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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Is leverage a good thing? In the aftermath of a major financial crisis brought about by 'too much debt,' the answer isn't as clear as it once was. Couple that with Europe's fiscal unraveling, and you could very easily conclude leverage is a bad thing, or at least something to avoid.

However, debt, in and of itself, is innocuous. The issue is how the borrower uses it. If they take out massive loans to finance consumption or the purchase of depreciating assets, leverage will ultimately have a debilitating effect. If the borrower uses someone else's money to generate wealth in excess of the interest the lender charges, leverage is a glorious, wonderful thing.

So, again, is leverage a good thing? It all depends on how you use it. To fund fancy dinners and vacations? Well, debt is probably a bad thing there. To start or expand a business? You might be onto something there. Why use your own cash if you can borrow at, say, 4-5% and generate a return of anything north of that?

The trick is for both the borrower and lender to understand the former's return potential on the borrowed funds. If less than the stated rate of interest, both parties should think twice about the transaction. If more, well, it is a slam dunk, a no brainer. If your assets are growing faster than your liabilities, you have used leverage wisely.

Now, you probably have read something about the "fiscal cliff" the US faces at the end of this calendar year. This is a term Ben Bernanke popularized to describe the end of a multitude of tax breaks and credits, coupled with a decrease in the amount of deficit spending, as agreed upon last summer. Use whatever number you want to use, the upshot is in 2013, if left unaltered, the US consumer will have less discretionary income, and the Treasury won't spend as much as originally forecast, even if it will still run a massive deficit.

Plenty of people are worried sick about this. What will happen to the US economy IF Washington enacts Draconian austerity measures? Now is NOT the time to embark on fiscal prudence, what with the economy stagnating and everything? Right? Well, you can never fully predict the future, but we can look at the past. What have we gotten for all the debt Washington has assumed on our behalf?

The numbers I am about to describe are only one way of looking at the data. Some scholarly types might take issue with the math and the logic. However, I think it more than fair to wonder: "just what has all this fiscal stimulus generated?" In truth, the question begs a doctorate level thesis, as opposed to a 3-page free, vaguely economic newsletter. So, there are my caveats; here is the skinny.

In nominal terms, the US economy was $15.319 trillion at the end of 2011. It was valued at $14.755 trillion at the end of 2010. That is an increase of $564 billion. Bet that kind of surprises you, huh? Who knew things were that good? How did we get there? How did we finance that growth?

Well, loans & leases on the books of commercial banks in the US, according the Fed's H.8 report, grew to $6.906 trillion in 2011 from $6.762 trillion in 2010. That is an increase of $144.3 billion, which looks pretty good. Hey, we turned $144.3 billion into $564 billion! I will make that trade and take that loan ALL day long! Leverage must be a very good thing!

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A national debt, if it is not excessive, will be to us a national blessing.

Alexander Hamilton

Something to Think About, *cont.*

But we should probably take into account the credit markets, including corporate, municipal and Federal agency debt (credit market instruments, i.e. bonds etc.), to get a better gauge of just how effective our leverage was. According to the Fed's L.1 table in its Z.1 report, credit market debt increased in 2011 from $53,397 trillion to $54,243 trillion….for an increase of $846.30 billion. Hmm.

So, between loans & leases on the books of banks AND credit market instruments, the US increased its debt load a tidy $989.60 billion in 2011. Then, we have the Federal government.

As you know, the Treasury borrowed a LOT of money in 2011, a lot, with most of it going straight onto the Federal Reserve's balance sheet AND to foreign holders. Focusing on just those two "lenders," how much did Washington go further into debt last year? Well, the Fed increased its balance sheet, with Treasury debt constituting more than the overall increase, some $505 billion last year. Foreign holders of US Treasuries? That amount increased from $4.436 trillion to $4.997 trillion, a $561 billion jump. Combined, these two entities helped finance at least $1.06 trillion in new US Treasury issuance. That is a lot of money.

So, if we add all this up, what do we get? Well, $1.061 trillion plus $989.6 billion equals $2.051 trillion. Hmm. That is a lot of additional leverage to generate $564 billion in GDP growth, isn't it?

Well, you have to remember perhaps not all debt results in immediate economic activity. Some of those private sector loans and credit instruments might lead to long-term wealth or security price appreciation. Hopefully, all of it would. Can we say that about US Treasury deficit spending? Particularly when the goal of any good stimulus package is immediate economic activity, right? Or at least relatively immediate?

