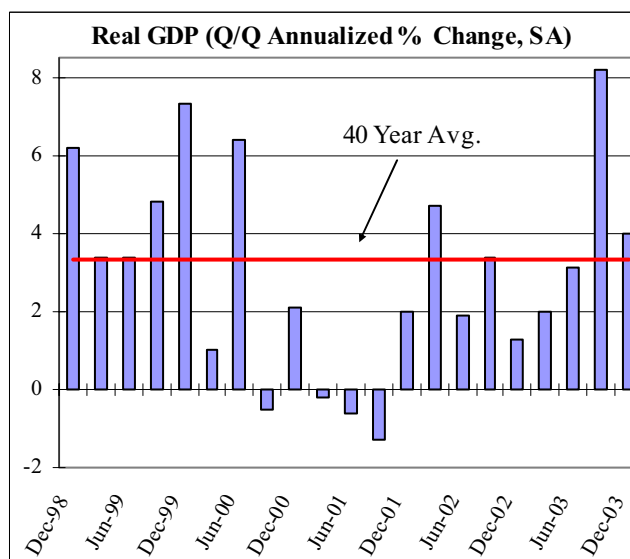


## Governmental Stimulus to the Rescue?

### Effects of Low Interest Rates, Liquidity and Deficit Spending

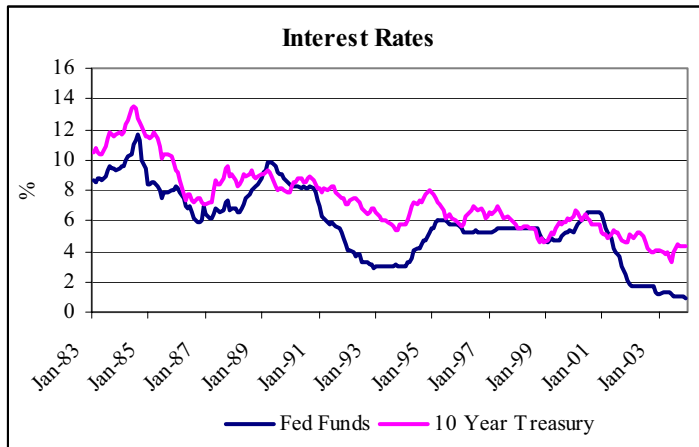
February 2004

We began 2003 with enormous levels of geopolitical and economic uncertainty. Abroad, the U.S. faced a potential war with Iraq and serious issues with North Korea. Domestically, deflationary concerns and a weak labor market, resulting from remaining excess capacity, caused fears of slipping back into a recession. Following three years of a declining stock market, the U.S. economy and capital markets appeared destined for a fourth consecutive year of difficulty. Fears were not assuaged during the first quarter of 2003. The Dow and S&P 500 indices declined by 4.1% and 3.5%, respectively, and the Nasdaq essentially remained flat. GDP growth for the quarter, at a mere 2.0% annual rate, was below the average rate expected by economists. Nevertheless, the year 2003 ended with the Dow, S&P 500 and Nasdaq posting gains of 25%, 26% and 50%, respectively, and annualized GDP growth rates increasing to 3.1% in the second quarter, 8.2% in the third and 4.0% in the fourth quarter. The cause of this turnaround was the largest economic intervention by the Federal government since the Great Depression.



In this *Industry Update*, we review the major economic events of last year and address the key factors that we believe will determine the economy's health in 2004. While the consumer sector, corporate sector, capital markets and real estate markets had varying degrees of impact on the economy throughout 2003, the most significant impact on the economy was made by the Federal government's intervention. Given its significance in 2003 and in order to help determine its relevance going forward, an analysis of the extent and nature of this intervention is warranted.

