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RISK MANAGEMENT

Could Housing's Recovery Go Parabolic in 2013?

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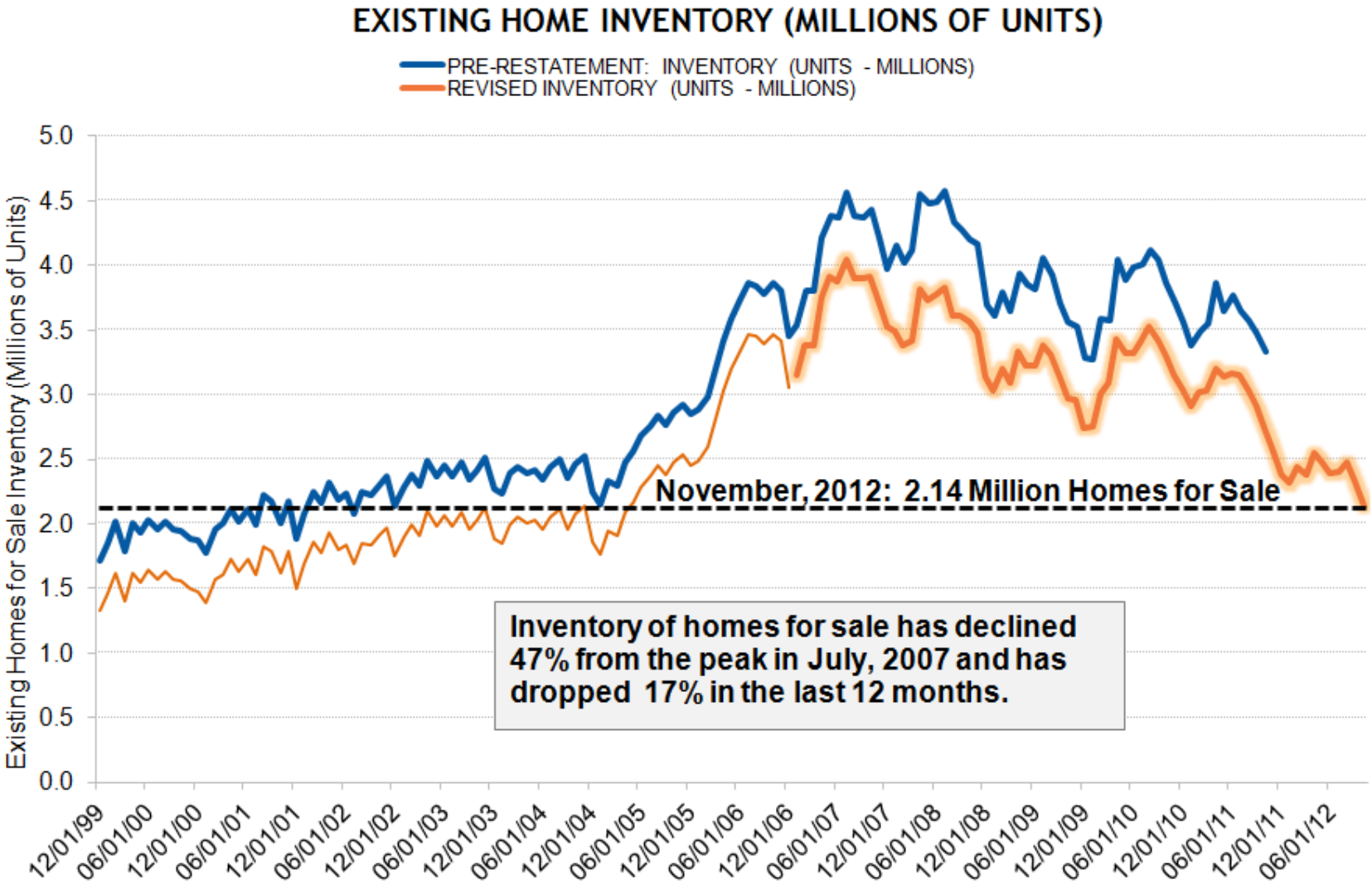
The Goal of Today's Call Is To Get One Simple Message Across:

We're Bullish On An Ongoing Housing & Home Price Recovery for 2013

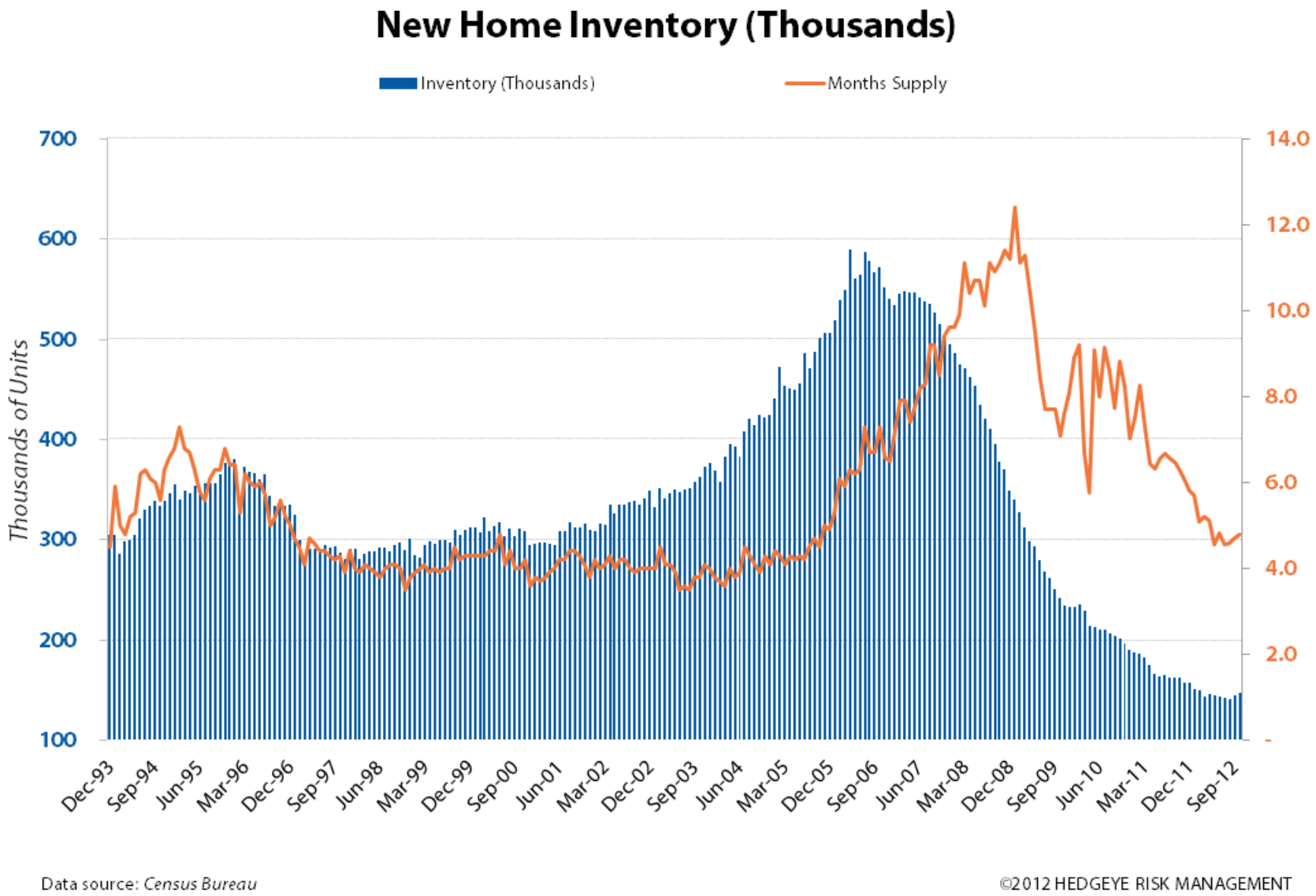
1. Supply Tailwinds

Housing Supply Has Been Falling Steadily, And Shows No Signs of Letting Up



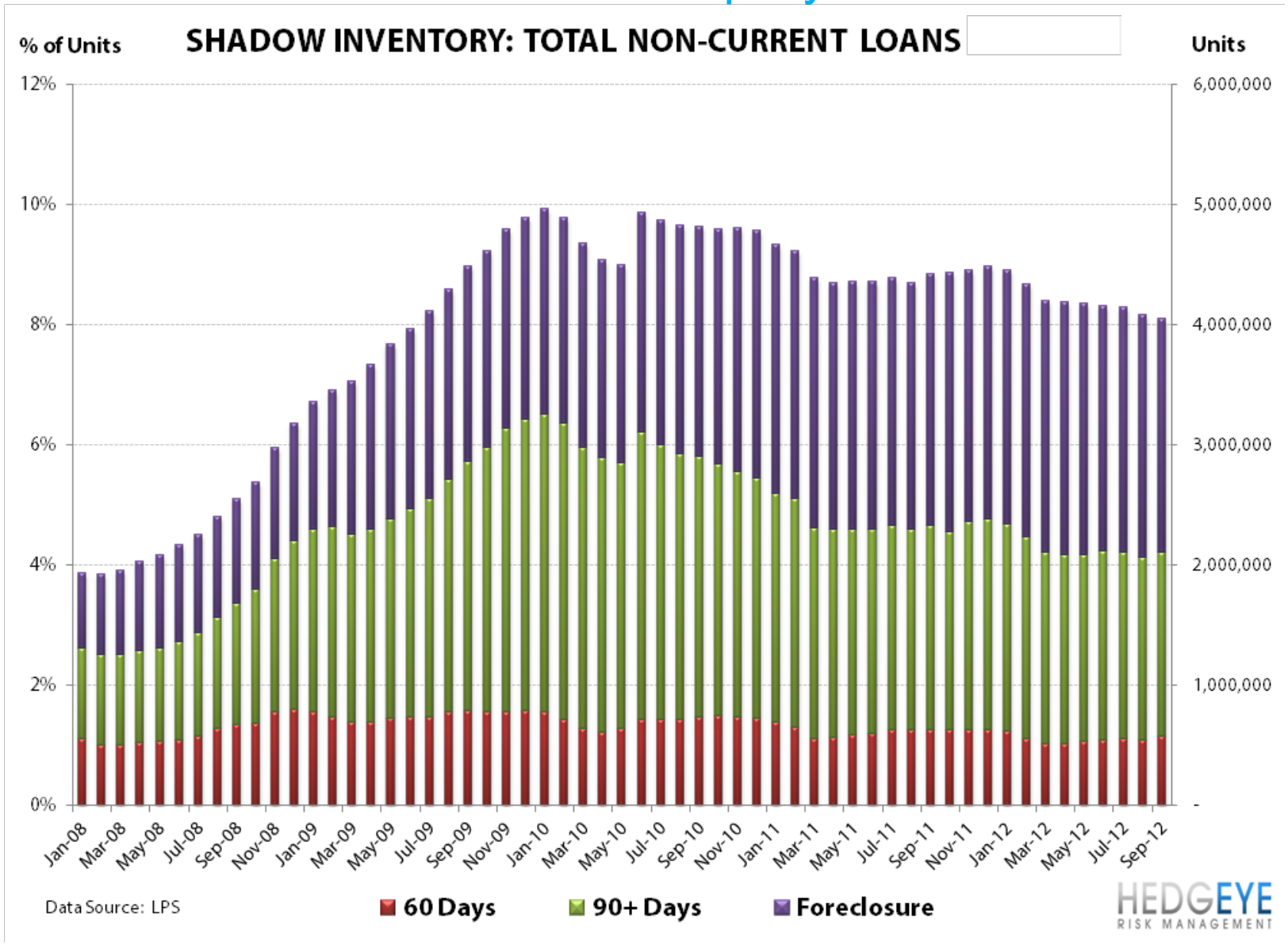
Data Source: National Association of Realtors

