

E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & James Bruss
DATE: July 30, 2009
SUBJECT: Is Banking Back?

Stupid question, sort of. As we all know, banking never left. But for about six months from last September through early March, the market treated banks like they were going the way of the dodo. Bank stocks were battered and brutalized as the world economy stood on the precipice (or, as the case may be, as we were *told* the world economy stood on the precipice). From September 19, 2008 (the Friday after Lehman Bros. went down) through March 9, 2009 (the end of the six-month skid) the S&P 500 lost 46%. Bank stocks were pummeled mercilessly and the SNL Bank & Thrift index lost 74%! Small banks fared better, but that is a relative term: the SNL Bank \$1B-\$5B index lost 61% and the NASDAQ Bank index lost 58% in that period.

Those who stuck around to see the wreckage have been rewarded—to some extent. The SNL Bank & Thrift index, weighted heavily by large cap stocks, has climbed more than 100% from March 9; the SNL Bank \$1B-\$5B index has increased 41%. Still, bank stock prices are well off their highs from 2006.

We have been contemplating the future of banking over the last several months and while we can't yet recognize its future form in all details, there are certain themes and trends we expect to play a role. We hope our thoughts on those subjects over the next several months are timely and useful.

We are constantly reminded of the headwinds banks and the economy face. Among the strongest is the worsening unemployment rate. Indeed, this is a serious obstacle for banks. Unemployment levels could blunt attempts to stabilize residential real estate credit losses or, worse, could prevent the bottom that appears to be taking shape in residential real estate. Unemployment will likely cause further stress in other areas of consumer lending as well, including credit card debt and auto loans. Finally, commercial real estate (CRE) and commercial and industrial (C&I) lending will suffer as consumers face reductions in hours and job losses, resulting in the need to trim personal debt and spending.

But while banks will continue to experience pain, well-positioned banks can begin to flourish in this environment with the necessary cost reductions, new sources of income (whether from fees or interest income as rates begin to normalize), and lessened competition (as a result of consolidation, failures, and fewer *de novos*). The market knows this and has historically led the way.

One cliché that often meets news of rising unemployment is that employment figures are a lagging economic indicator. It's a cliché because it's true. In the nasty double-recession of the early 1980s, high unemployment lingered after the economy had bottomed. Our last two recessions saw the economy pull out of its decline even as unemployment continued to rise:

Early 1980s – Two recessions occurred in quick succession in the early 1980s, the second of which was more severe. January 1980 was designated by the National Bureau of Economic Research (NBER – the official arbiter of business cycle dating) as the peak before the first of these two recessions. In November 1982, the economy bottomed, ending the second recession. Unemployment, which had been as low as 5.6% in May 1979, spiked up to 10.8% by the last two months of 1982.