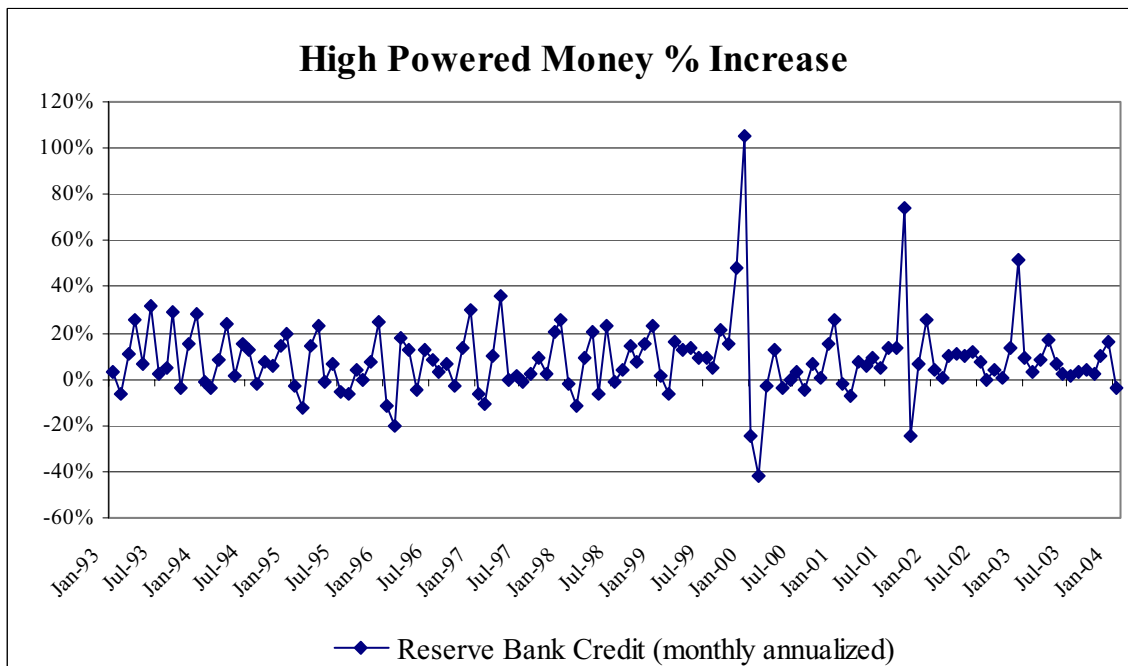
## 2001: THE STIMULUS BEGINS



The monetary stimulus supporting the 2003 rally actually began as far back as the beginning of 2001, when the Federal Reserve began reducing the target federal funds rate from its level of 6.5% at that time. By the end of 2001, a series of 11 cuts had reduced the rate to 1.75%. Despite this relatively low rate, economic growth was sluggish throughout 2002. With inflationary concerns being replaced by fears of deflation and the severe recession that deflation would bring,

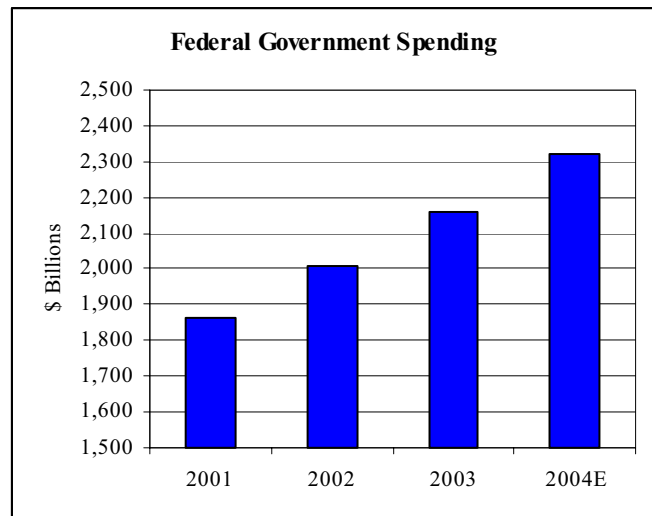
the Fed made a further 50 basis point reduction in November, 2002. One more cut in June, 2003, reduced the rate to its current level of 1.0%, resulting in 45-year lows for both short- and long-term interest rates.

Interest rate reductions were not the only monetary stimulus tool used by the Federal Reserve. Beginning in late 2002, the Fed began to balloon its own balance sheet, which is the “high powered money” that supports all other monetary aggregates. The Fed builds its balance sheet by purchasing Treasury securities through the capital markets, thereby injecting liquidity into the banking and capital market system, with the hopes of stimulating lending and capital market activity. As shown by the graph below, the Fed has taken such aggressive action only two other times in recent history, both of which involved unusual circumstances. The first began in August 1999 to address the concerns over Y2K, which played a key role in creating the tech and telecom bubble. The second was in response to the events of September 11, 2001.