The Inventory of New Homes Is At All-time Lows

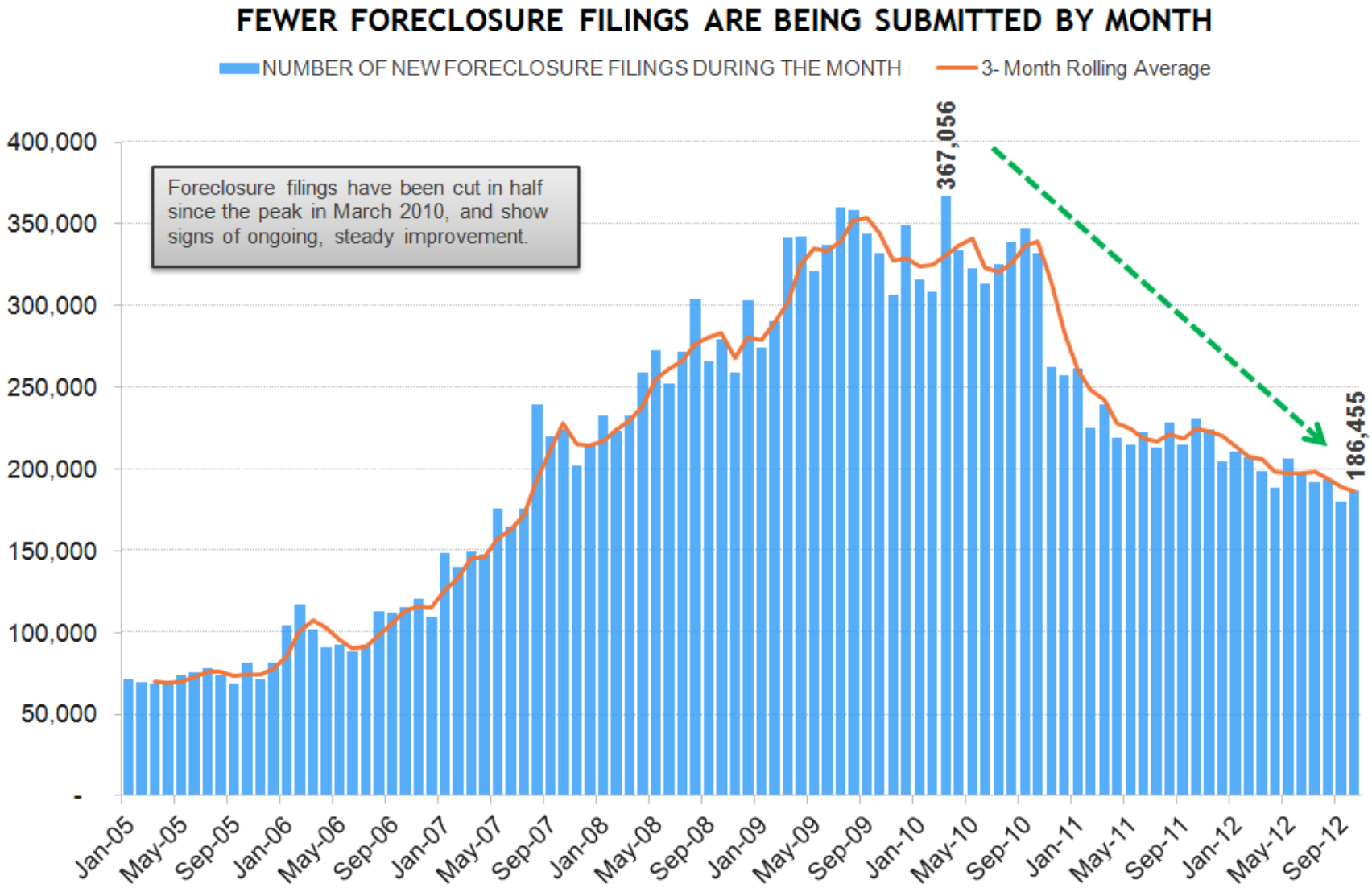


Data source: *Census Bureau*

Supply in the Distressed Market Is Also Falling, Albeit Less Rapidly



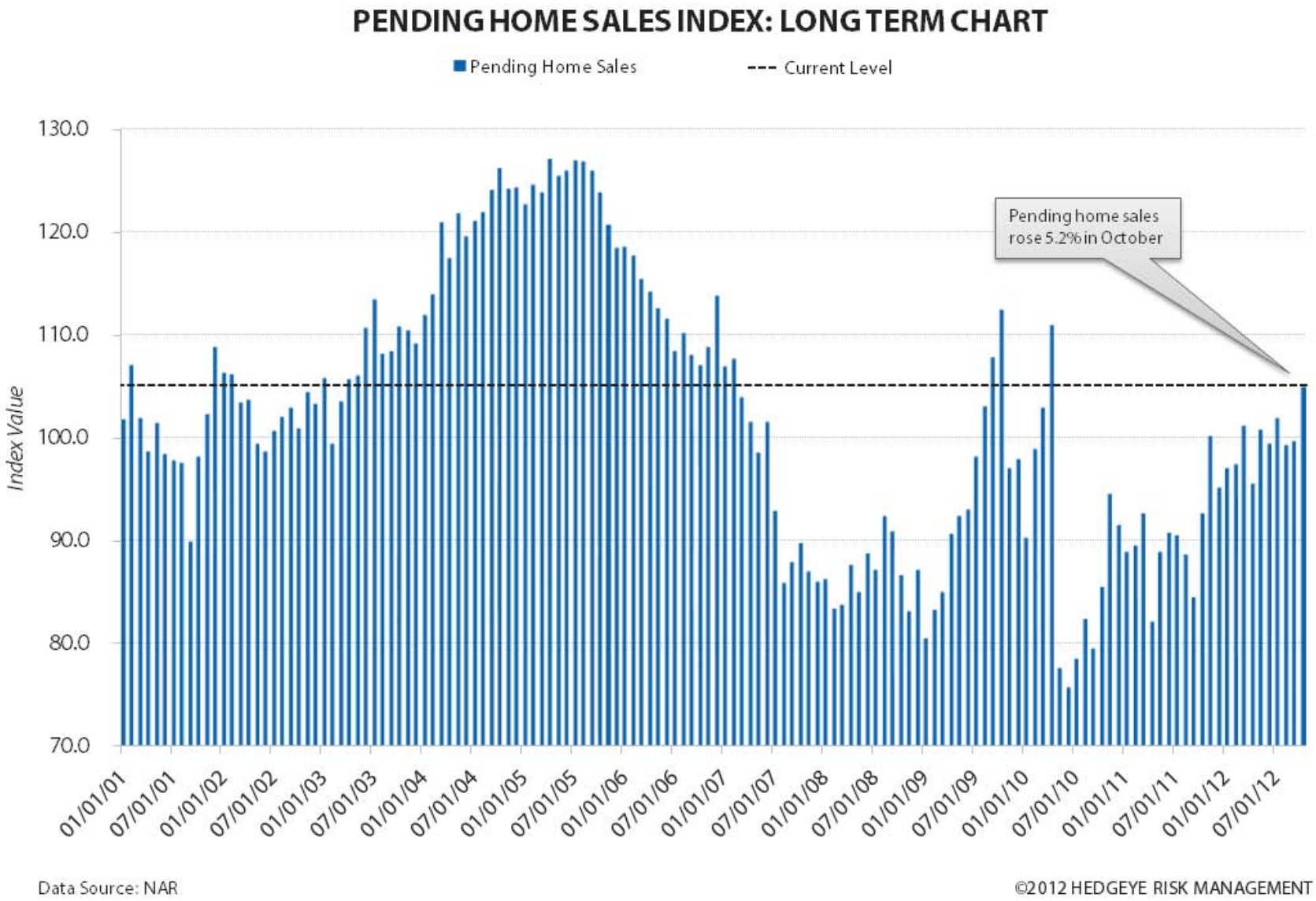
New Flows Into Distressed Have Dropped By Half



