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Growth, Innovation and Leadership eBulletin

A quarterly eBulletin from the people who bring you the Growth, Innovation and Leadership Global Congress on Corporate Growth

June 2008 Vol 1/Issue 2

Financial Services Industry Outlook: Challenges and Opportunities in May 2008

By **Clare Walker**
Consultant
Business & Financial Services
Frost & Sullivan

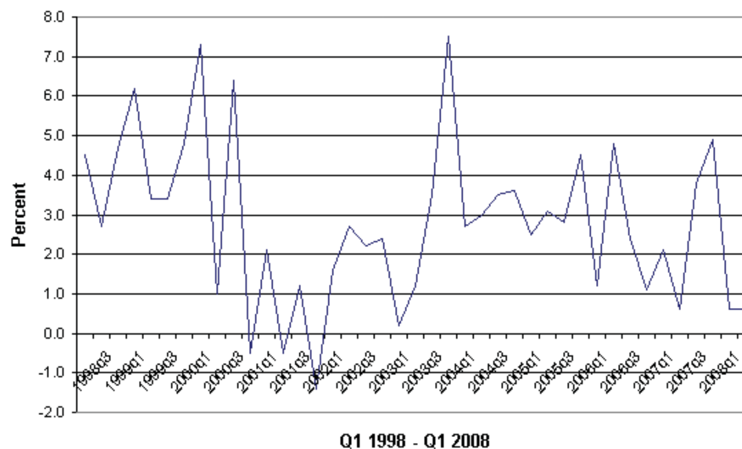
The Current U.S. Economic Outlook

The U.S. economy has been experiencing a period of turbulence brought on by the declines in the housing market, the subprime mortgage crisis, and the subsequent debilitating credit crunch. There has been incredible volatility in the global markets, including the plummet of the European and Asian markets in January; global markets have seen losses of more than $5 trillion this year. The U.S. markets have been volatile as well; with the Dow, S&P 500, and NASDAQ all dropping since the beginning of the year. March brought significant changes; the financial sector was rocked when Bear Stearns neared collapse before drastic moves by the federal government ensured that did not happen and altered the financial services landscape. As things change almost daily, the full effects of this move will be played out over weeks and months. Declining economic indicators and even more announcements of major losses at banks suggest the U.S. might be heading into the first recession since 2001, although this continues to be debated by economists. Fundamentally, however, the market seems to be pricing as a recession and investors have been taking advantage, providing some buoyancy in the markets for the last few months.

Economic Fundamentals

While the Gross Domestic Product (GDP) is still rising, the rate of growth decreased to 0.6% in Q4 2007 after an increase of 4.9% in Q3 2007 (Chart 1). Though a recession remains uncertain and debatable, the slowdown in growth to near stagnation is a major concern. The most recently released information was for Q1 2008, and the GDP growth rate remained at 0.6%, staving off some worries about further decline.

Chart 1
GDP Percent Change from Preceding Quarter
Q1 1998 - Q1 2008



Source: Bureau of Economic Analysis

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There is also evidence that the labor market is softening, corporate spending is slowing, and consumer confidence is declining. In fact, consumer spending outpaced GDP growth over the past ten years at a rate of 3.6% vs. 2.9%; this difference is possibly unsustainable and we are likely facing a period of retrenchment and belt-tightening. The surge in price of energy, food and gold will also play parts in the continuing U.S. economic woes.

Now that the Fed has moved to make momentous changes in the financial industry by lending to and bailing out Wall Street firms, however, it is possible that we have seen the worst of the credit and financial crisis. The weak U.S. dollar is actually helping businesses by increasing foreign exports; and economic indicators such as real money supply and manufacturers' new orders for consumer goods and materials were positive at the end of February, signaling a possible overall stabilization of the economy.

The Federal Reserve's Response

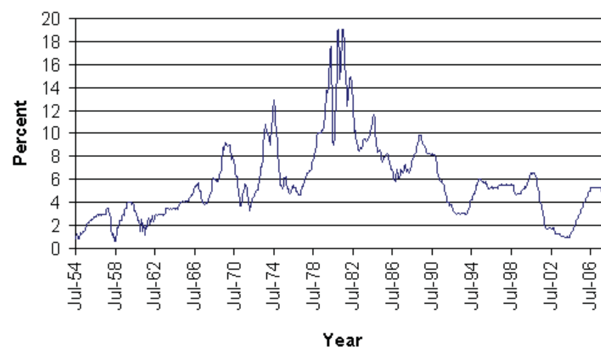
In response to what it has called a "weakening of the economic outlook and increasing downside risks to growth," the Federal Reserve has cut interest rates six times since September 18, 2007. After meeting again most recently on March 18, 2008, they cut rates once more by ¾ of a point, bringing the federal funds rate down to 2.25% – the lowest it has been since 2004.

Subsequent to the rate cuts in March, the Fed made several unprecedented decisions. The first was to bail out Bear Stearns from its liquidity emergency and agreeing to take on $30 billion in securities for J.P. Morgan in order to get the deal done, which involved J.P. Morgan's purchase of almost 40% of Bear shares at $2 each. The price J.P. Morgan will pay has since been increased to $10 per share as of March 24 – one week after the original deal was made.

