Deutsche Bank

15 July 2008

The Thoughts of Jim Reid

A Trillion-Dollar Mean Reversion?

Credit Strategy

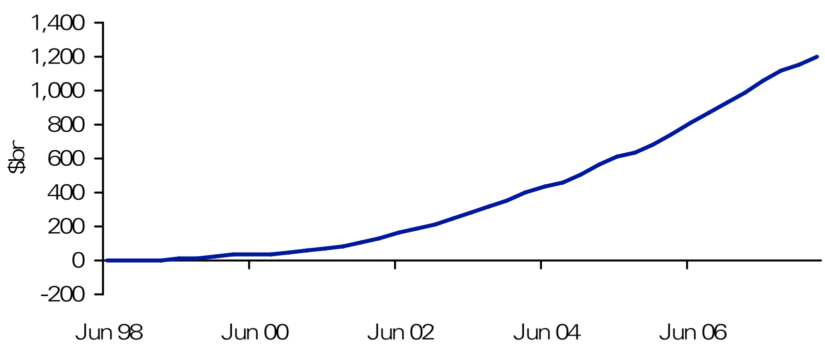
Research Team

Jim Reid
Strategist
(+44) 20 754-72943
jim.reid@db.com

Nick Burns, CFA
Strategist
(+44) 20 754-71970
nick.burns@db.com

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



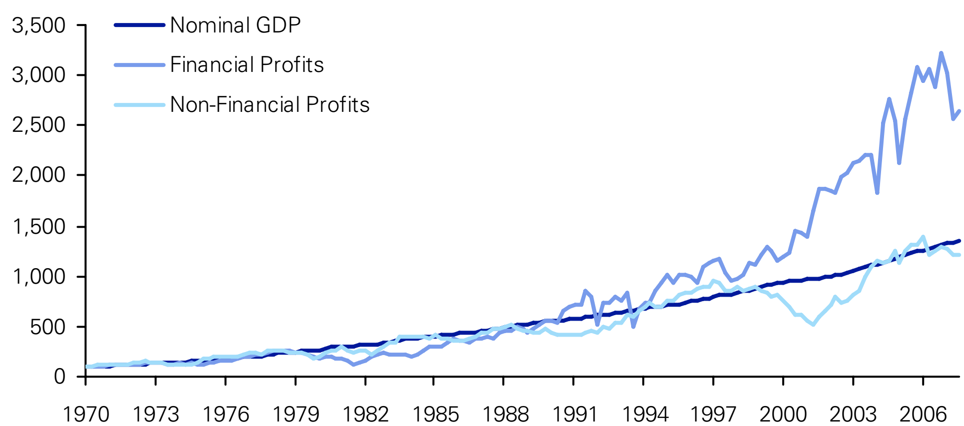
Source: Deutsche Bank

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 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 their 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

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Jim Reid

Regulatory Disclosures

SOLAR Disclosure

For select companies, Deutsche Bank equity research analysts may identify shorter-term trade opportunities that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. This information is made available only to Deutsche Bank clients, who may access it through the SOLAR stock list, which can be found at http://gm.db.com

Disclosures required by United States laws and regulations

See company-specific disclosures above for any of the following disclosures required for covered companies referred to in this report: acting as a financial advisor, manager or co-manager in a pending transaction; 1% or other ownership; compensation for certain services; types of client relationships; managed/comanaged public offerings in prior periods; directorships; market making and/or specialist role.

The following are additional required disclosures:

Ownership and Material Conflicts of Interest: DBSI prohibits its analysts, persons reporting to analysts and members of their households from owning securities of any company in the analyst's area of coverage.

Analyst compensation: Analysts are paid in part based on the profitability of DBSI, which includes investment banking revenues.

Analyst as Officer or Director: DBSI policy prohibits its analysts, persons reporting to analysts or members of their households from serving as an officer, director, advisory board member or employee of any company in the analyst's area of coverage.

Distribution of ratings: See the distribution of ratings disclosure above.

Price Chart: See the price chart, with changes of ratings and price targets in prior periods, above, or, if electronic format or if with respect to multiple companies which are the subject of this report, on the DBSI website at http://gm.db.com.

Additional disclosures required under the laws and regulations of jurisdictions other than the United States

The following disclosures are those required by the jurisdiction indicated, in addition to those already made pursuant to United States laws and regulations.