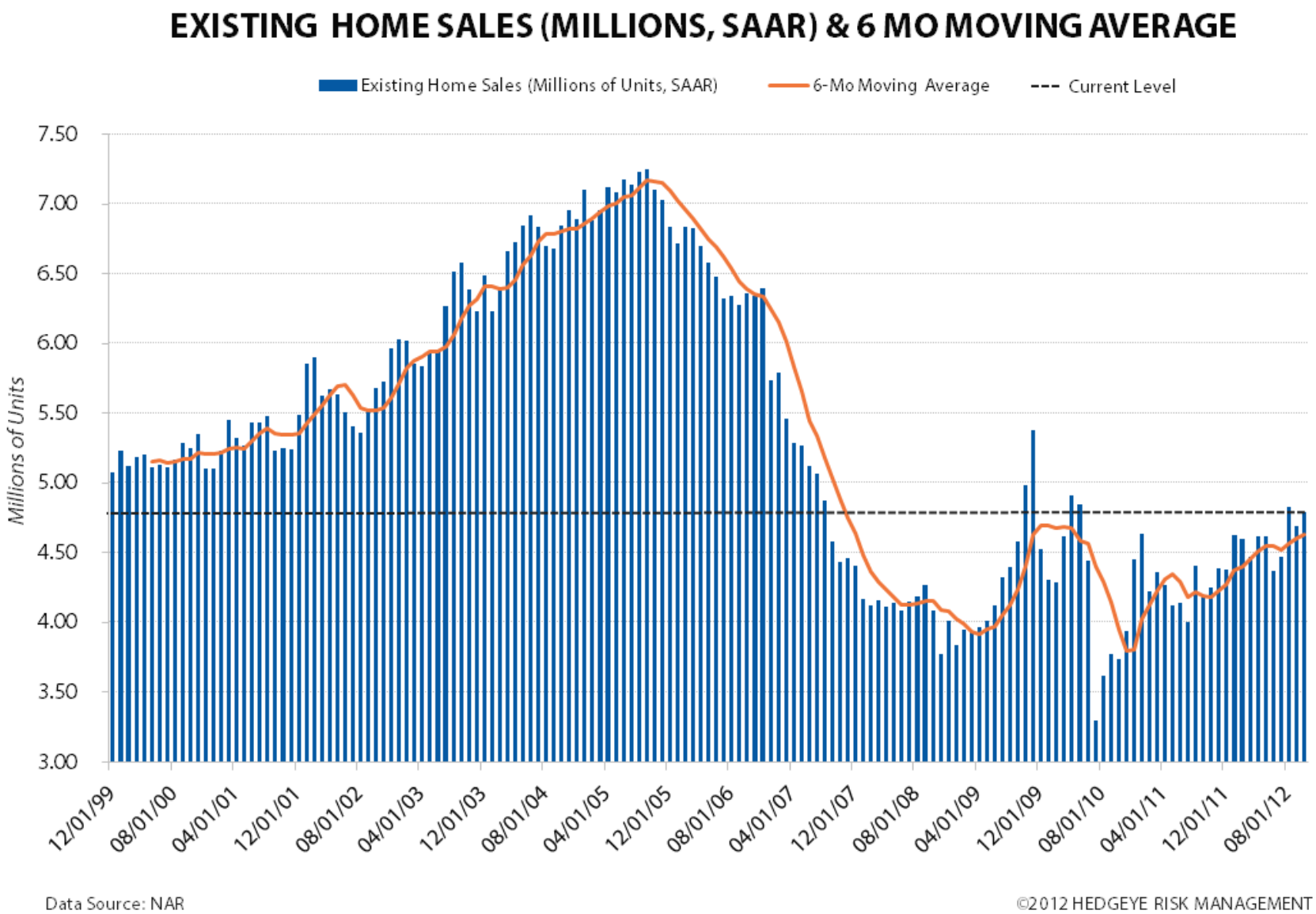
Data Source: RealtyTrac

2. Demand Tailwinds

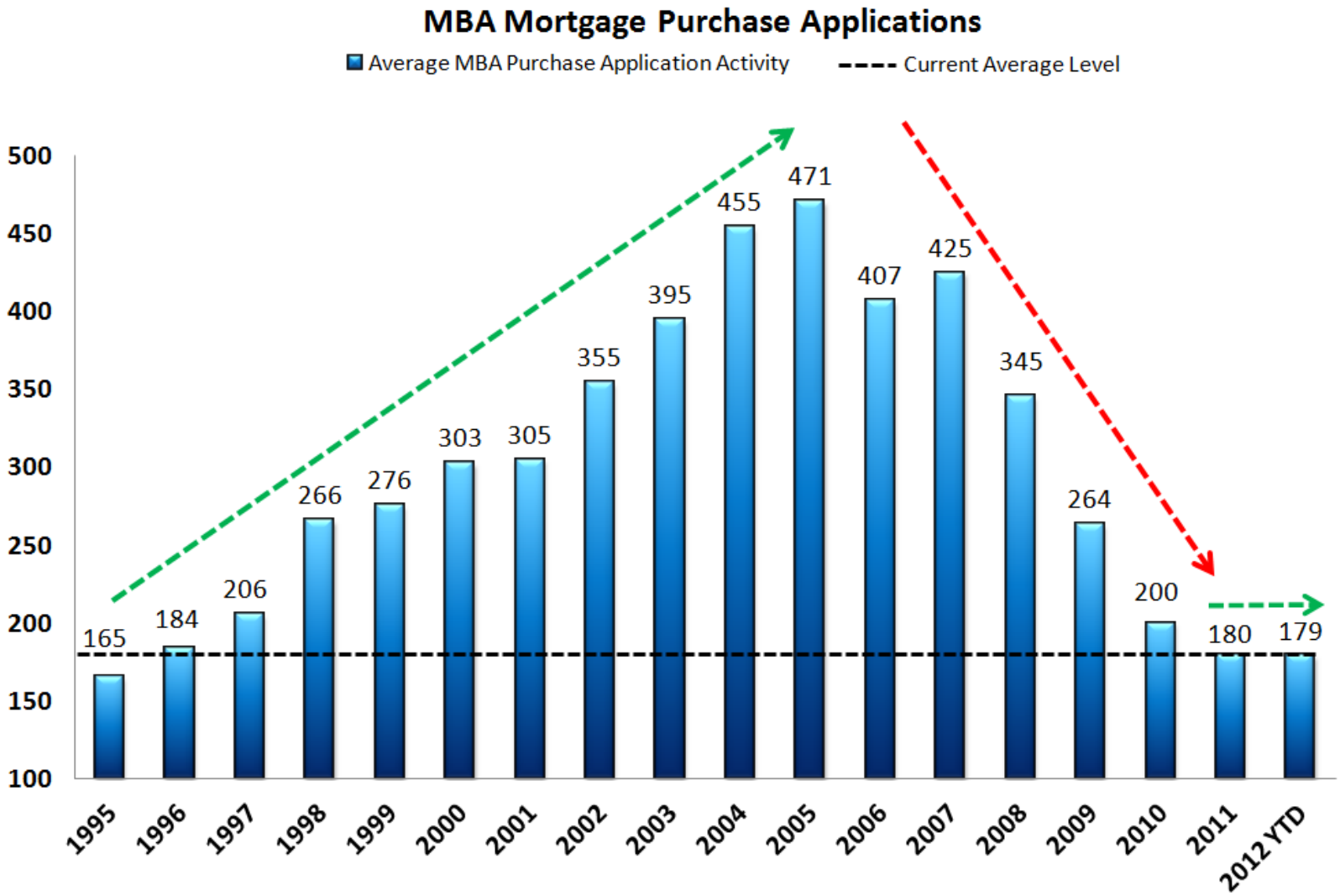
On The Demand Front, Pending Home Sales Are Rising Sharply