The Fed also decided to lend money to other investment banks, providing a significant source of needed funds. It also allowed Fannie Mae and Freddie Mac to increase its investments in U.S. mortgages by $200 billion, giving the mortgage market a lift. This represents a huge turn of events, and though questions remain regarding what kind of implications this will all have going forward for government involvement in the markets, this seems to have had a positive effect thus far. These initial moves predicated another major overhaul to regulations announced on April 1, with the intention being prevention of future catastrophes, including consolidating bank regulation, creating a new type of insurance charter, improving the oversight of mortgage lending and increasing transparency for the Fed.

Historically, the Fed had the limited portfolio of protecting depositors in commercial banks and influencing the money supply. This is the first time the Fed has interceded in the investment banking industry to this extent. It is practical then to now expect the pendulum of regulation to swing back. There has been a post-regulatory environment in finance for some time, at least since the repeal of Glass-Steagall of 1933. It is likely that regulations will now tighten; consider, for example, the regulatory response to Enron, which was Sarbanes-Oxley. It follows that there will be a regulatory reaction to the current situation.

Chart 2
Monthly Effective Federal Funds Rate
July 1954 - April 2008



Source: Board of Governors of the Federal Reserve System

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The Weakened Financial Services Industry

The financial services industry has been heavily impacted by the subprime mortgage crisis, itself brought on by the bursting housing bubble that began in 2006. It has been suggested that the Fed contributed to the housing bubble by keeping rates too low for too long after the recession of 2001, leading to easy borrowing. This, combined with the low inflation rates and strong growth in the economy, propelled financial institutions to look for and take on risk in the influx of collateralized debt obligations (CDOs) backed by mortgage-backed securities (MBS). However, as the housing market dropped, the default rates on subprime and Adjusted Rate Mortgages (ARMs) to risky borrowers increased, leading to defaults and foreclosures. The mortgage lenders were impacted first, but the losses soon extended to others holding mortgage-backed securities and other derivatives related to securitized debt. Major banks and other financial institutions have reported losses of over $280 billion between the middle of last year and the end of April 2008; and many speculate losses could spiral upwards of $500 billion.

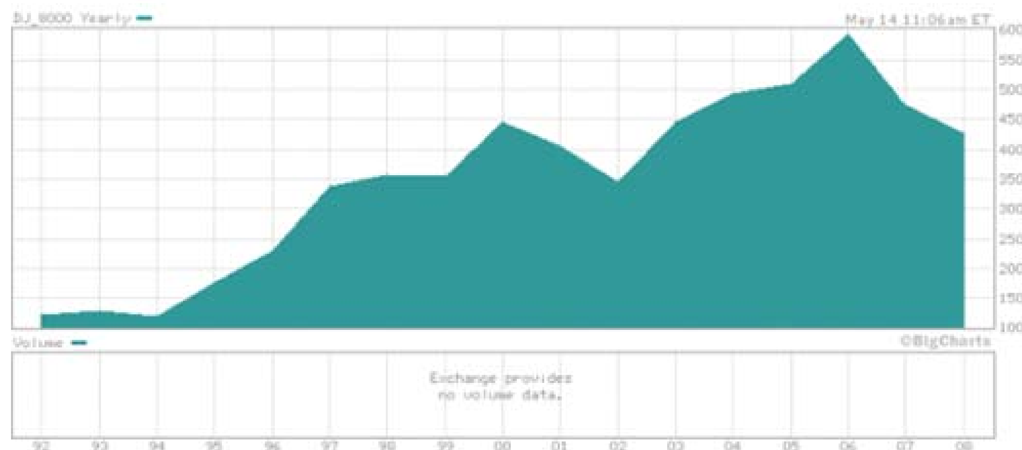
The market is still reeling from the sale of Bear Stearns as well. The credit crunch has the potential to damage the economy further; banks will likely become increasingly cautious about lending to one another as so much uncertainty still surrounds which other institutions will be hit and the exact extent of subprime losses. The lack of liquidity that Bear was facing was crippling; as of March 13, its cash position was down to $2 billion, which was going to force a bankruptcy protection filing if a last-minute loan did not come through.

The Importance of Perspective

It is crucial to keep the current economic environment in perspective, and to realize that while there are certainly negative indicators, the U.S. economy is technically not yet in a recession. The Fed's rate cuts and bailout along with the government's fiscal stimulus package will help, but to what extent remains to be seen. Anxiety over many uncertainties surrounding the subprime crisis is affecting the markets, and as the extent of the losses and who is incurring them becomes clearer, some of this should subside.

It is important to keep in mind the financial services industry has experienced incredible growth over the past decade (Chart 5). The Dow Jones US Financial Index – which is made up of 178 banks, financial services and insurance companies – peaked in 2006 at almost 600. Moreover, historically, financial services companies have rebounded within the 12-18 months following a recessionary period, boding well for **2009**.

Chart 5
Dow Jones US Financials Index Performance
January 1992 - May 2008



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