

2007 Special Report: U.S. Banking — 2nd-Quarter Interest Review

Inflation Concerns Push Yield Curve Toward Normal Slope

After a year under water, the U.S. Treasury yield curve has resumed a normal, positive slope, with long-term yields higher than short-term yields. As viewed using six-month and 10-year Treasury securities, the yield curve turned negative June 2, 2006, nearly four weeks in advance of the Federal Reserve's June 29 final tightening action of the last interest-rate cycle.

In the year that has followed, credit-market sentiment has gyrated around when the Fed might begin to ease in order to stimulate a flagging economy. Following the sequence of numbered curves in the accompanying graph provides a sense of how variable expectations have been. As suggested in the *2007 Special Report—U.S. Banking: 1st-Quarter Interest Review*, "... consensus forecasts of a looming Fed easing remain at risk of being frustrated." Those expectations now have been frustrated, at least temporarily, as credit-market sentiment in the past month has shifted focus to inflation concerns and toward accelerating instead of slowing economic activity.

Despite the market's mood swings, the underlying fundamentals have changed little in the past quarter, and new expectations of a looming Fed tightening also may be frustrated in the months ahead, unless circumstances beyond its control force the U.S. central bank to act.

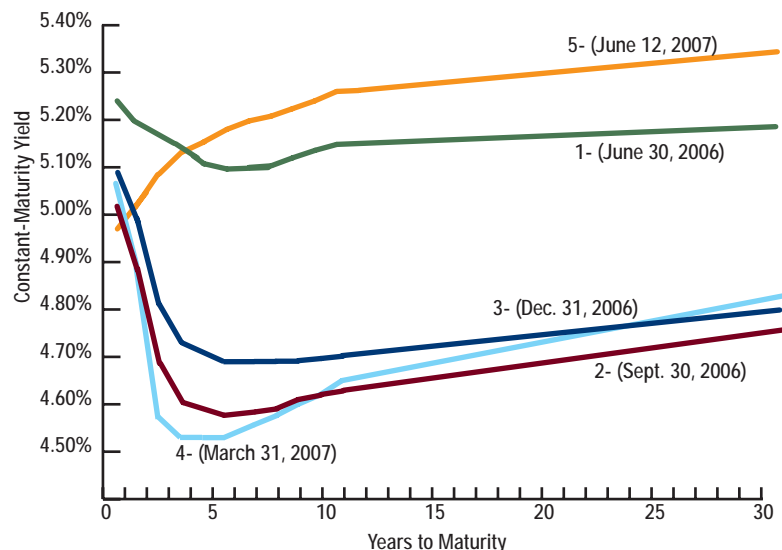
Economic growth slowed to a near halt in the first quarter of 2007, based on current reporting of the gross domestic product. Although some in the markets anticipate an economic rebound, the U.S. economy rarely changes direction quickly, and such shifts normally are foreshadowed by parallel movement in leading indicators. Since the more reliable indicators have not turned to the upside, risk

is high that recent strength seen in some May data may be just fleeting aberrations of unusual weather or seasonal factors. Renewed reporting of a downturn in business activity could quickly fuel renewed speculation of Fed easing.

Inflation, however, remains strong and appears likely to persist for the near term. Unfortunately from the Fed's standpoint, current inflation is driven largely by distortions in commodity prices (i.e., cartel-influenced oil and drought-impacted food). That means current inflation would not respond easily or quickly to higher interest rates, while at the same time higher rates would tend to soften economic activity further. Raising interest rates is more effective in combating higher prices when strong economic demand drives the price increases.

An ongoing conflict between a soft economy and rising inflation remains a good bet to hold Fed policy in check for a while. Beyond

Treasury Yield Curve, Quarters-Ended June 2006 to June 2007*



* June 2007 as of June 12.

Source: Federal Reserve Board.

This report was written by Khanh Vuong, assistant vice president, and John Williams, senior business analyst, with the A.M. Best Co.



economic activity and inflation, the Fed's concerns center on maintaining orderly and liquid financial markets. Accordingly, the upside risk to Fed interest rate policy remains the U.S. dollar. With the U.S. markets so heavily dependent on foreign capital for liquidity, heavy selling pressure against the greenback could trigger a defensive rate hike by the Fed. The downside risk to Fed interest rate targets remains any systemic liquidity crisis that might evolve from any number of factors. These include market distortions created by problems from nontraditional loan underwriting, as already has started to surface in the subprime, adjustable-rate lending market.

In any event, the positively sloped yield curve likely will hold for the near future. While it is not clear what portion of the banking industry was positioned to take advantage of the recent relative gain in longer-term versus shorter-term interest rates, the positively sloped yield curve offers banks a more comfortable and standard pricing environment for the future. As discussed in the *2007 Special Report — U.S. Banking Issues: Loan Margin Pressures Collide with Rising Credit Costs*, the recent negatively sloped yield curve was a factor in compressing net interest margins industrywide.

A.M. Best Co.

Special Report

June 25, 2007

PUBLISHER, PRESIDENT AND CHAIRMAN
Arthur Snyder

EXECUTIVE VICE PRESIDENT/CHIEF OPERATING OFFICER
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

GROUP VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty

PRODUCTION
Thomas Dawson IV, Associate Editor
Joanna Herren, Senior Designer

Copyright © 2007 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site www.ambest.com.

Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of \$ 7,500 to \$ 500,000.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.



A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
www.ambest.com

A.M. Best Europe Ltd.
12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44-20)-7626-6264
Fax: (44-20)-7-626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.
Unit 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852)-2827-3400
Fax: (852)-2824-1833
www.ambest.com.hk