Existing Home Sales Are Bouncing Back

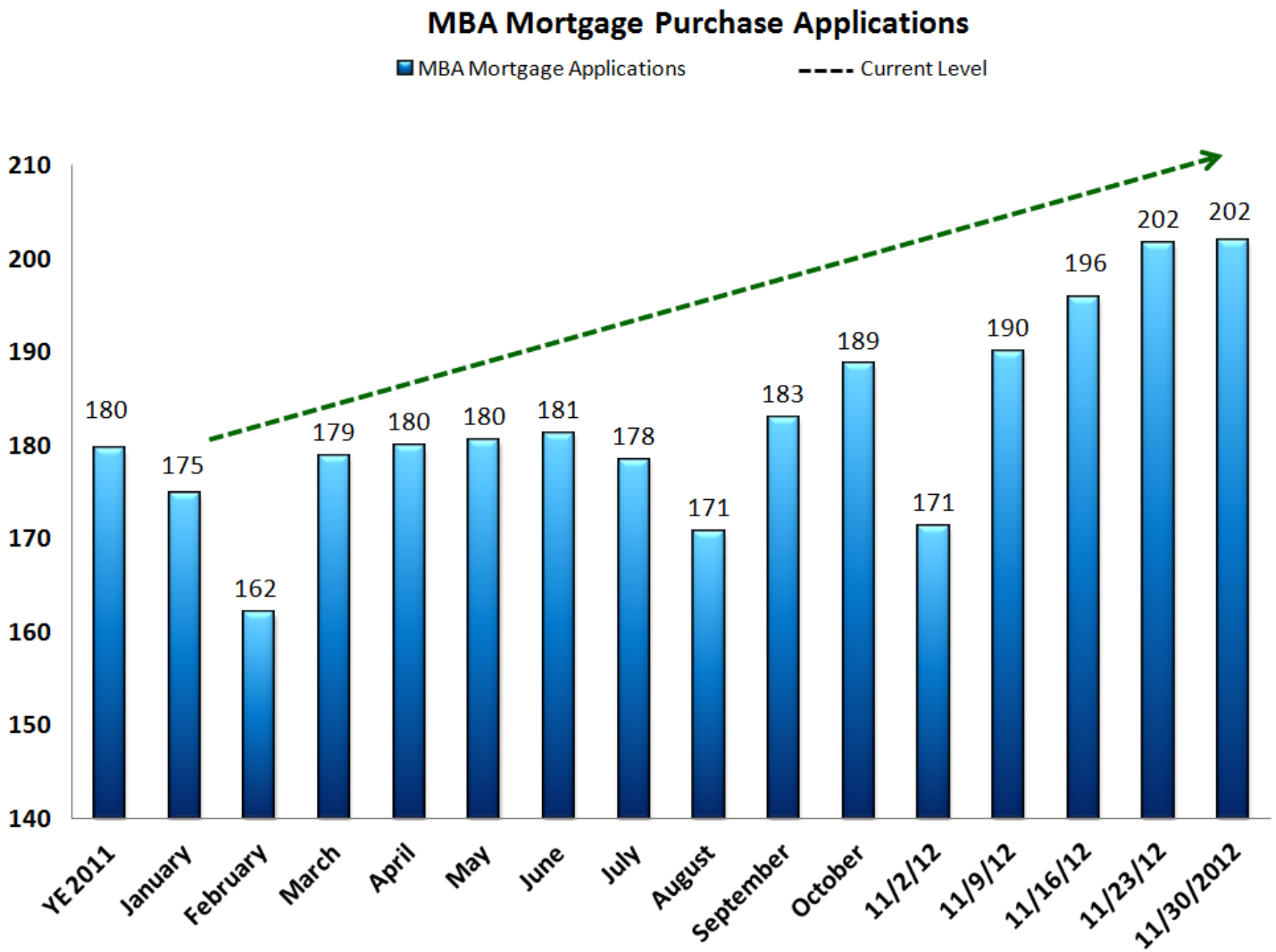


From A Long-Term Standpoint, Mortgage Demand Has Finally Stabilized



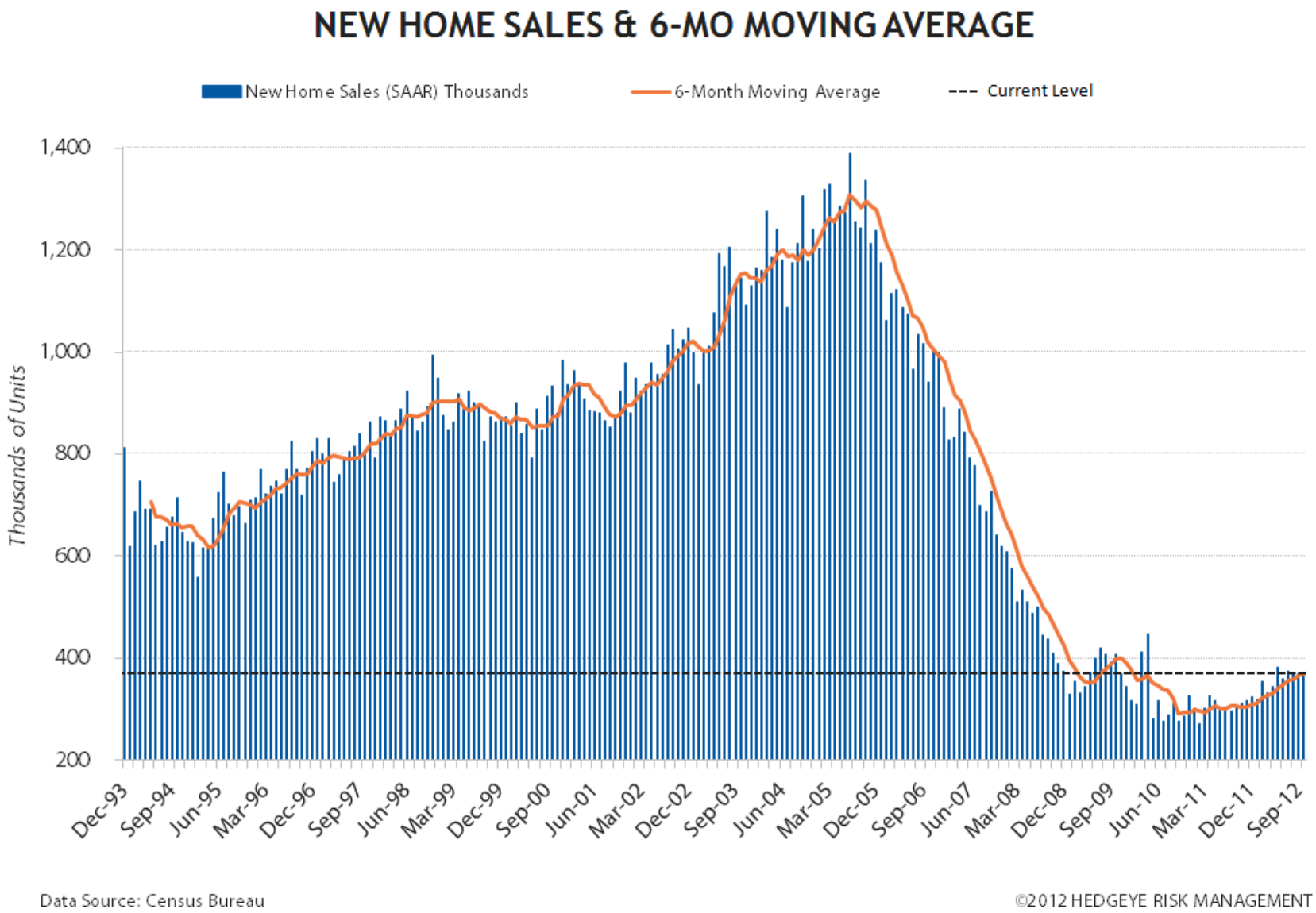
Data source: Mortgage Bankers Association