So, let's take that $989.6 billion increase leverage, the bank loans and credit market debt, out of the equation, and focus solely on the US Treasury. Fair? Naw; I admit it, but the conclusion doesn't change all that much. Especially, considering the Russell 3000 Index (a broad market gauge) was up only 1.03% in 2011, including dividends, AND the S&P Case-Shiller –20 City Composite Home Price Index was DOWN 4.05% last year, you could reasonably argue all that private sector debt didn't create a lot of wealth last year, without even going to the trouble of sharpening my pencil.

So, again, the Fed financed at least $505 billion worth of US Treasury debt in 2011, and foreigners tacked on another $561 billion. All told, it would appear the Treasury spent around $1.198 trillion more than it brought in last year. On the flipside, income tax receipts went up $192.924 billion. Hmm.

So, for GDP growth of $564 billion and income tax receipts of an additional $193 billion, the US Treasury spent upwards of $1.198 trillion it didn't have, with the monetary authority and foreign investors accounting for 89%. If you were in the private sector; if you were pricing this loan; if you were underwriting it; if you were looking at things like IRR (internal rate of return); if you were looking at balance sheet fundamentals, if you were looking at this increase in debt on its own merits, as opposed to aesthetics, this, um, doesn't make a lot of sense. In fact, by private sector standards, this increase in debt stunk, as the borrower essentially ate the leverage, by that I mean consuming it with little to show for it.

Another way of looking at the effectiveness of public debt is its percentage of GDP. Did it go up? Did it go down? What is the trend? After all, we can borrow $100 trillion dollars, and I mean soak up every single currency unit of savings in the universe, but if our economy and wealth go up by, say, $125 trillion….take that leverage. However, if we borrow AND the GDP does NOT increase by the amount of the increase in leverage, that is a bad loan.

In 2011, US Treasury public debt outstanding as a percent of year-end GDP was 99.4%. In 2010, it was 95.1%. For kicks, it was 87.4% in 2009, and 76.0% in 2008. To be politically correct, in 2000, Clinton's last year, outstanding public debt was 56.9% of GDP. I guess you could argue, where the rubber meets the road, the US Treasury has NOT gotten a lot of bang for its buck(s) this century. It has borrowed and spent poorly.

For grins, in 1990, this percent was 55.3%. As mentioned in the previous paragraph, it was 56.9% ten years later. As such, it would appear the Treasury did a reasonable job borrowing money last decade EVEN as outstanding public debt INCREASED by around $2.4 trillion!

In essence, Washington has borrowed a ton of money over the last decade, plus a couple of years, with very little to show for it other than an increased debt load. Sure, you could argue things would be much worse IF Washington hadn't borrowed all that dough, and, you know, we could debate it until Doomsday and never really know. Sometimes, you have to take the mental gymnastics and theories out of the discussion and simply ask: "what in the [heck] have we gotten for our money?" The easy, simple, and obvious answer is: not much, if anything. We have consumed the leverage, and are in worse fiscal shape than we have been in quite literally generations. Is there any real argument to that?

In so many ways, we have financed consumption over the last decade, as opposed to true growth. The numbers are what the numbers are. This is NOT an effective use of leverage, no matter what Paul Krugman might say. Hey, I helped start a bank, so I am, technically, an entrepreneur, a business owner, and a banker. So, I have an opinion on this, and at least some insight.

So, someone in Washington, anyone, and I don't care their political party, demographic, taste in music, or favorite sports team, needs to step up and start thinking like a sane borrower...a business owner. What is the end aim? Is it increased economic activity? Or is it votes? For 12 years, it looks like it has been the later, and it has to change. Our economic future quite literally does depend on it.

In the end, leverage is neither a good or bad thing, on its own. It is the borrower which makes it either detrimental or beneficial. It is the borrower who decides whether to use it for consumption or growth. In the end, however, it is the lender who has to decide whether the borrower is a good credit risk, and since the Fed and foreigners have been financing the US Treasury, I think you know what domestic investors/lenders think about the US Treasury. Whew….the private sector funded roughly ONLY 11-12% of the Treasury's deficit last year? I mean what does that tell you? Either the private sector is out of cash, or it has lost faith in the Treasury to be productive with its money!

That is a scary thought, and makes the thought of even more debt to fuel basically consumption, as opposed to wealth generation, in my opinion, a bad thing.