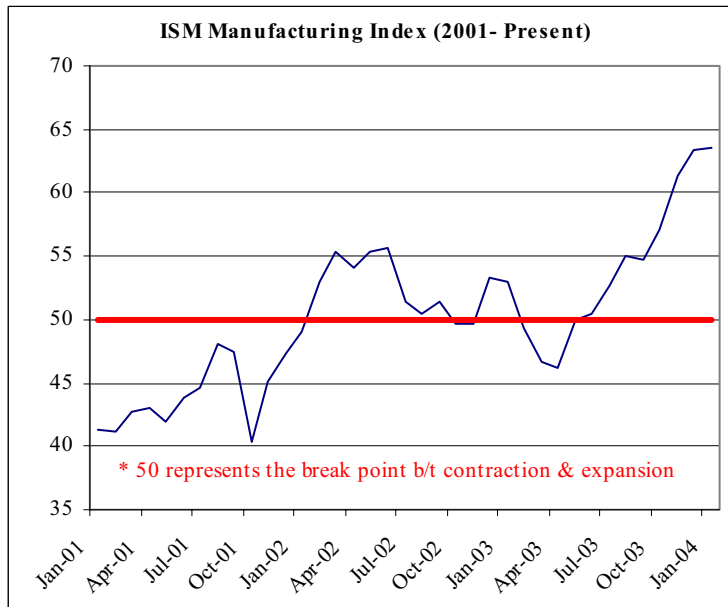
Adding to the unprecedented amount of stimulus by the Federal Reserve was the massive fiscal stimulus by the Federal government, which combined aggressive tax cuts with an explosion of governmental spending. This stimulus also began in 2001 with the first of two tax cuts. The second set of tax cuts, enacted in 2003, were the third largest in the history of this country, and also included advance payment of the increase in the child tax credit. This feature resulted in taxpayers receiving a total of approximately \$13 billion during the 3<sup>rd</sup> quarter of 2003 in the form of \$400 checks.

The government also provided additional fiscal stimulus through significant increases in spending. Total spending increases were \$148 billion and \$146 billion in fiscal years 2002 and 2003, respectively, and the increase for the current fiscal year 2004 is estimated at \$161 billion. As one would expect, discretionary spending on defense and homeland security accounted for a large portion of these spending increases. Not surprisingly, these spending increases, coupled with tax cuts, have resulted in budget deficits that have grown from \$158 billion in fiscal year 2002 to \$375 billion in fiscal year 2003, and an estimated \$521 billion in fiscal year 2004.



### **2003: THE STIMULUS TAKES HOLD**

The fact that fiscal and monetary stimulus measures begun in early 2001 did not seem to take hold until the second quarter of 2003 is a consequence of several dynamics. First, the excess capacity and debt built into the economy during the 1990s boom caused many to question whether the stimulus actions would gain traction at all, after watching Japan take similar measures and fail to prevent a deflationary cycle. Further, the timing of the stimulus effect was impacted due to unforeseen events. Under ordinary circumstances, the full effect of interest rate reductions is not realized for 12 to 18 months after the reductions are made, and tax cuts generally have little effect until the year following enactment. Based upon these suppositions, one would expect the 2001 interest rate reductions and tax cuts to have provided fuel for a solid recovery to begin in mid to late 2002. Forestalling this effect were unusual circumstances that began with the numerous financial scandals – e.g., WorldCom – that erupted in the summer of 2002. By the time concerns relating to these scandals began to subside, they were replaced by war concerns that began to build after the U.S. called for a forced change of the Iraqi regime in September 2002. During the period that war concerns continued to build and prevent any substantive economic recovery, the effects of the fiscal and monetary stimulus were building. As a result, with the end of major combat operations in Iraq in May, 2003, the stimulus was finally able to gain traction, resulting in the broad rally seen in the latter half of the year.



Effects of the stimulus taking hold in 2003 could be seen in nearly every segment of the economy. As mentioned earlier, GDP growth was strong in the third and fourth quarters, and equity values for nearly every industry appreciated significantly during the second half of the year. The battered manufacturing industry even experienced an uplift during the year, as evidenced by the Institute for Supply Management's Manufacturing Index that rose from a low 46.2 in April to 63.4 in December.

For the third time in three consecutive years, the largest refinancing boom in the country's history was also experienced during the summer months, and the tax refund checks that followed in the third quarter provided another boost. This further spurred consumer spending and helped improve credit conditions, at least temporarily, as evidenced by a downward trend in the level of nonperforming assets for publicly traded banks and thrifts to an average of less than 1% of assets. In light of these positive developments, it is no surprise that the Conference Board's Consumer Confidence Index ended the year at 91.7, significantly above the year's low of 61.4 recorded at the end of the first quarter.