From An Intermediate-Term Standpoint, Mortgage Demand Is Now Improving

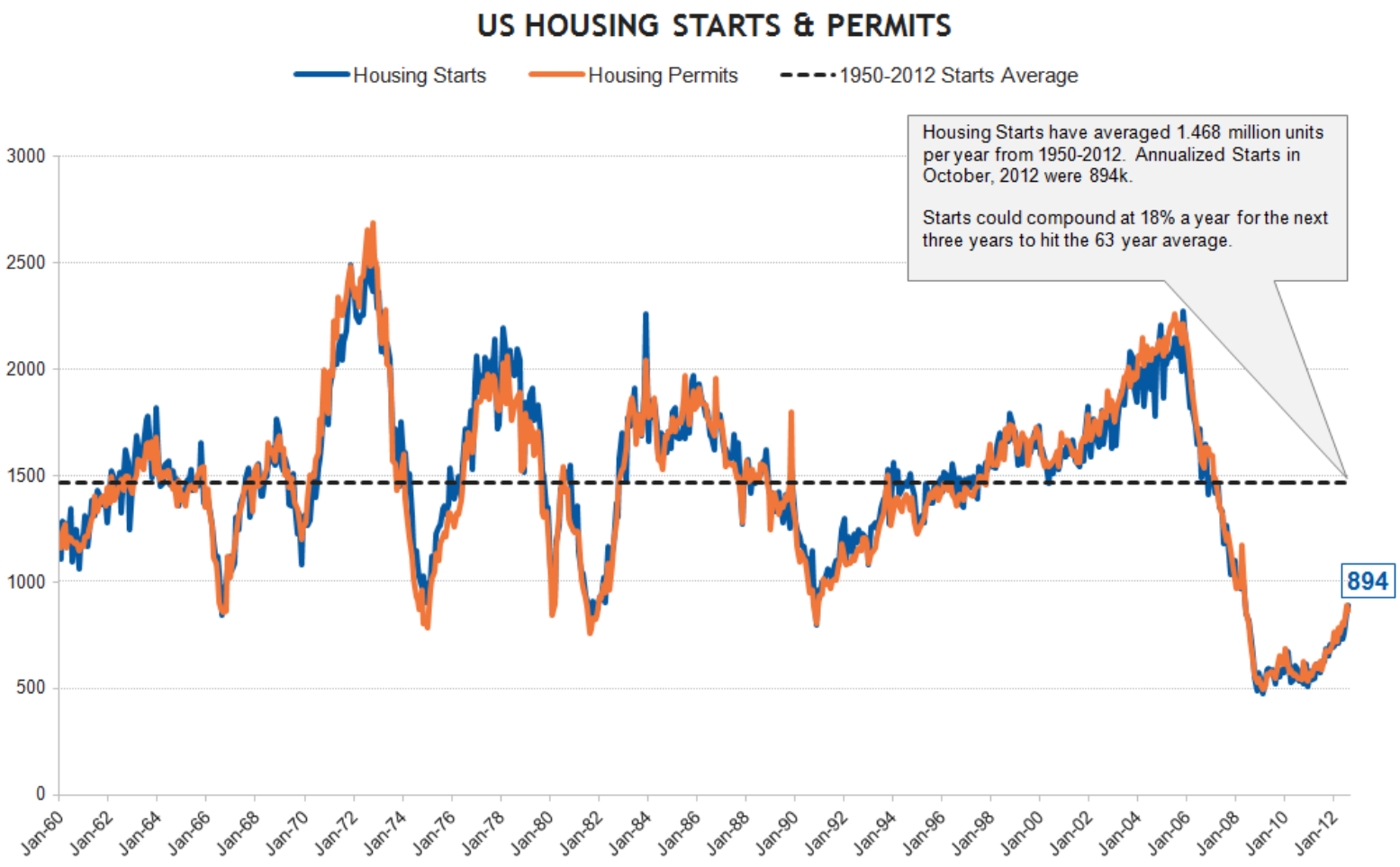


Data source: Mortgage Bankers Association

New Home Sales Have Seen The Smallest Relative Increase

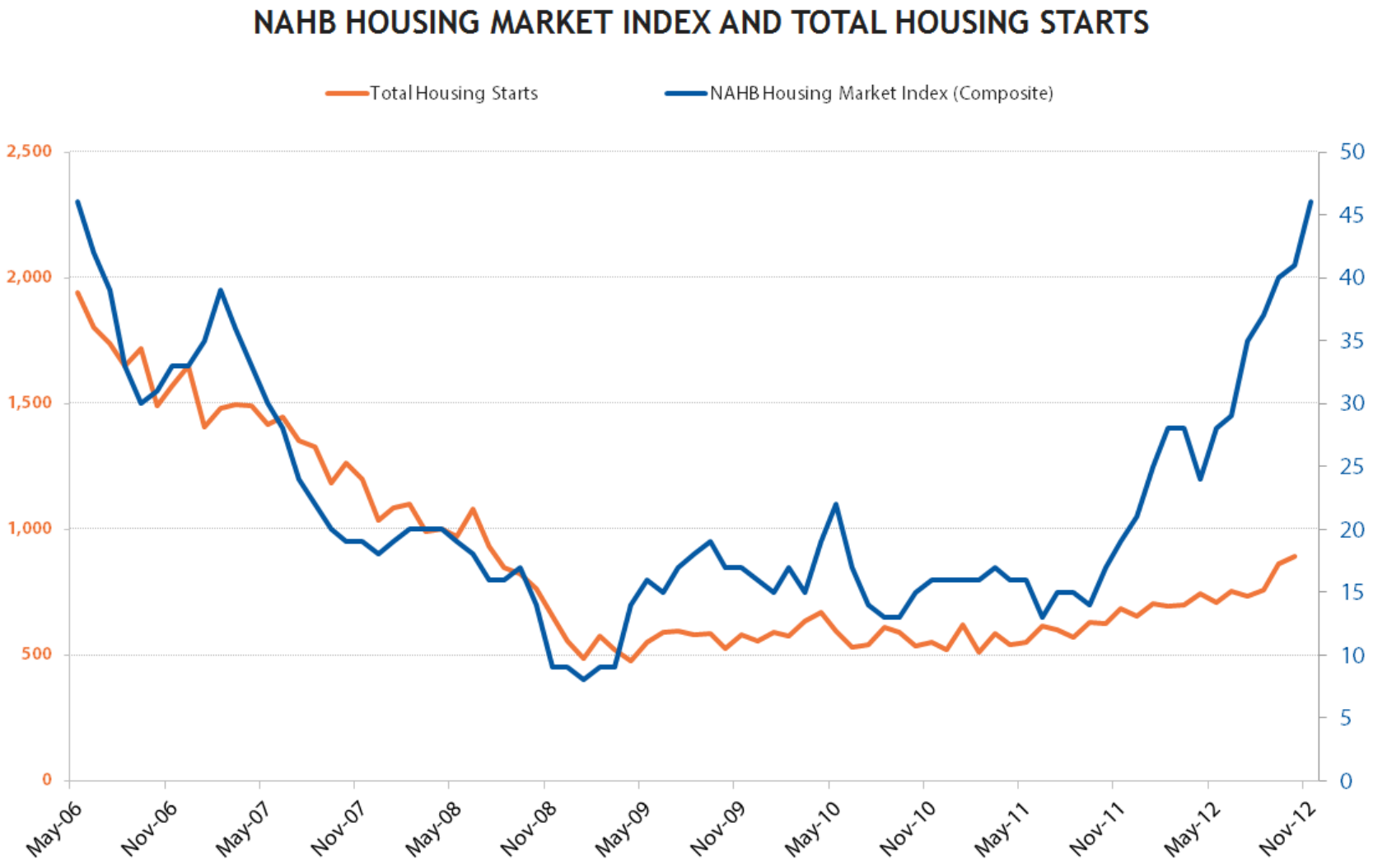


Housing Starts Remain 40% Below Their Long-Term Trend



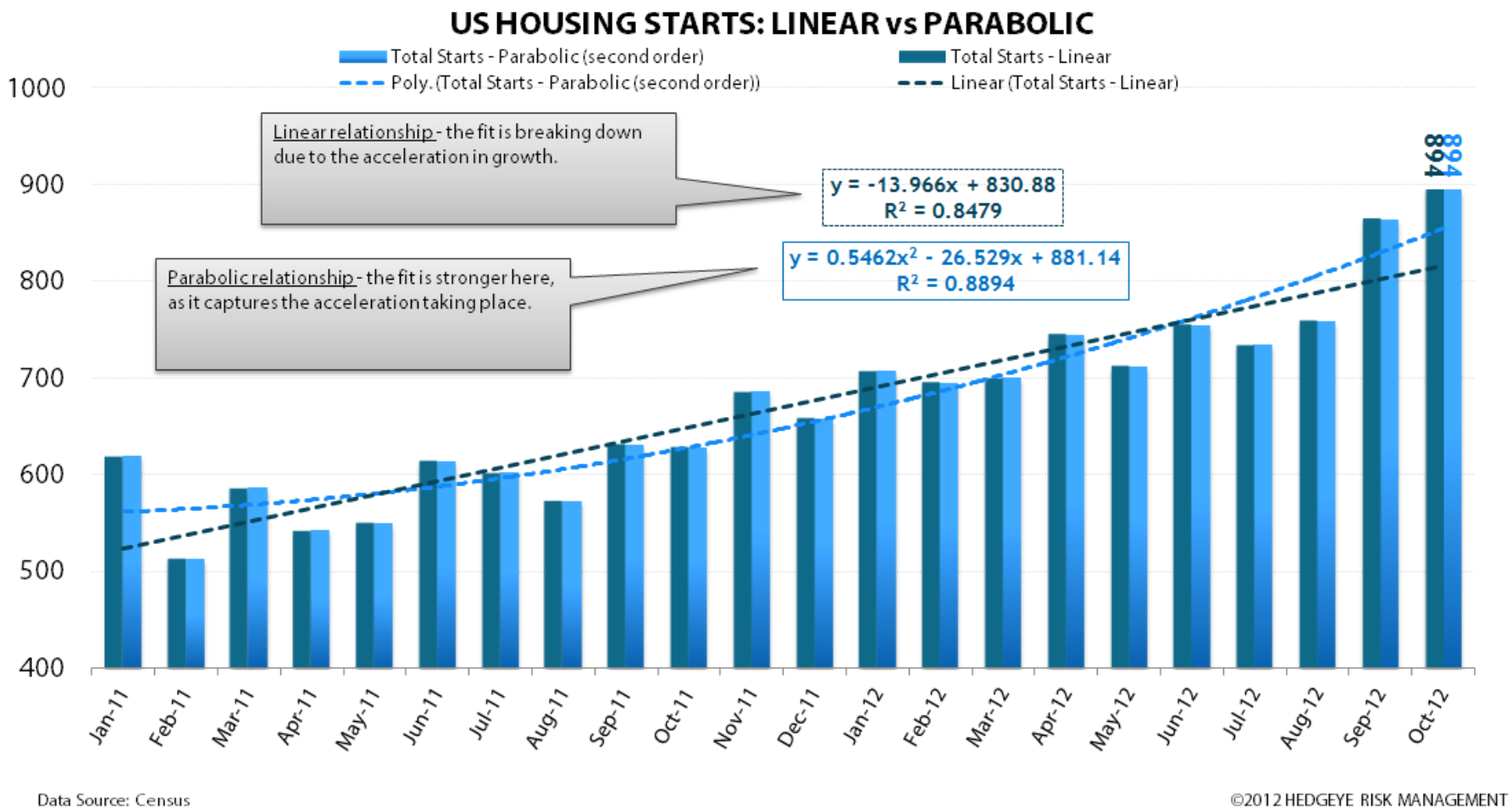
Data Source: Census Bureau

Builder Confidence Is Soaring



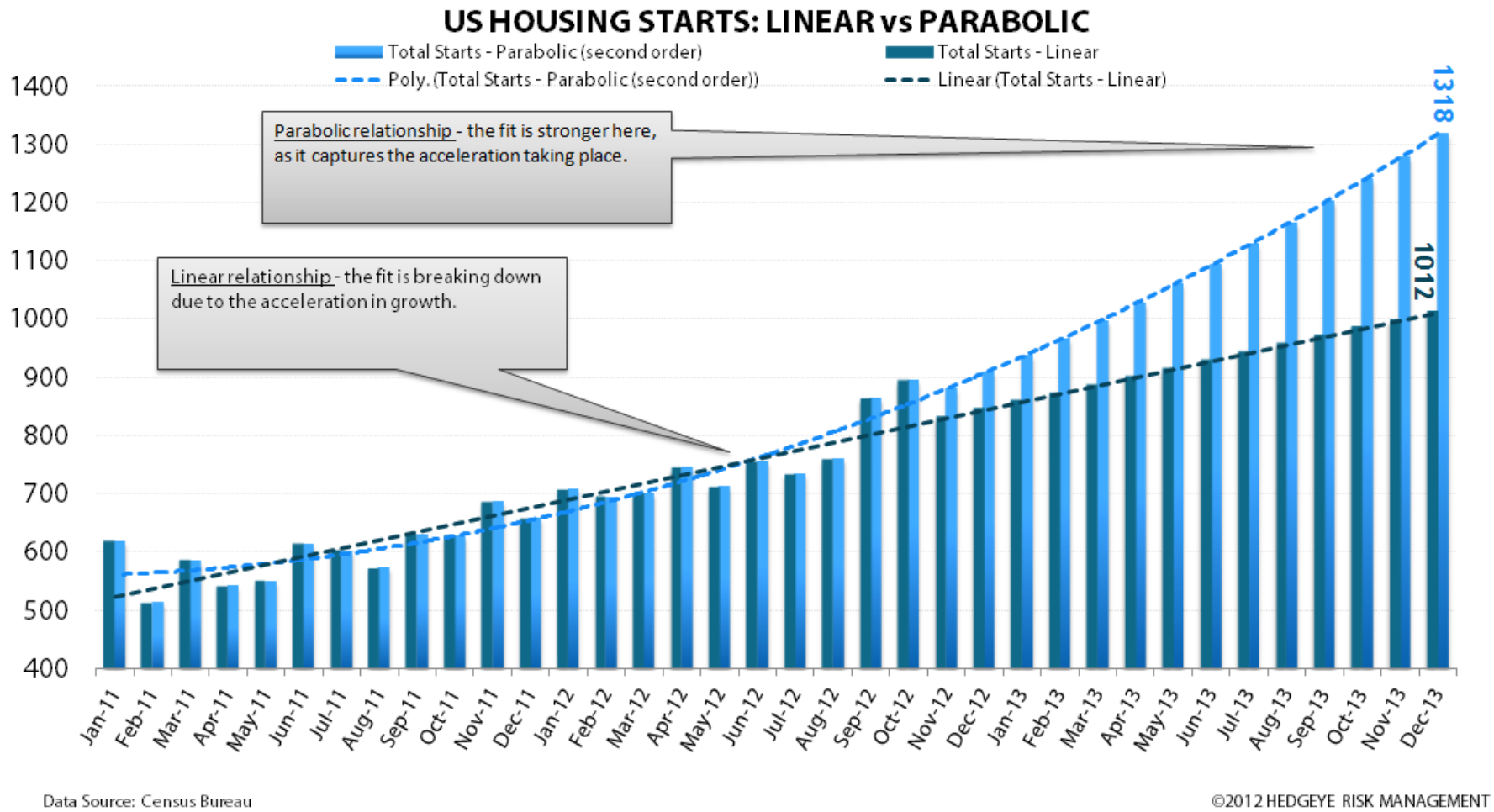
Data Source: NAHB, Census

Housing Starts Are Showing Signs of Accelerating