Important Economic Releases

<table>
<tr><th>Release</th><th>Survey</th><th>Actual</th><th>Prior</th><th>Comments</th></tr>
<tr><td>Advance Retail Sales (June)</td><td>0.2%</td><td>-0.5%</td><td>-0.2%</td><td rowspan="11">The data this week was, um, not real vibrant. There were a couple of brighter spots, but, all in all, the reports confirmed what we already knew: the economy cooled a little during 2Q. I would hesitate before saying things completely fell apart or are falling apart; however, only Pollyanna could take a look at these releases and start singing “Happy Days Are Here Again.”

Still, I am of the opinion that, as blah as these numbers were/are, the Fed does NOT need to enter the mix with another round of quantitative easing. Its ammunition is running very low, and it needs to keep as much in reserve as is possible for a real emergency, as opposed to some moderately disappointing economic reports. By emergency, I mean another financial and credit crisis like we had in 2008.

In the meantime, the next couple of weeks are going to be about corporate earnings, and, thus far, the earnings season has gotten off to a decent start….not necessarily great, but much better than the alternative. Of course, things can change, but if they don’t, stocks will continue to offer reasonable relative value. Notice I used the word relative, as opposed to absolute. With growth what it is, it is incredibly difficult to forecast double digit returns for the remainder of the year, and any outperformance will and should be magnified.</td></tr>
<tr><td>Business Inventories (May)</td><td>0.2%</td><td>0.3%</td><td>0.3%</td></tr>
<tr><td>Consumer Price Index (June)</td><td>0.0%</td><td>0.0%</td><td>-0.3%</td></tr>
<tr><td>Total Net TIC Flows (May)</td><td>$41.3B</td><td>$55.0B</td><td>$27.2B</td></tr>
<tr><td>Industrial Production (June)</td><td>0.3%</td><td>0.4%</td><td>-0.2%</td></tr>
<tr><td>Capacity Utilization (June)</td><td>79.2%</td><td>78.9%</td><td>78.7%</td></tr>
<tr><td>Housing Starts (June)</td><td>745K</td><td>760K</td><td>711K</td></tr>
<tr><td>Initial Jobless Claims</td><td>365K</td><td>386K</td><td>352K</td></tr>
<tr><td>Philadelphia Fed (July)</td><td>-8.0</td><td>-12.9</td><td>-16.6</td></tr>
<tr><td>Existing Home Sales (June)</td><td>4.62M</td><td>4.37M</td><td>4.62M</td></tr>
<tr><td>Leading Indicators (June)</td><td>-0.1%</td><td>-0.3%</td><td>0.4%</td></tr>
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Tables & Data Points

STOCKS	**Dow Industrials**	**S&P 500**	**NASDAQ**	**Russell 2000**	**Nikkei 225 (¥)**	**DJ STOXX 50 (€) Price**
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
6/28/12	12,602.26	1,329.04	2,849.49	775.89	8,874.11	2,157.62
7/4/12	12,943.82	1,374.02	2,976.08	818.49	9,104.17	2,312.41
7/12/12	12,573.27	1,334.76	2,866.19	789.62	8,720.01	2,228.01
7/19/12	12,943.36	1,376.51	2,965.90	802.17	8,795.55	2,302.45

BONDS	**3-Mo UST**	**6-Mo UST**	**2-Yr. UST**	**5-Yr. UST**	**10-Yr. UST**	**30-Year UST**
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
6/28/12	0.08	0.16	0.30	0.69	1.58	2.68
7/4/12	0.08	0.15	0.30	0.70	1.63	2.74
7/12/12	0.10	0.15	0.26	0.62	1.48	2.56
7/19/12	0.08	0.13	0.22	0.61	1.51	2.61

OTHER	**Prime**	**Fed Funds**	**3-Month LIBOR**	**Gold/troy oz.**	**Oil—WIT/brl.**	**$/Euro**	**JPY/$**	**$/GBP**	**CAD/$**
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
6/28/12	3.25	0.25	0.46	1,550.40	77.69	1.244	79.45	1.552	1.033
7/4/12	3.25	0.25	0.46	1,621.80	87.66	1.253	79.88	1.559	1.013
7/12/12	3.25	0.25	0.46	1,565.30	86.08	1.220	79.31	1.543	1.019
7/19/12	3.25	0.25	0.45	1,580.40	92.66	1.228	78.59	1.573	1.007

Disclosure