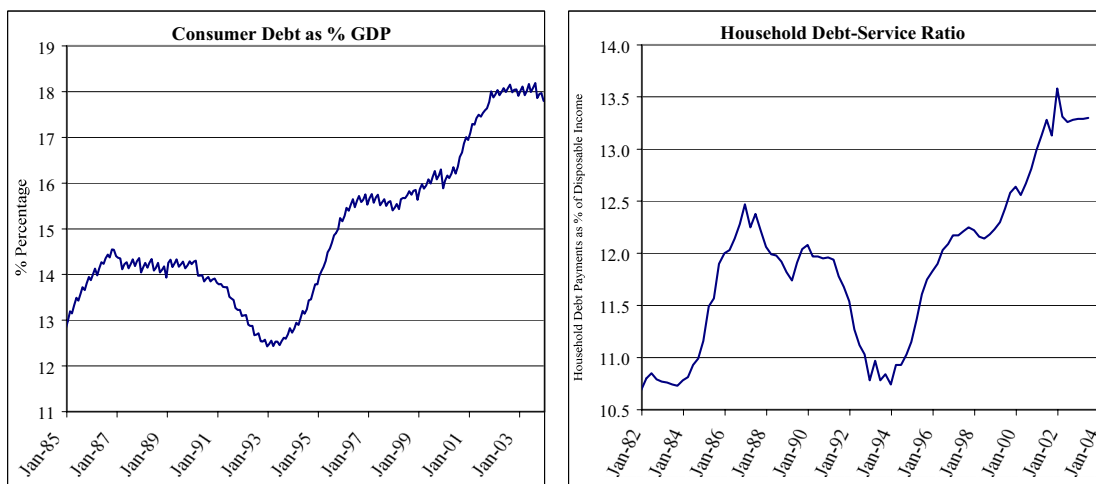
Not every aspect of this recovery is positive, however, as some factors indicate the rally of 2003 was driven primarily by excess liquidity and that fundamental improvements necessary for sustained economic growth are lacking. Unlike the economic recovery period of 1992 through 1995 that was led by the business community at a time when the Federal government was increasing taxes and trying to reduce spending, this recovery is clearly being driven by the Federal government, which is cause for great concern. While the government stimulus has resulted in rising equity and property prices, lower interest rates, the printing of dollars and extremely high budget deficit spending contributed to the dollar's significant fall during 2003 against most major currencies. Improving trends in credit conditions may be somewhat temporary if due primarily to the refinancing of poorer quality credits, as credit problems typically do not resurface until at least 12 to 18 months after refinancing. Furthermore, the most recent recession failed to wring out certain excesses to the extent necessary for a healthy, sustained recovery. Once government stimulus begins to dissipate, the economy is likely to face significant headwinds caused by these remaining excesses.

While a multitude of factors can influence the economy at any given time, those that bear the most significance on its overall direction warrant the most in-depth analyses. Therefore, in order to help determine the prospects for 2004 and beyond, it is most important to examine the key issues within the consumer, real estate, corporate, capital markets, and government sectors.

## CONSUMER SECTOR

The strength of the consumer going forward is, in our opinion, the area of deepest concern. Consumer confidence, a key component to any economic recovery, is currently quite high, but the historically fickle nature of consumer attitude dictates that reliance upon this indicator should be limited.

Consumer spending, which held the economy intact from 2001 through 2003, continues to be a major force in this recovery, and the spending continues to be financed primarily through debt. Household debt increased 10.8% last year, largely the result of a record refinancing boom, and the personal savings rate remaining around a mere 2%. Because of GDP growth and low interest rates, the level of consumer debt as a percentage of GDP and the Household Debt Service Burden remained flat from the last two years. However, both are still near historical highs, which is particularly disturbing in light of the current 45-year low interest rate environment. With short-term interest rates having collapsed from 6.5% to 1%, the Household Debt Service Burden should have declined significantly during this time period.

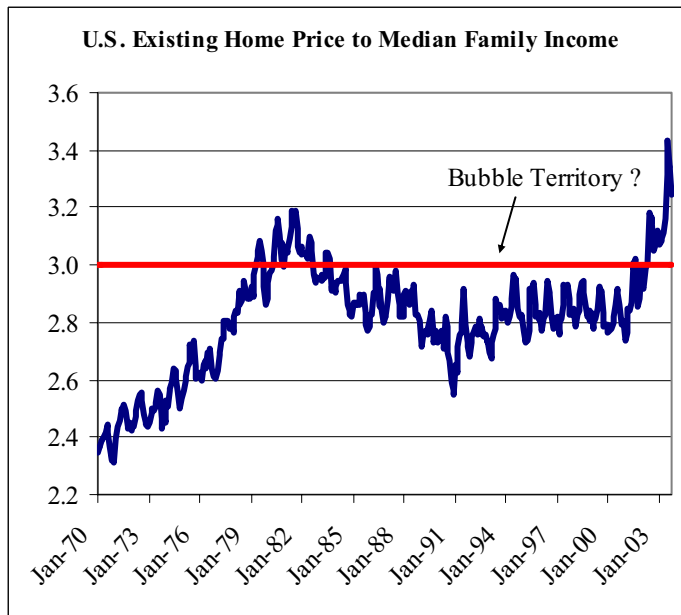


As long as rates remain at these historically low levels, consumers appear able to service the current level of debt, based upon a downward trend in the level of nonperforming assets for banks and thrifts. However, this high level of total debt causes severe sensitivity to any increase in interest rates, and the ability of consumers to continue borrowing to finance spending is likely to decrease.