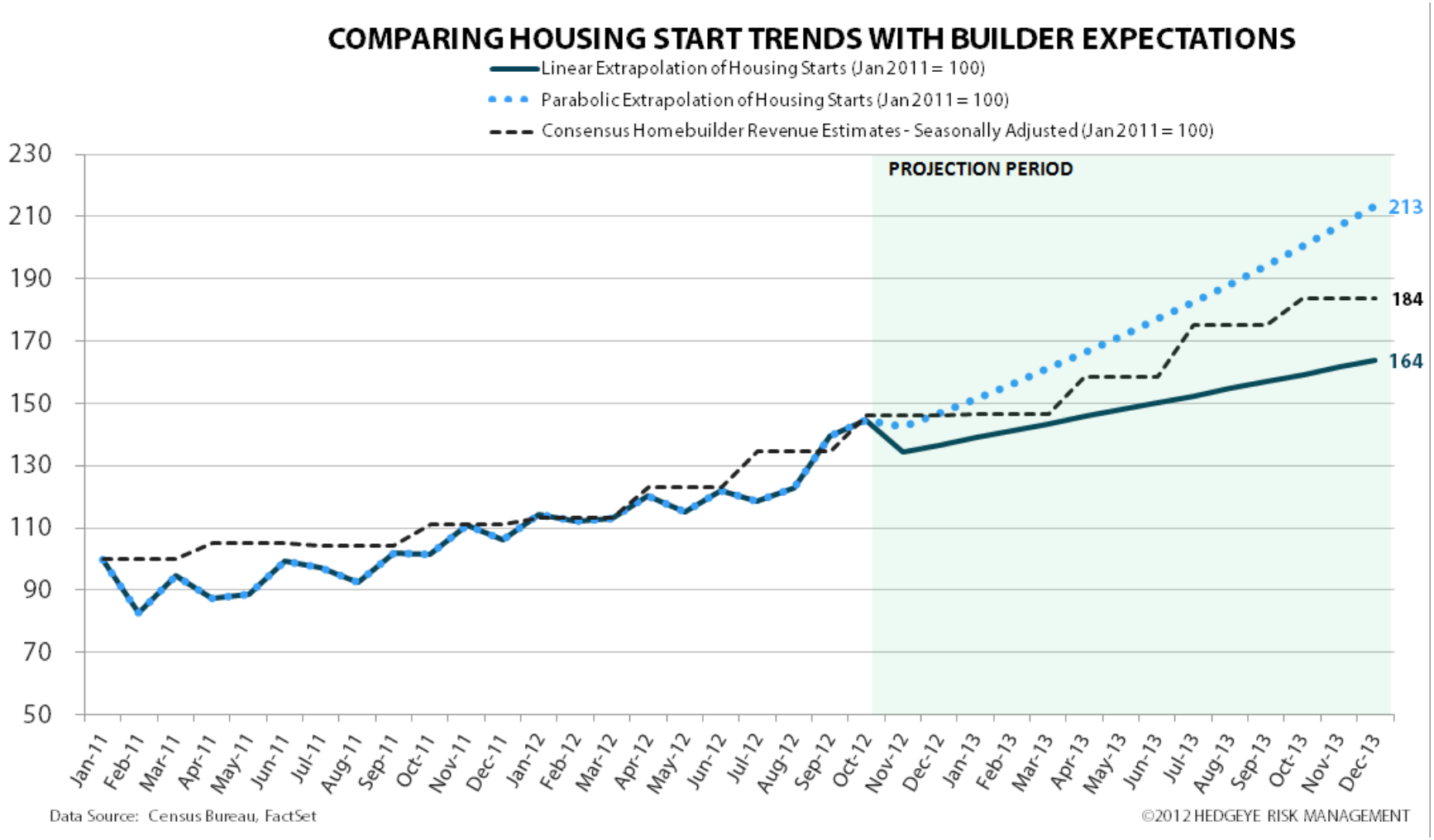
Data Source: Census

Accelerating Growth Could Bring Starts Back to Long-Term Trends Sooner Than Markets Expect

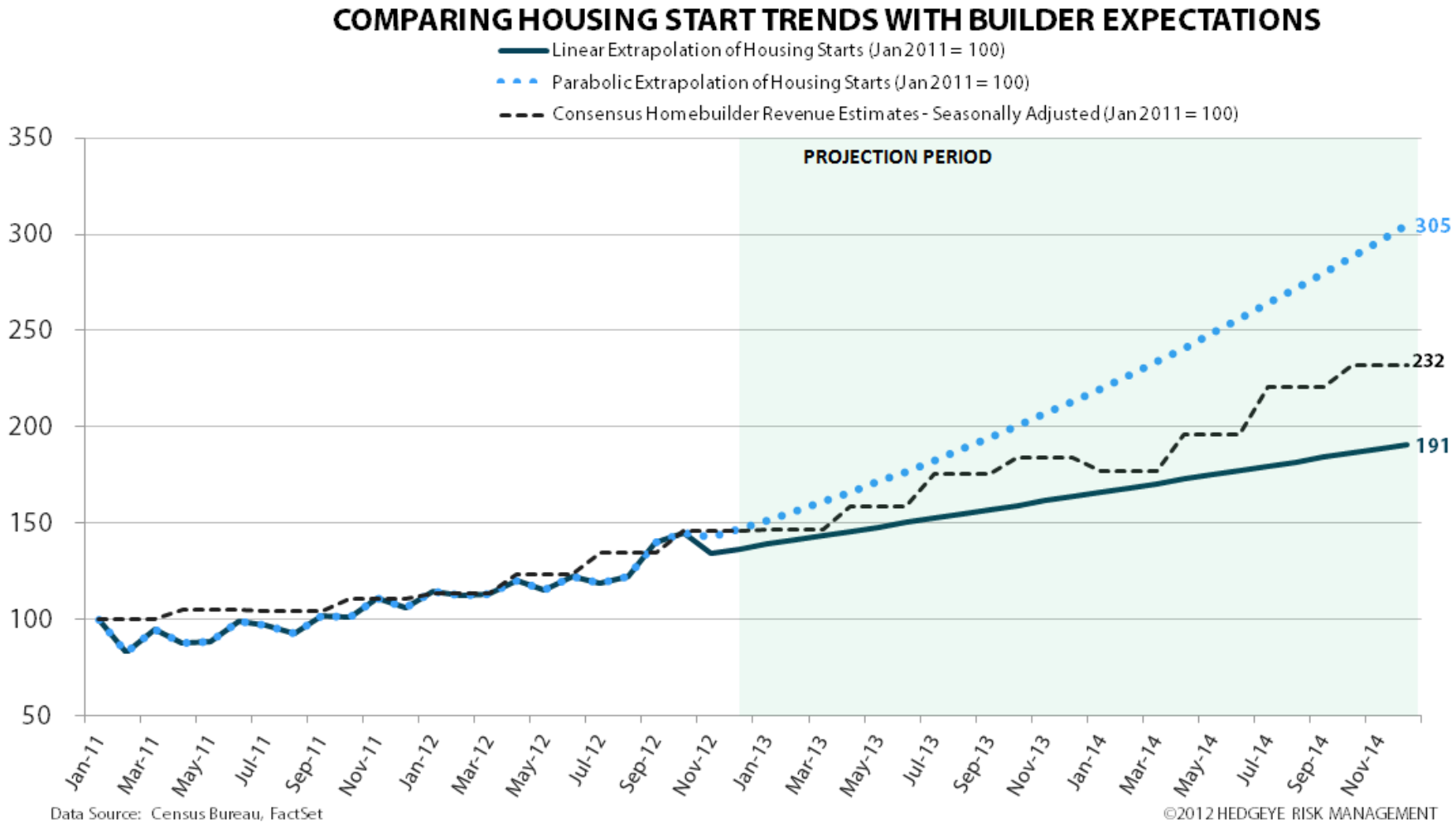


Data Source: Census Bureau

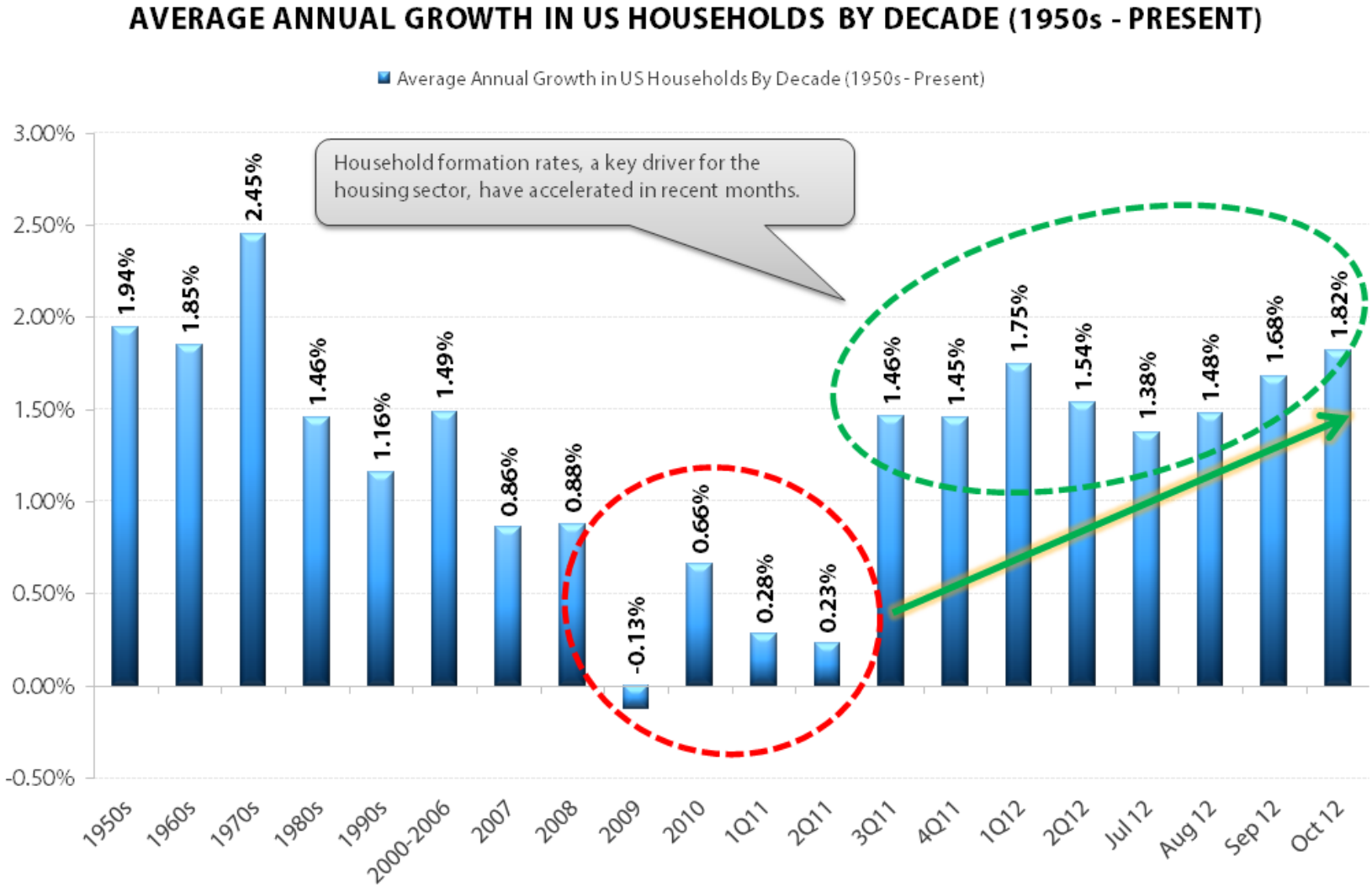
2013 Builder Estimates Fall Between Linear & Parabolic



Likewise for 2014 Estimates



Household Formation Is Accelerating, Fueling the Recovery in Starts



Data Source: Census Bureau

Meanwhile, In the Distressed Market Demand Continues to Grow.