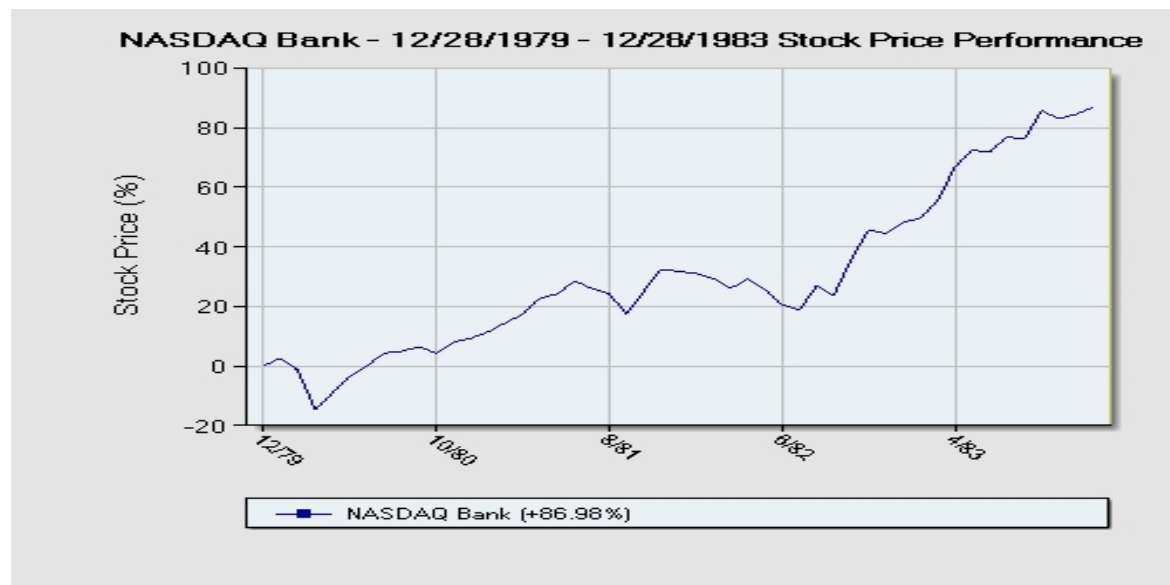
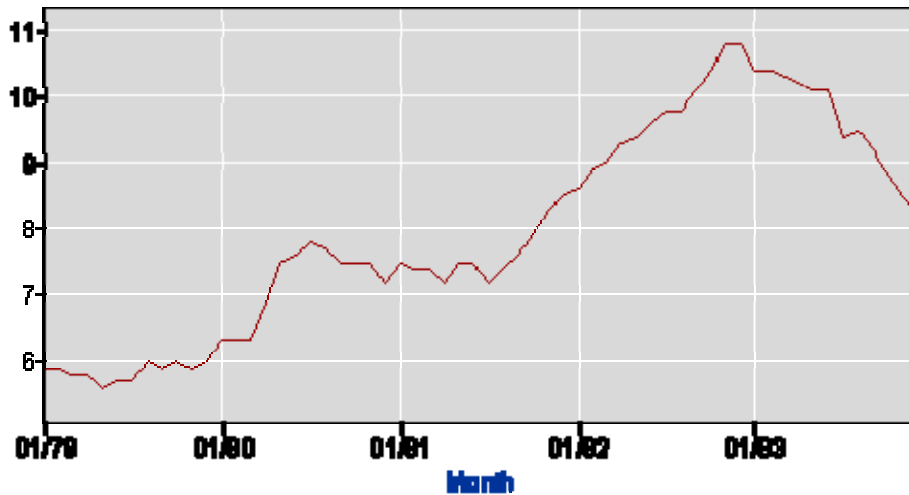
Early 1990s – July 1990 was the peak before the recession of the early 1990s. In March of 1991, the economy bottomed. But unemployment, which found its low at 5.5% in June of 1990 according to the Bureau of Labor Statistics (BLS), peaked at 7.8% in June of 1992—15 months after the end of the recession.

2001 – The milder recession of 2001 followed a similar trend. Unemployment reached a low of 3.9% in the fall of 2000. The economy peaked in March 2001 and bottomed in November 2001. But unemployment continued apace until June of 2003, when it peaked at 6.3%.

As Ed Yardeni pointed out in his Morning Briefing yesterday, the Consumer Confidence Index and Consumer Sentiment Index, both of which fell off in the last couple months, are correlated to employment levels. This is perfectly understandable as losing one's job has a tendency to dampen one's mood. But it's also instructive in that these indices can lag behind economic recovery, just as employment levels do. In fact, in the recessions of the early 1990s and 2001, the Consumer Confidence Index did not begin to recover until a year after the recessions ended.

So unemployment and consumer confidence statistics lag behind economic recoveries? So what, you ask? It's relevant because economic recoveries usually lag behind recoveries in bank stocks. Looking at the same periods from the perspective of the financial markets, one can see that bank stocks recover long before employment does. Compare the following graphs:

Unemployment Rate (%) January 1979 through December 1983 (Source: Bureau of Labor Statistics)