Adding to the concern of consumer debt levels is continued weakness in the labor markets. The year ended with an unemployment rate of 5.7% in December, down from the 6.0% level in December 2002. A significant portion of this decrease, however, resulted from discouraged workers withdrawing from the labor force after an extended period of unemployment. Initial jobless claim numbers trended downward in 2003 but remained at more than 350,000 per week for most of the year (any number over 350,000 is typically indicative of contraction in the labor markets). Continuing claims were also high, remaining well above 3 million throughout the year. Without significant improvement in the labor markets, consumer spending is likely to contract and consumer credit conditions are likely to deteriorate.

## REAL ESTATE SECTOR

The real estate sector, especially residential, has also provided meaningful stimulus as a result of 45-year-low interest rates. As addressed in our December 2003 *Industry Update*, housing has experienced record appreciation and sales over the last five years, which has spurred a large portion of consumer spending. However, other trends and conditions indicate that trouble may lie ahead for the housing market. Despite home values that have been rising to record levels, average owners' equity in their homes has been declining to record lows. Since the early 1980s, when the overall level of owners' equity reached a near-term high of 70%, owners' equity has steadily declined – reaching an all-time low of 54% in 2003. Furthermore, the median home value across the U.S. has increased to almost 3.4x the median family income, far surpassing the previous peak reached in the early 1980s (which was an aberration due to extraordinarily high long-term interest rates), and 18% higher than the average level that existed for most of the 1990s. As detailed in our December 2003 *Industry Update*, prices are now at or near what many would consider bubble levels in many major metropolitan areas and along the coasts, and even a slight increase in interest rates may have a substantial, negative impact on housing prices.

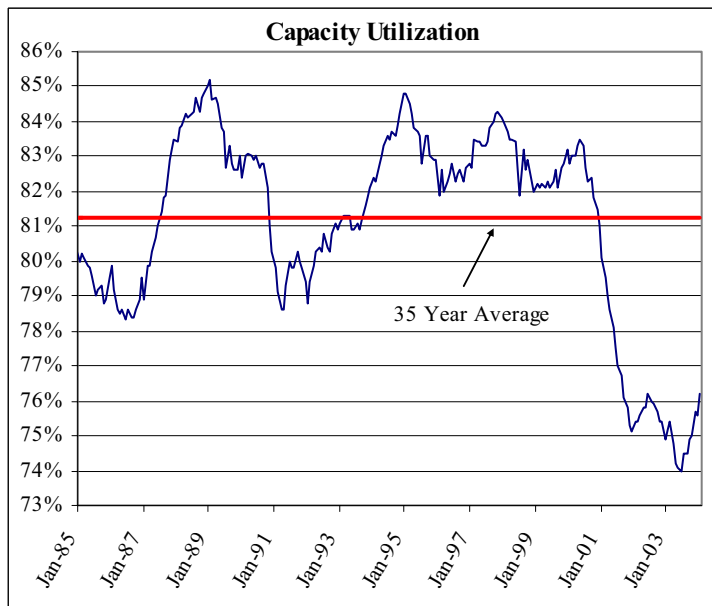
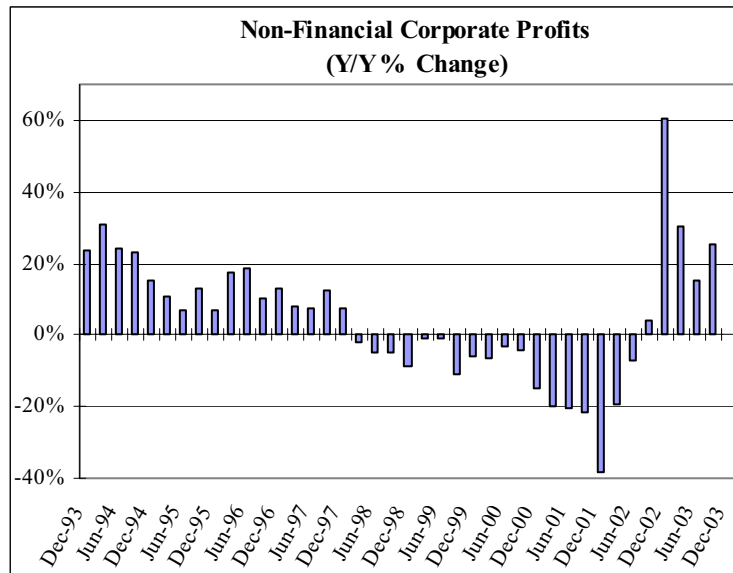


