WEALTH MANAGEMENT
MONITOR

THE PROVIDENT BANK | Wealth Management Group

Volume 2 Edition 4 | April 30, 2010

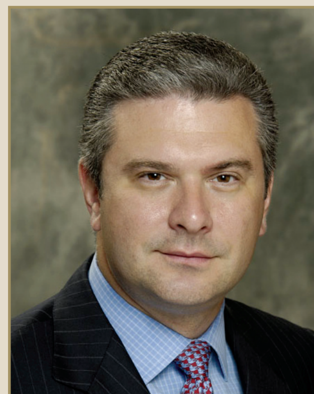
Economic Theme:
The New Bank Robbers

Our year-end Wealth Management Monitor, dated December 21, 2009, included a Bonus Comment section: Positive Consumer Spending in the Short-Run. We projected that current dollar Personal Consumption Expenditures (PCE) would experience growth of 1% for 4Q2009 and nearly 2% for 1Q2010, as contrasted with year-over-year declines each month from November 2008 to September 2009. In hindsight, while we managed to be directionally correct and detect an inflection point, the magnitude of improvement in PCE growth has exceeded our expectations by a fair margin. Preliminary PCE growth for 1Q2010 was recently reported as a nearly 4% year-over-year gain. This overshoot (relative to our expectations) is particularly perplexing when one considers factors such as the rather modest improvement in personal income gains, anemic signs of job growth, tight credit conditions, and weak housing prices. So, where is the "excess" spending coming from?

For starters, we can rule out personal income growth, which normally provides a good indication of how strong spending growth should be over time. This is proven by statistically correlating spending with income growth from 1Q2001 to 1Q2010. The correlation produces a 72% R-squared and, most interestingly, suggests that spending is about 2.5% or $250 billion stronger than indicated by income growth in recent quarters. If this analysis is anywhere close to reality, what's causing the disparity?

One explanation is what can be termed the "new bank robbers". These are individuals who continue to live in their homes during periods of serious delinquency, some stage of foreclosure, or strategic default. Further, these tend to be extended periods of mortgage relief – 14 months on average, according to Lending Processing Services, and up to 18 months in states such as New Jersey, according to Moody'sEconomy.com. While foreclosure and delinquencies should be familiar terms, strategic defaults are a fairly recent phenomenon. The term refers to individuals who stop paying their mortgages because the value of the mortgage exceeds the value of the house. The strategic default decision is growing in popularity. Recently-published research by the Kellogg School of Management at Northwestern University concludes that foreclosures perceived to be strategic rose from 22% in March 2009 to 31% in March 2010. The new bank robbers are aided by a slow foreclosure process, attributable in part to an overwhelmed legal and financial system and bank loan loss reserve implications in taking possession of the properties.

We have made rough calculations of how much excess cash is being generated through missed mortgage payments during foreclosure, delinquency and strategic default. We believe the number approximates $100 billion or 40% of the $250 billion in excess spending. This assumes that most of the excess cash is being spent, a notion that is supported by savings rate data, as described below.



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Between the end of 2009 and February of this year, the savings rate has gone from 4% to 3%, a decline of 25%. In dollar terms, the decrease in savings represents another $100 billion or 40% of excess spending. The recent acceleration in government transfer payments, such as extended unemployment benefits (nearly two years), conceivably account for some of the remaining 20% of excess spending. Transfer payments now represent 18% of personal income.

The point of this exercise is to point out the magnitude and likely sources of risks to consumer spending growth going forward. The timing of any negative impact is difficult to gauge, especially as mortgage relief will likely intensify in the short run as foreclosures, delinquencies and strategic defaults rise. Eventually, however, consumer spending could flatten out or decline as mortgage relief is curtailed, and the savings rate heads toward zero.

Return Expectations

The S&P 500 return has met expectations anticipated in our last Wealth Management Monitor. A further decline in corporate credit spreads and positive earnings surprises have supported the move to a recent high of 1217. Corporate credit spreads have about met our target, suggesting the risk trade may be nearing an end. We view re-regulation of the financial sector as an intermediate-term risk. Both equities and bonds will likely be range bound in the near term. In recent weeks, bond yields have spiked on supply concerns and then rallied as liquidity remains ample.

ASSET ALLOCATION RECOMMENDATION

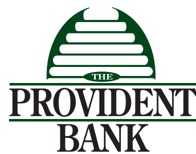
We have not changed our asset allocation strategy during the past month. We remain overweight domestic equities and underweight domestic and international bonds. We are also overweight convertible bonds, preferred equity and MLPs in the alternative asset category. The following chart contains previous, current and benchmark allocations for the balanced strategy:

Provident Balanced Strategy
Previous/Current Allocation vs. Benchmark Allocation (February 19, 2010)

Category	Asset Class	Previous	Current	Benchmark
Alternatives (11%)	Global Real Return Bonds	3%	3%	4%
	MLPs	0%	2%	1%
	Preferred Equity	0%	2%	1%
	Convertible Bonds	0%	2%	1%
	Gold	2%	2%	2%
Equities (39%)	Emerging Markets	6%	5%	5%
	International Equity	13%	13%	13%
	Domestic Equity	18%	21%	19%
Fixed Income/Cash (50%)	Cash	12%	6%	4%
	Domestic Real Return Bonds	5%	5%	6%
	International Bonds	10%	8%	11%
	Short-Term Credit	0%	2%	0%
	Short-Term Treasury Bonds	0%	2%	0%
	Domestic Bonds	31%	27%	33%

MARKET CLOSES

S&P 500 Index: 1186.69	**Dow Jones Industrial Average**: 11,008.61	**10-Year Treasury Yield**: 3.66%



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