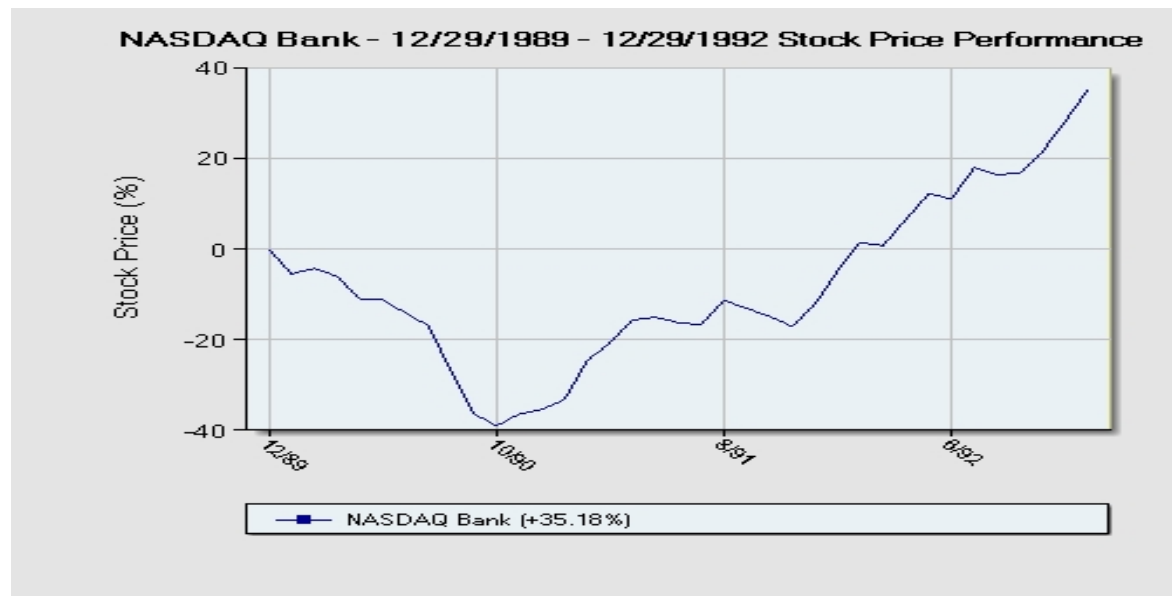
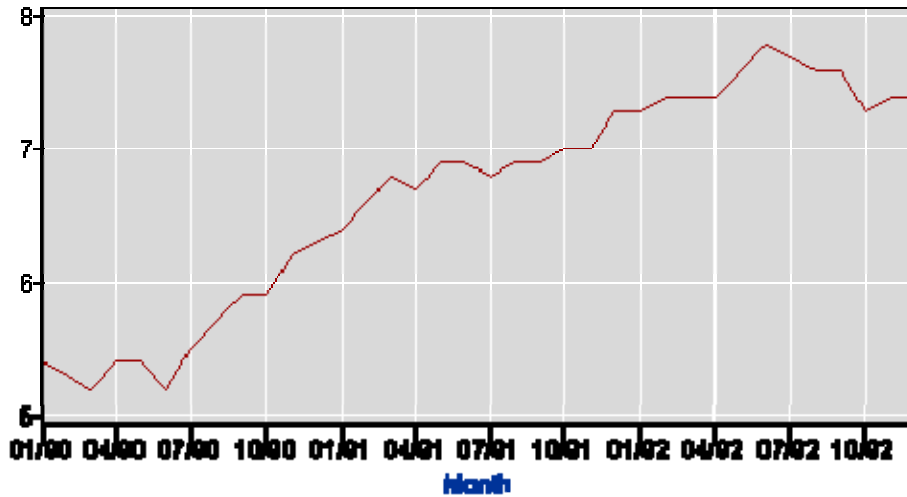


(Source: SNL Financial, LC)

The NASDAQ Bank index jumped off its low in early 1980, and exploded upward long before unemployment peaked in late 1983.

In the early 1990s, the market for bank stocks similarly recovered long before the labor market did.

Unemployment Rate (%) January 1990 through December 1992 (Source: Bureau of Labor Statistics)