The commercial real estate market has also seen distortion as a result of the current interest rate environment. A disconnect between the earning power and the valuation of most commercial properties has occurred. Commercial vacancy rates – 18.2% nationally, and much higher in several major markets – are approaching the highs seen during the real estate depression of the late 1980s and early 1990s. Nevertheless, property values remain high. Values are being propped up by lower financing costs that act as an offset to the reduction of income generated by these increasingly vacant properties, but this offset will quickly disappear in a rising interest rate environment. The risk posed by this situation, therefore, is the substantial decrease in values that is almost certain to occur if tenant demand does not build substantially before interest rates begin to rise.

## CORPORATE SECTOR

After suffering the brunt of the recession, the corporate sector is now far better positioned to drive economic growth. Low interest rates and ample liquidity have allowed corporations to refinance and reduce financing costs, which, combined with aggressive cost-cutting measures, has resulted in improved cash flows, profitability and balance sheet strength. Ordinarily, this would indicate that increases in capital expenditures and employment are forthcoming, but certain factors are working against this desired result. Since the improvement in

corporate profitability is due primarily to cost-cutting and a reduction in financing costs as opposed to strong top-line growth, the trend may be temporary and therefore not necessarily a sign that capital expenditures and employment will increase. U.S. businesses also face increased price competition from countries such as China and India, whose businesses have the advantage of low-cost labor and, because of the internet, the ability to sell goods worldwide on a productivity-adjusted basis. As a result, many U.S. corporations are shutting down domestic plants and operation centers and outsourcing those jobs to China and India.



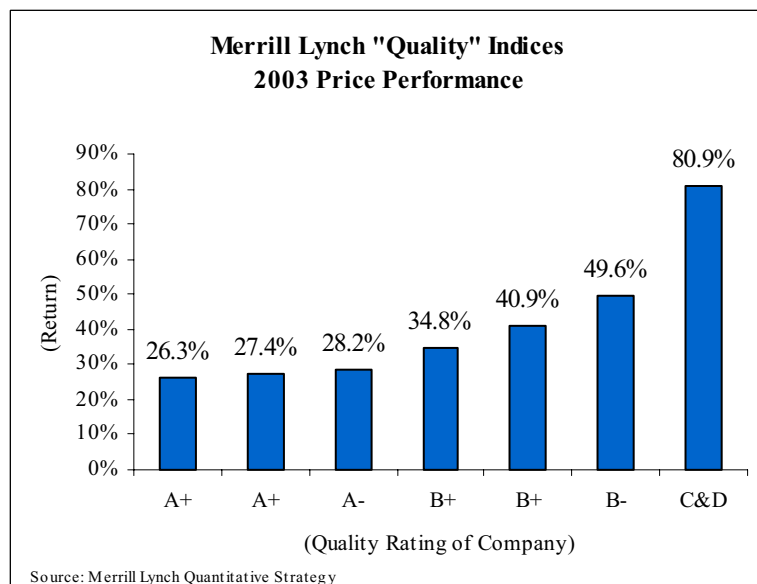
The other impediment to a near-term improvement in capital expenditures and employment levels is the capacity utilization rate. The capacity utilization rate, which measures the amount of production capacity actually being used, remains stubbornly low as the economy continues to struggle with the burden of excess capacity. This is in spite of a declining dollar that, theoretically, should have caused foreign markets to absorb some of the excess capacity. The collapse of businesses in sectors with excess capacity, which is a normal and essential component of economic recovery, simply has not occurred to the extent necessary.

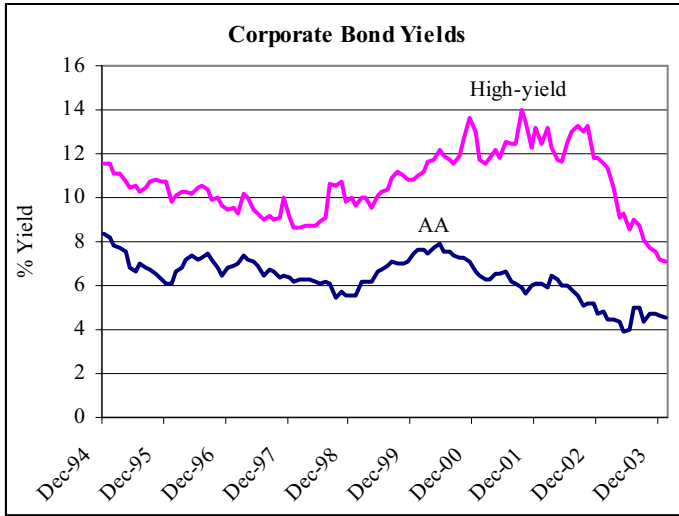
## CAPITAL MARKETS

The capital markets also enjoyed a very robust recovery during 2003, which has further helped to buoy the overall economy. The rise in the stock market has helped to strengthen the confidence of both consumers and corporate executives, stimulating increased consumer and capital expenditures and additional economic growth. In turn, this additional spending and economic growth has led to increased corporate profits and renewed investor confidence, which has led to a further rise in the stock market.

