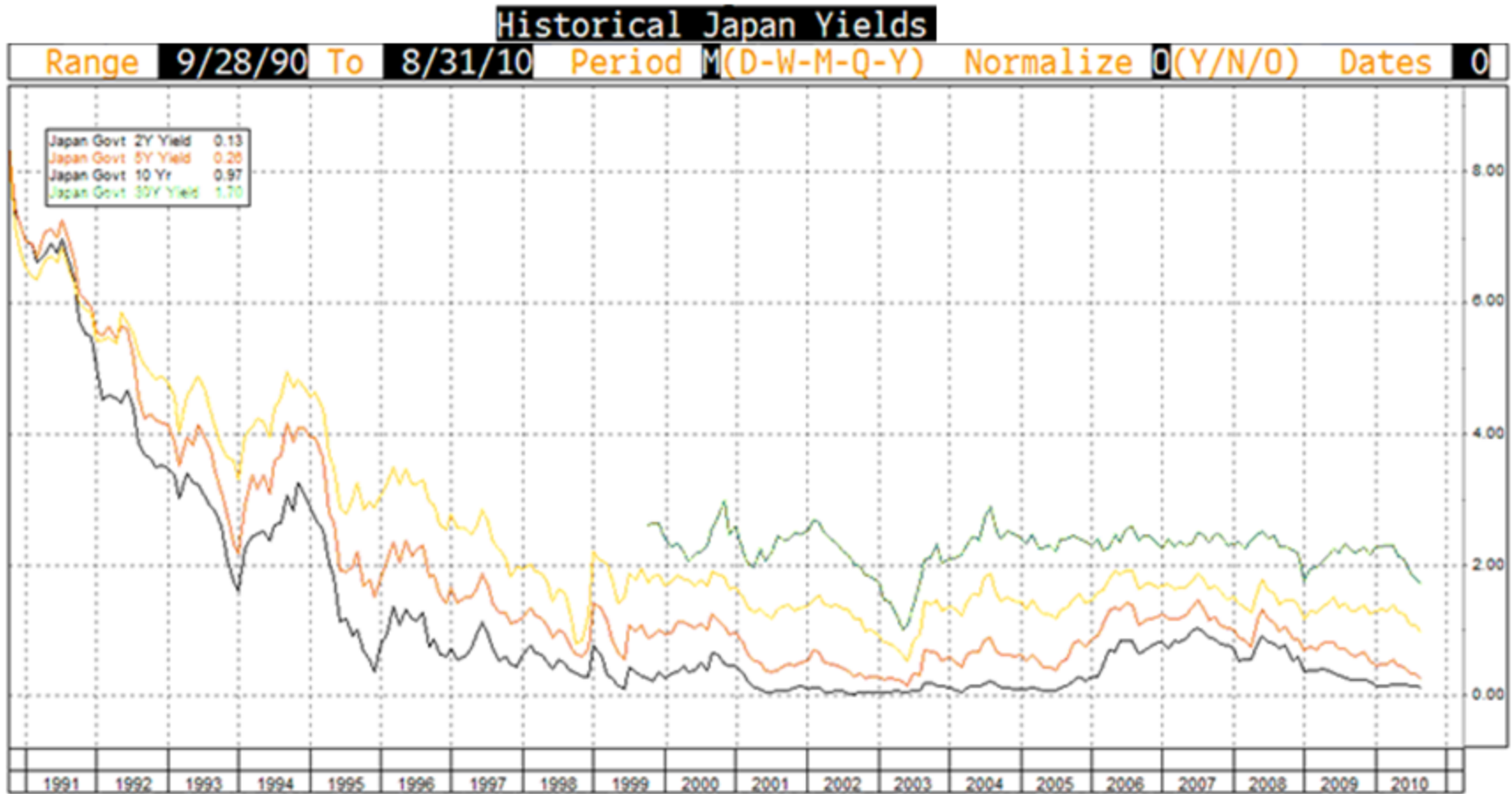


Yield Curve Slope

12/31/07 - 02/06/12



Japanese Historical Gov't Yields



Where are Rates Going?

- Fed on-hold for years
 - Anchors short-end of the yield curve
- Additional quantitative easing & operation twist
 - Anchors long-end of the yield curve
- Global shocks
 - Precipitates the flight to quality
- **Result: Rates stay low for years**

IV. The Issue

Source of Revenue¹

Area	Net Interest Income/ Revenue	Non-interest income/ Revenue
Major Markets		
Philadelphia	92	8
Washington	92	8
Middle Markets		
Central Jersey	90	10
Baltimore	92	8
Harrisburg	86	14
Small Markets		
Wilkes-Barre/Scranton	89	11
Lehigh Valley	91	9
Eastern Shore	92	8

¹195 banks based in these areas with assets under \$20 billion. For the quarter ended September 30, 2011.
Source: SNL.

Decreased Loan Demand

Banks Based In Region ¹	Loans/Assets	
	9/30/11	12/31/08
Major Markets		
Philadelphia	66.7%	73.2%
Washington	70.4	75.1
Middle Markets		
Central Jersey	64.5%	70.8%
Baltimore	73.0	78.6
Harrisburg	67.6	77.2
Small Markets		
Northeast PA	67.4%	76.0%
Lehigh Valley	53.3	58.2
Eastern Shore	78.5	81.1
Median	67.1%	74.1%

¹195 banks based in these areas with assets under \$20 billion.

Source: SNL Securities, Charlottesville, Virginia.

Margins Will Come Under Pressure

Banks Based in Region	9/30/11	12/31/08	Change
NIM	3.73%	3.42%	+31
Asset side			
Yield on loans	5.67%	5.63%	+03
Yield on securities	3.02	4.74	(1.72)
Liabilities side			
Cost of int. bearing deposits	1.19	3.12	(1.93)
Cost of borrowings	2.45	3.51	(1.06)

¹195 banks based in these areas with assets under \$20 billion.
Source: SNL Securities, Charlottesville, Virginia.

Summary

- Decreased demand for loans creates **larger** investment portfolios
- Yield on security portfolios has and will continue to decline
 - No more offset from declining cost of funds
- More attention to investment portfolio
 - Balance yield, risk and liquidity

V. Strategies & Recommendations

What can we do?

- Don't fight the Fed
- Balance sheet restructuring
 - Deleverage profitably
 - Leverage profitably
 - Roll down MBS coupons
- “Loan surrogate” investment strategy
- Growth through acquisitions
 - Whole bank acquisition
 - Sources of non-interest income