



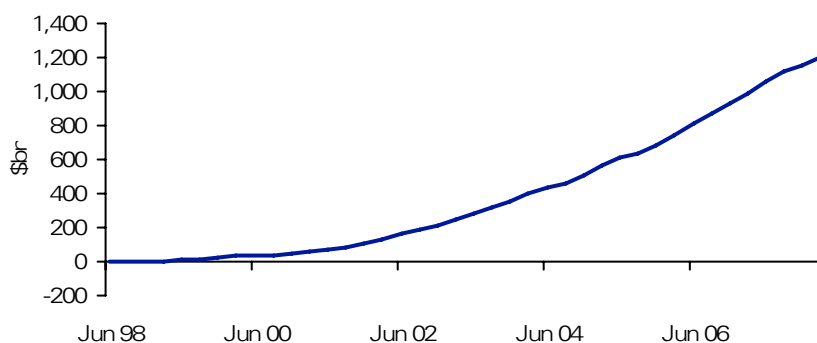
15 July 2008

The Thoughts of Jim Reid

A Trillion-Dollar Mean Reversion?

The chart that we have spent most time discussing over the last 12 months is our oft-published time series of US financial vs non-financial profits. We rerepublish it in this note (Figure 2 overleaf) but today the main event is a chart derived from this data showing how much, in dollar terms, US financial profits have deviated from the mean over the past decade on a cumulative basis. When you track financial profits in Figure 2 there is a definite point in the late 1990s where earnings start their eventual exponential march upwards for the next decade. The source of the data is the US GDP numbers so it won't exactly track how the equity market reports profits but the trend should be the same over time. Figure 1 then calculates how much "excess profits" in dollar terms have been made by the sector on a cumulative basis since 1998 over and above the growth in nominal GDP.

Figure 1: Cumulative "excess profits" of US financials over the last 10 years



Source: Deutsche Bank

The chart suggests that the US Financial sector has made around 1.2 Trillion (\$1,200bn) of "excess" profits in the last decade relative to nominal GDP. Clearly one may take the view that in a Globalised world we should look at Global GDP. There is some truth in this but it would not have a substantial impact on the numbers.

So mean reversion would suggest that \$1.2 trillion of profits need to be wiped out before the US financial sector can be cleansed of the excesses of the last decade. Clearly this is too extreme if you believe that the financial sector has seen a sustainable structural change in its business model over the last decade or that it

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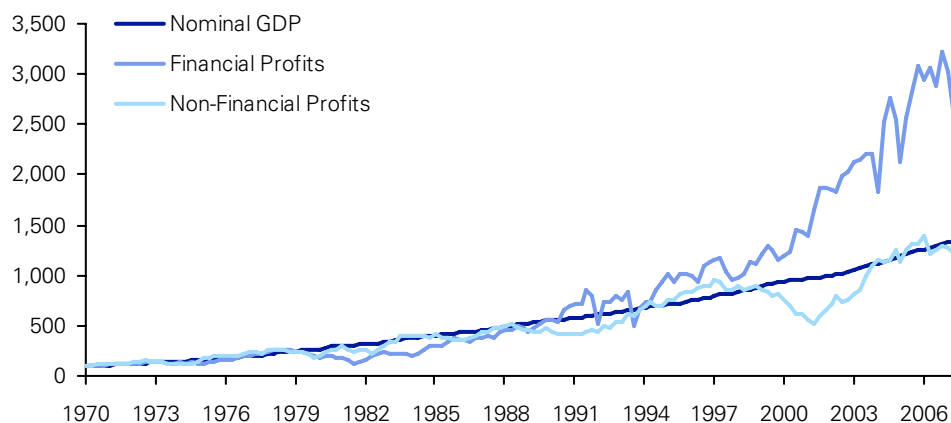
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is uniquely positioned to exploit strong Global growth. Sectors do change/grow in importance over time and if you believe that financials should be a larger share of the economy now than in 1998 then you need to allow for this. However, this is the kind of argument that has helped lead to this credit crisis. The financial sector has grown rapidly over the past decade, has embraced high leverage, and we've also seen a shadow banking system emerge that didn't really exist a decade or so ago. Calculating the "natural" appropriate size for the financial sector relative to the rest of the economy is a phenomenally difficult conundrum. The overall financial sector made up just over 2% of US GDP in the late 1940s and is now at c.8% and only just off the highs.

Given that the WDCI function on Bloomberg reports that \$184bn has been written down by US financials so far in this crisis, if one believes that the size of the financial sector should shrink to levels seen a decade ago then one could come to the conclusion that there is another trillion dollars of value destruction to go in the sector before we're back to the long-run trend in financial profits. A scary thought and one that if correct will lead to a long period of constant intervention from the authorities in an attempt to arrest this potential destruction. Finding the appropriate size of the financial sector in the "new world" will be key to how much profit destruction there needs to be in the sector going forward.

Figure 2: US nominal GDP vs financial and non-financial profits (rebased to 100, 1970)



Source: Deutsche Bank, Bureau of Economic Analysis

Appendix 1

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