However, the shape and pace at which stock prices have risen is cause for some concern. Clearly, excess liquidity and low interest rates have played a major role in the recent rise in stock prices, fueling a significant amount of speculation in the markets that has resulted in a run-up in valuations that has far outpaced the improvement in fundamentals for much of the market. For example, the Nasdaq 100 Stock Index is now trading at over 53x trailing twelve months earnings, even after a substantial earnings improvement in 2003. This dynamic is very reminiscent of the liquidity driven rally, and ultimate bubble, experienced in 1999 and 2000, as excess liquidity and low interest rates have created distortions in valuations and a significant misallocation of capital. This is evidenced by the type and quality of companies that experienced the most significant rise in values during 2003.

In general, during the broad equity rally that occurred in 2003, the poorer the quality of a company, the higher the degree of stock price appreciation. For example, while C- and D-rated companies with high betas have recently experienced the highest levels of appreciation, the A-, AA-, and AAA-rated companies have experienced some of the lowest levels of appreciation. This phenomenon is purely speculative and can primarily be attributed to the abnormally low interest rate environment and excess liquidity in the markets described above.



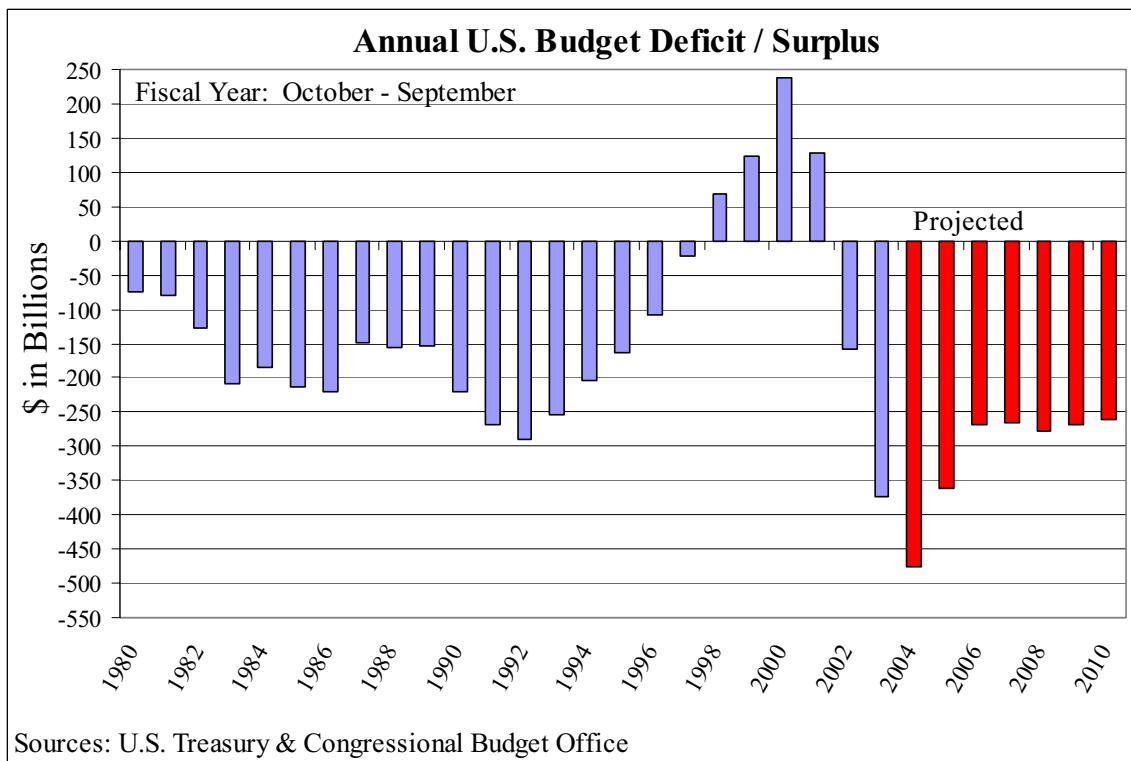


Another effect of the stimulus was a narrowing of corporate bond spreads. Low interest rates, combined with an increasing belief that the economic recovery was on solid footing, made financing easier to obtain for all companies. While this was an intended and desired effect, excess liquidity has resulted in corporate bond spreads narrowing to an extent that does not properly reflect the risk of lesser-rated credits, which may lead to significant capital loss if credit conditions worsen. Furthermore, given that most C- and D-rated companies operate in market

segments with excess capacity, the continued flow of capital into these areas is likely to worsen excess capacity problems.