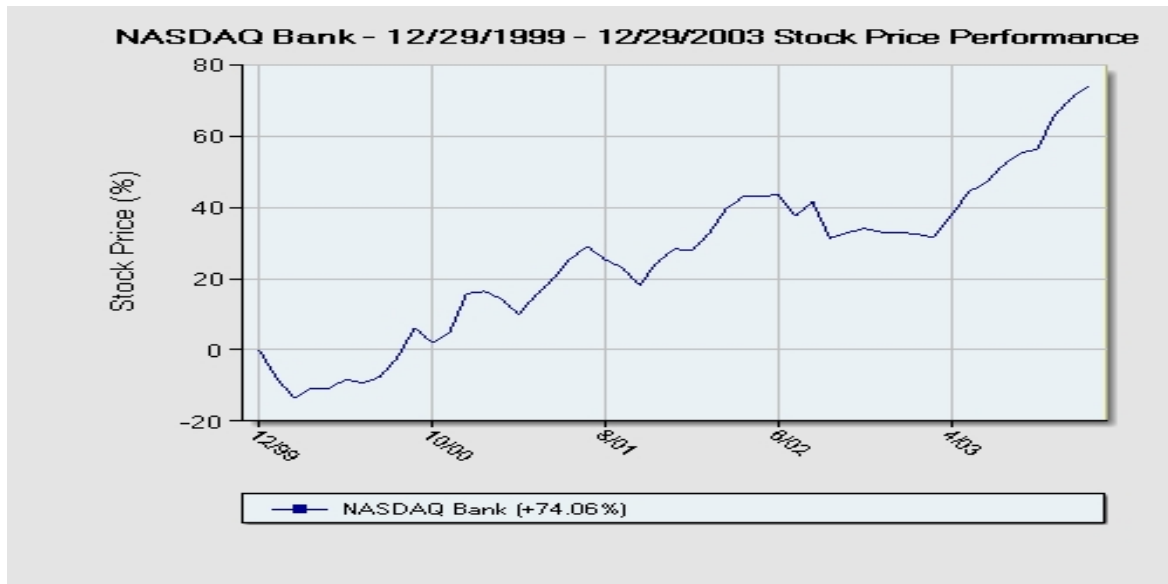
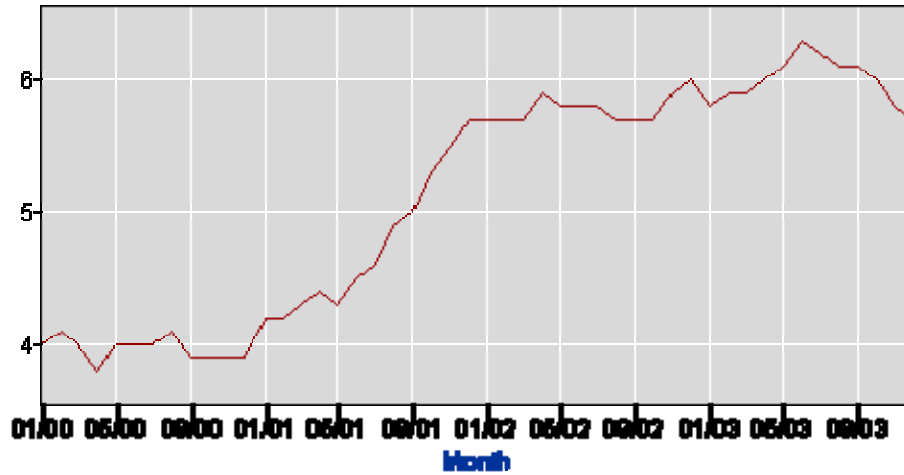


(Source: SNL Financial, LC)

By the time the financial markets are hatching a recovery, the unemployment rate is just beginning to take off. In fact, from their lows in late October of 1990, the markets rebounded quite dramatically before the unemployment rate began to taper off in June of 1992. During that 20-month period alone, the SNL Bank & Thrift index was up 115%, the SNL Bank \$1B-\$5B index gained 92%, and the NASDAQ Bank index rose 82%; the S&P 500 was up a mere 35%.

The 2001 recession experienced a very similar dynamic:

Unemployment Rate (%) January 2000 through December 2003 (Source: Bureau of Labor Statistics)