12/4/2012 – "Praxis Capital Launches New Real Estate Fund" - Sacramento Bee

11/15/2012 – "Hedge Fund Blackstone Buying $100 Million in Foreclosed Homes Every Week" - Firedoglake

11/14/2012 – "Investors See Continued Potential from Florida Residential Distress, Launch Four Opportunities, Including Two New Foreclosure Funds" - Yahoo Finance

11/8/2012 – "FHFA Launches REO-to-Rental Plan" - Nuwire

11/4/2012 – "Warren Buffett Just Made A Huge Bet on the U.S. Housing Market" - Business Insider

6/13/2012 – "Private Equity Has Too Much Money to Spend On Homes" - Bloomberg

4/25/2012 – "AllianceBernstein Raises $680 Million in First PE Real Estate Fund" -Altassets

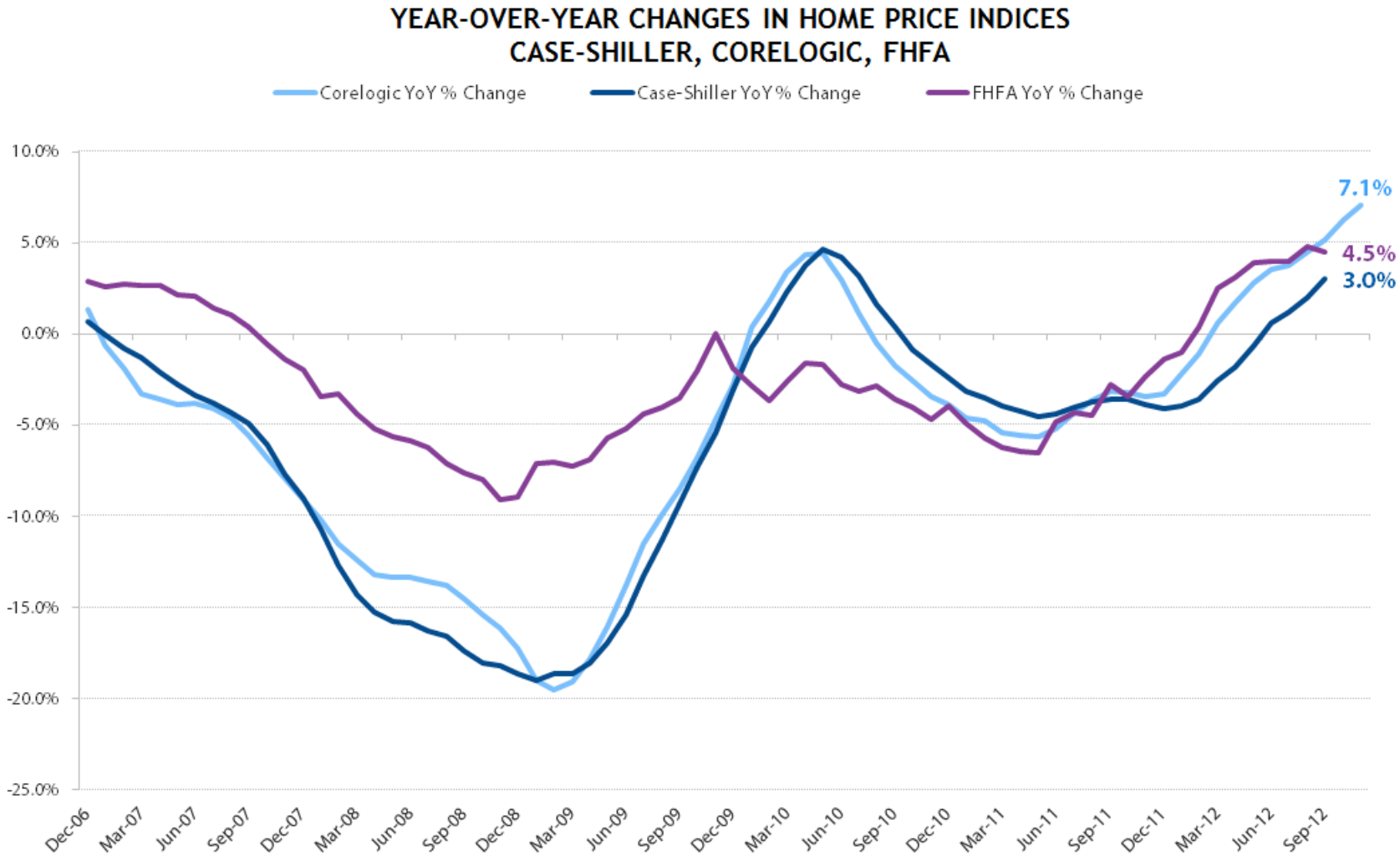
4/13/2012 – "Blum Capital to Launch Distressed Real Estate Fund" -Reuters

4/2/2012 – "Investors Are Looking To Buy Homes in the Thousands" – New York Times

3/7/2012 – "Warren Buffet Says Buy Real Estate Now" -CNBC

3. Price Tailwinds

Home Price Indices Are Showing Growing Momentum



Data Source: Corelogic, Case-Shiller, FHFA

Most Markets Are Doing Well, Except, Perhaps, New York

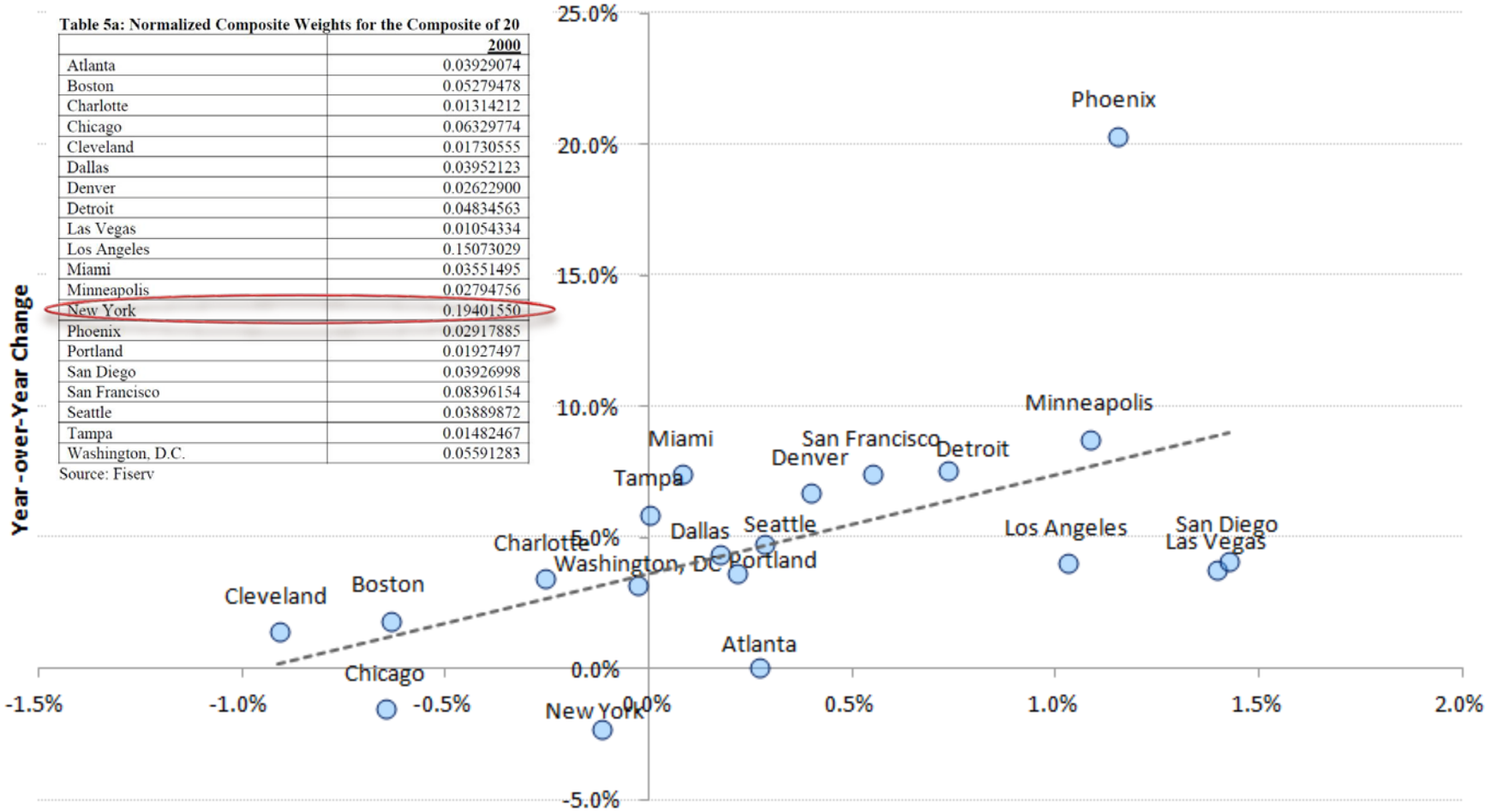
CASE-SHILLER: LTM VS. MoM HPI PERFORMANCE BY CITY

Case-Shiller: LTM vs. MoM HPI Performance by City ----- Linear (Case-Shiller: LTM vs. MoM HPI Performance by City)