### GOVERNMENTAL STIMULUS

The federal budget deficit is another critical factor to consider when assessing economic growth prospects. After a brief period of surpluses at the beginning of this decade, the federal budget has reverted to massive deficit spending with substantial deficits projected for the remainder of this decade. Sizeable deficits were experienced in the 1980s, as well; however, current demographics make the projected level of deficit spending much more dangerous. In the 1980s,



the largest segment of the U.S. workforce – the baby-boom generation – was comprised of people in their late teens to early 30s. With the retirement of that generation set to begin in just seven years, a massive fiscal burden is looming, as entitlement spending – e.g., Social Security and Medicare – will explode at the same time that the ratio of workers to retirees will fall substantially. Waiting to address this imbalance will only exacerbate the problem and require drastic fiscal adjustments, most likely in the form of massive tax increases and/or cuts in entitlement benefits.

Another risk caused by deficit spending is the dependence upon foreign capital. The large federal budget deficits, combined with the low rates of U.S. private saving, create a need to attract savings from abroad to finance domestic spending and investment activities. The governments of China and Japan have recently become major financiers of the U.S. economy, buying nearly 50% of all new issuances by the U.S. Treasury during 2003, in order to mitigate the dollar's recent declines against their own currencies. While Japan was motivated by the U.S. being its largest export market, China had the additional motivation of its currency peg to the dollar. Regardless of motivation, the purchase of U.S. Treasury securities by foreign central banks has helped U.S. interest rates remain low even with a weakening dollar and extremely high deficit spending. Unfortunately, this activity has lessened the Federal Reserve's ability to control long-term interest rates. Even a reduction in the buying of U.S. debt by these foreign central banks is certain to cause mid- to long-term interest rates to increase, which is also likely to result in consumer credit deterioration, decreased consumer spending and slower economic growth.

## **OUTLOOK FOR 2004**

As evidenced by the review of the various sectors above, asset values and the U.S. economy have become reliant upon incredibly low interest rates. Thus, interest rates and growth in the labor markets are the two key factors that will determine the economic landscape in 2004. Certain foreign economies, namely China, India and Japan, will have a major influence on the direction of U.S. interest rates and labor growth throughout this year. Growth in these economies results in an increase of wealth for their large populations, which ultimately increases demand for goods and, thereby, benefits the global economy. However, these countries also create significant pressures on the U.S. labor market. The continued outsourcing of jobs to foreign countries at a rate equal to or faster than the U.S. economy is producing new jobs will place downward pressure on wage growth and create considerable strain on the labor markets. These stresses, combined with the already high level of consumer debt, could result in a significant decline in consumer spending that would undermine economic growth prospects.

The fact that the Federal Reserve has used up most of its ammunition to stimulate economic growth through the 13 rate cuts to date is especially concerning in light of the current valuation of equities and real estate, the two largest asset classes in the U.S. economy. Equity prices, especially those for poorly performing companies, have increased to levels that cannot be supported by fundamental valuation methods. High commercial real estate values are being propped up by low interest rates, and several signs indicate that housing values in many areas are in bubble territory. This situation is considerably more risky than the conditions faced in 2000 when the overvaluation was limited to the three sectors of technology, biotechnology and

telecommunications, and the Federal Reserve had considerable leverage with a federal funds rate of 6.5%. Today, overvaluations exist across many sectors of the equity markets ***and*** in real estate values, and the Federal Reserve has exhausted its stimulus arsenal. Thus, if there is any break in asset values from these heightened levels, the fall could be quite pronounced and have a severe recessionary effect on the economy. These factors, along with the risk of any geopolitical or economic shock, place the current economy in a very precarious position.

The Federal government and the Federal Reserve, in particular, will undoubtedly be as proactive as possible in promoting economic growth throughout 2004 and beyond. The upcoming Presidential election almost guarantees that the Bush administration will continue pushing stimulus measures, and any aggressive action with respect to interest rates by the Federal Reserve is considered unlikely. Therefore, in the absence of any shock, the continued effects of government stimulus will likely allow the economy to stay intact and remain on its recovery path for most of 2004. Hopefully, the economy will become healthy enough during the year to grow without the aid of additional stimulus, inasmuch as it is very likely that the effectiveness of the existing stimulus will begin to diminish by year-end.

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