Analyst compensation: Analysts are paid in part based on the profitability of Deutsche Bank AG and its affiliates, which includes investment banking revenues

Australia: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

EU: A general description of how Deutsche Bank AG identifies and manages conflicts of interest in Europe is contained in our public facing policy for managing conflicts of interest in connection with investment research.Disclosures relating to the firm's obligations under MiFiD can be found at http://globalmarkets.db.com/riskdisclosures.

Germany: See company-specific disclosures above for holdings of five percent or more of the share capital. In order to prevent or deal with conflicts of interests Deutsche Bank AG has implemented the necessary organisational procedures to comply with legal requirements and regulatory decrees. Adherence to these procedures is monitored by the Compliance-Department.

Hong Kong: See http://gm.db.com for company-specific disclosures required under Hong Kong regulations in connection with this research report. Disclosure #5 includes an associate of the research analyst. Disclosure #6, satisfies the disclosure of financial interests for the purposes of paragraph 16.5(a) of the SFC's Code of Conduct (the "Code"). The 1% or more interests is calculated as of the previous month end. Disclosures #7 and #8 combined satisfy the SFC requirement under paragraph 16.5(d) of the Code to disclose an investment banking relationship.

Japan: See company-specific disclosures as to any applicable disclosures required by Japanese stock exchanges, the Japanese Securities Dealers Association or the Japanese Securities Finance Company.

Disclosures under the Financial Instruments and Exchange Law

Company name: Deutsche Securities Inc.

Registration number: Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No.117

Member of associations: Japan Securities Dealers Association (JSDA), The Financial Futures Association of Japan

This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation.

New Zealand: This research is not intended for, and should not be given to, "members of the public" within the meaning of the New Zealand Securities Markets Act 1988.

Russia: The information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a licence in the Russian Federation.

South Africa: Publisher: Deutsche Securities (Pty) Ltd, 3 Exchange Square, 87 Maude Street, Sandton, 2196, South Africa. Author: As referred to on the front cover. All rights reserved. When quoting, please cite Deutsche Securities Research as the source.

Turkey: The information, interpretation and advice submitted herein are not in the context of an investment consultancy service. Investment consultancy services are provided by brokerage firms, portfolio management companies and banks that are not authorized to accept deposits through an investment consultancy agreement to be entered into such corporations and their clients. The interpretation and advices herein are submitted on the basis of personal opinion of the relevant interpreters and consultants. Such opinion may not fit your financial situation and your profit/risk preferences. Accordingly, investment decisions solely based on the information herein may not result in expected outcomes.

United Kingdom: Persons who would be categorized as private customers in the United Kingdom, as such term is defined in the rules of the Financial Services Authority, should read this research in conjunction with prior Deutsche Bank AG research on the companies which are the subject of this research. Disclosures relating to the firm's obligations under MiFiD can be found at http://globalmarkets.db.com/riskdisclosures.

David Folkerts-Landau

Managing Director

Global Head of Research

	Global Company Research	Global Fixed Income Strategies & Economics
Stuart Parkinson Chief Operating Officer	Guy Ashton Global Head	Marcel Cassard Global Head

Europe	Germany	Asia-Pacific	Americas
Pascal Costantini Regional Head	Andreas Neubauer Regional Head	Michael Spencer Regional Head	Karen Weaver Regional Head

Principal Locations

Deutsche Bank AG
London
1 Great Winchester Street
London EC2N 2EQ
Tel: (44) 20 7545 8000

Deutsche Bank AG
New York
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

Deutsche Bank AG
Hong Kong
Cheung Kong Center,
2 Queen's Road Central
Hong Kong
Tel: (52) 2203 8888

Deutsche Bank AG
Japan
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6701

Deutsche Bank AG
Frankfurt
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 0

Deutsche Bank AG
Boston
225 Franklin Street
Boston, MA 02110
United States of America
Tel: (1) 617 988 8600

Deutsche Bank AG
Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Bank AG
Australia
Deutsche Bank Place, Level 16
Corner of Hunter & Phillip
Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

Subscribers to research via email receive their electronic publication on average 1-2 working days earlier than the printed version.

If you would like to receive this or any other product via email please contact your usual Deutsche Bank representative.

Publication Address:
Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
(44) 20 7545 8000

Internet:
http://gmr.db.com
Ask your usual contact for a username and password.

Global Disclaimer