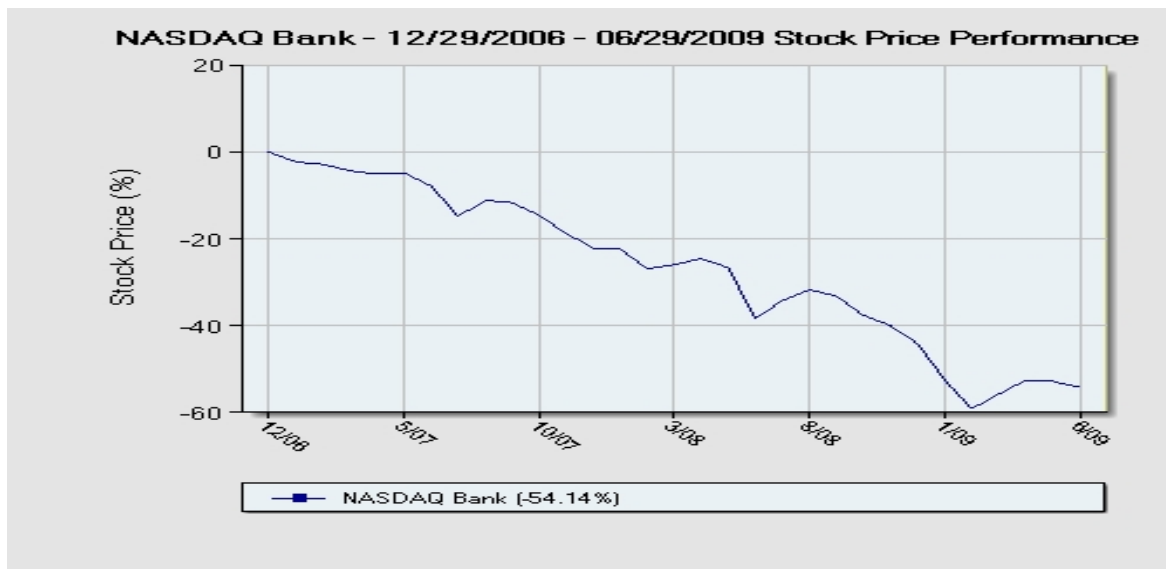
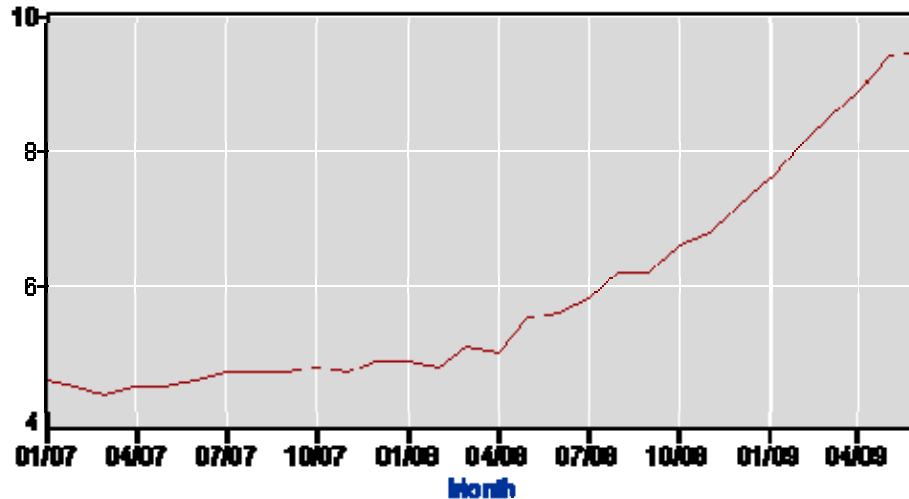


(Source: SNL Financial, LC)

While the S&P 500 continued to suffer after the recession ended, bank stocks recovered more quickly, with small banks leading the way. But even viewing the market from lows in October 2002 (almost a year after the end of the recession) through the peak of unemployment in June 2003, bank stocks performed extremely well. Small banks built on 2001 gains as the SNL Bank \$1B-\$5B and NASDAQ Bank indices added another 22% during that 9-month period, while the SNL Bank & Thrift index gained 37%.

How does the current recession measure up? According to NBER, the recession started in December 2007. Unemployment reached a low of 4.4% in March 2007; in June of this year it was up to a nasty 9.5%. Meanwhile, the financial markets have begun to recover even as the unemployment rate accelerates upward.

Unemployment Rate (%) January 2007 through June 2009 (Source: Bureau of Labor Statistics)



(Source: SNL Financial, LC)

The familiar trend from the last three recessions appears to be redeveloping. While banks have rebounded dramatically since March, they have a long way to go. We are cautious in our optimism, because we recognize the severity of the current recession may mean a longer and less potent recovery. Indeed, we are told daily this one is different. Yes, but they all are. Yet in many ways they are similar. As surely as we must face the facts that make today's recession unique, we must take into account the history of prior recessions.

We are confident banks that survive the maelstrom will emerge on the other side more secure, more efficient, and more resourceful. As banks begin to see loan delinquencies and losses decline, and earnings normalize, this industry will once again claim its rightful roles as the key driver of the economy and of successful investors' portfolios. Investors will be rewarded for their confidence in that fact.

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