Table 5a: Normalized Composite Weights for the Composite of 20

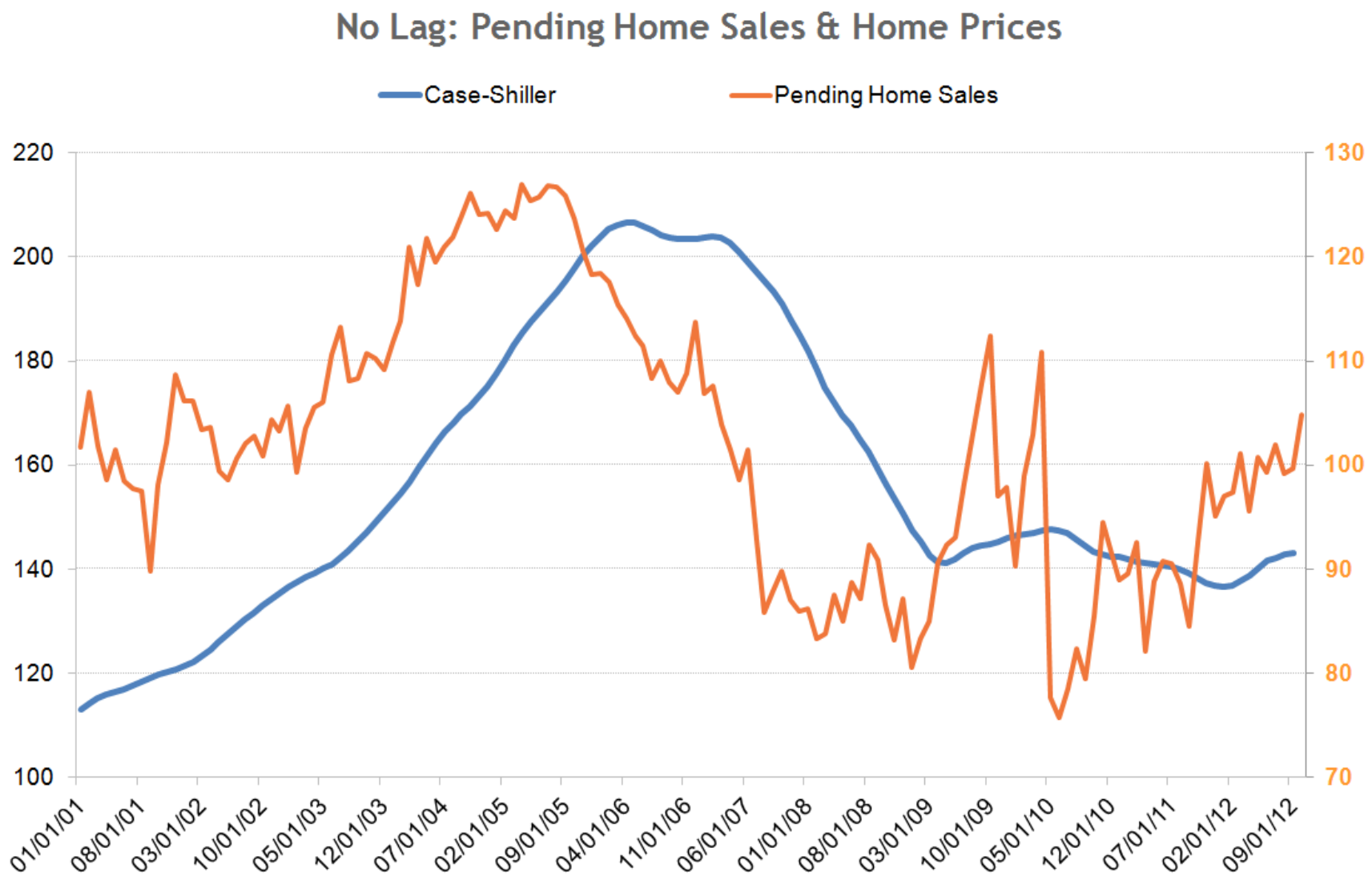
	2000
Atlanta	0.03929074
Boston	0.05279478
Charlotte	0.01314212
Chicago	0.06329774
Cleveland	0.01730555
Dallas	0.03952123
Denver	0.02622900
Detroit	0.04834563
Las Vegas	0.01054334
Los Angeles	0.15073029
Miami	0.03551495
Minneapolis	0.02794756
New York	0.19401550
Phoenix	0.02917885
Portland	0.01927497
San Diego	0.03926998
San Francisco	0.08396154
Seattle	0.03889872
Tampa	0.01482467
Washington, D.C.	0.05591283

Source: Fiserv



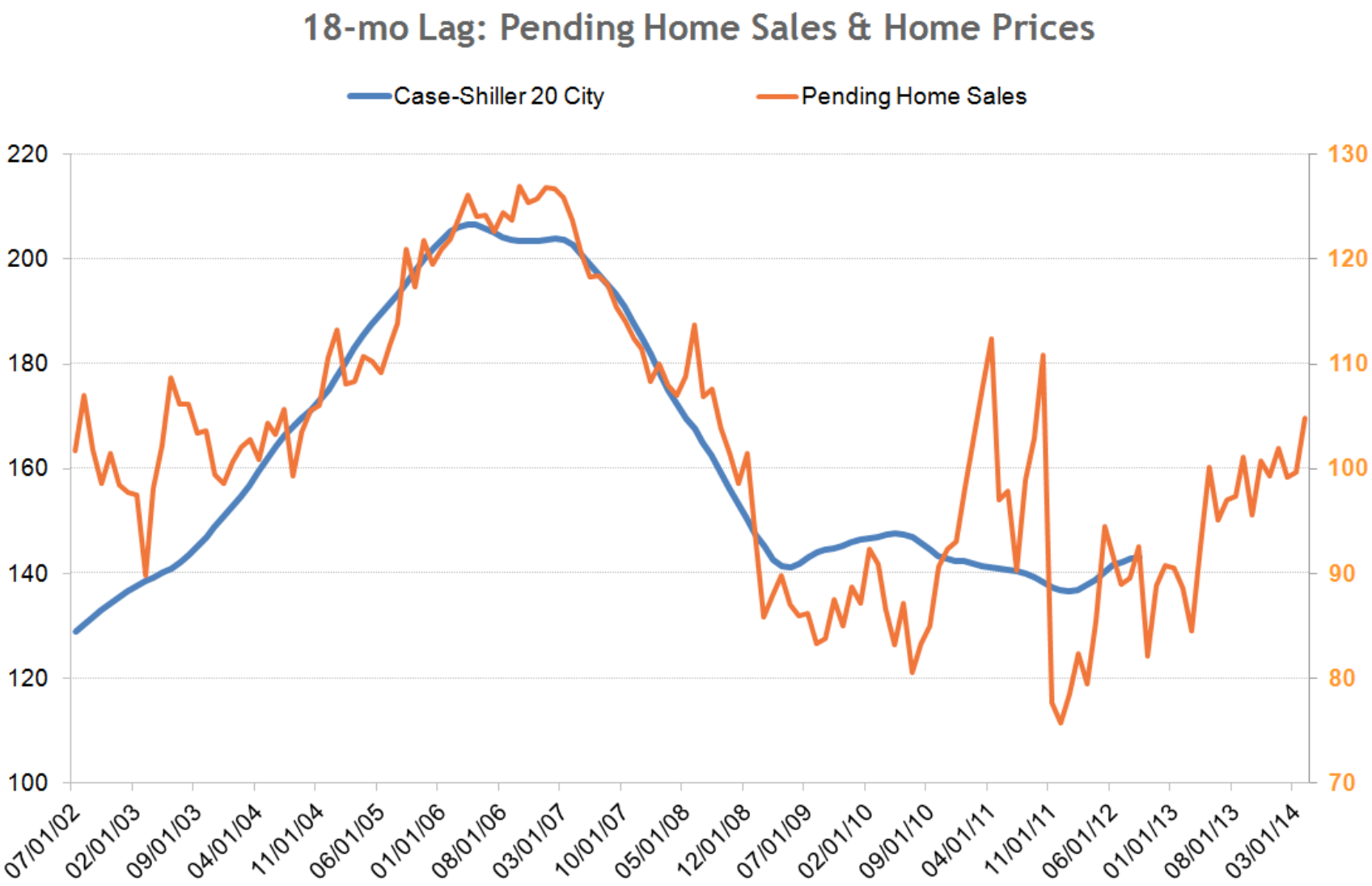
Data Source: Case-Shiller

Home Prices Lag Demand Trends



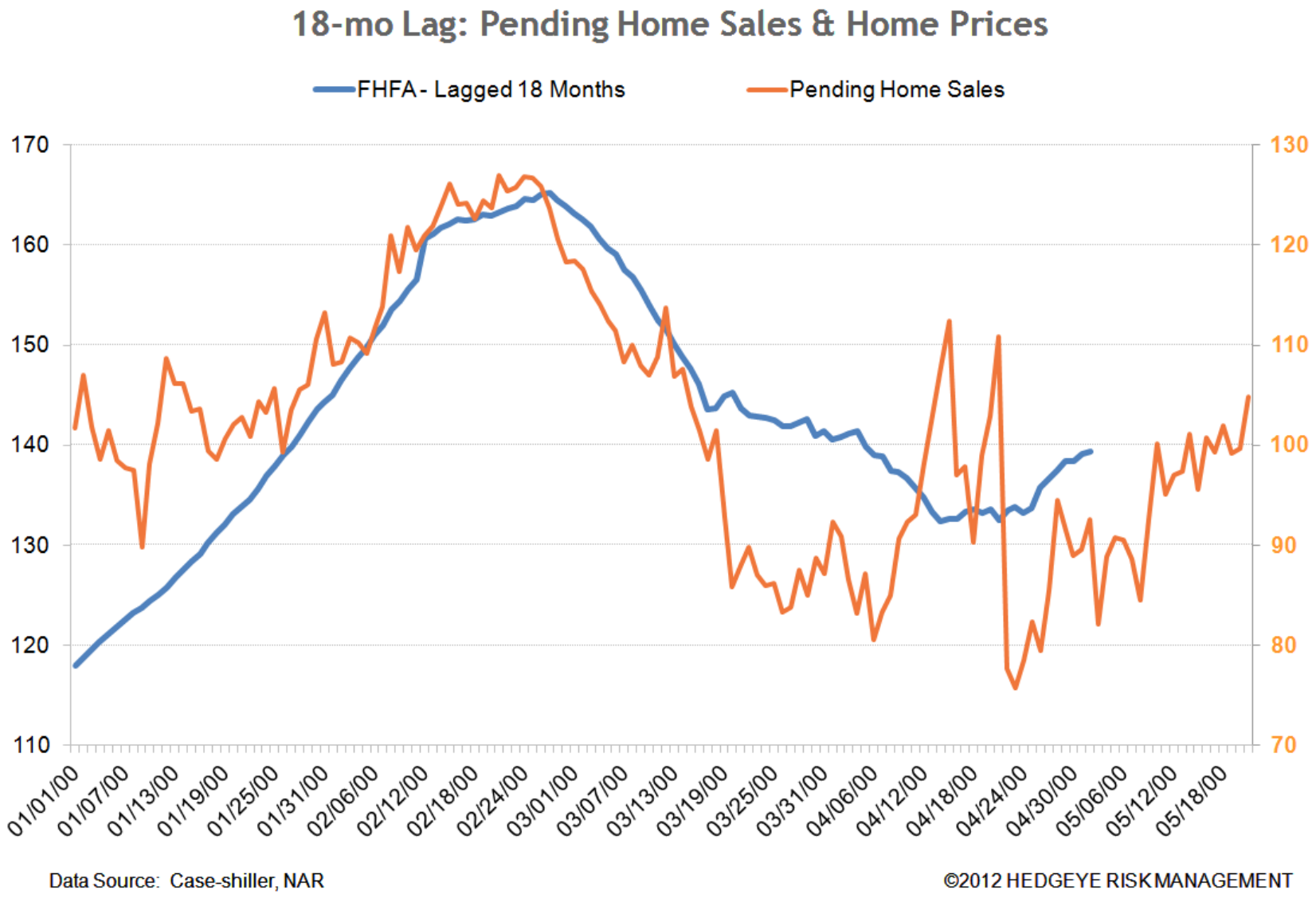
Data Source: Case-shiller, NAR

By Lagging Demand 18 Months, We Find a Good Fit

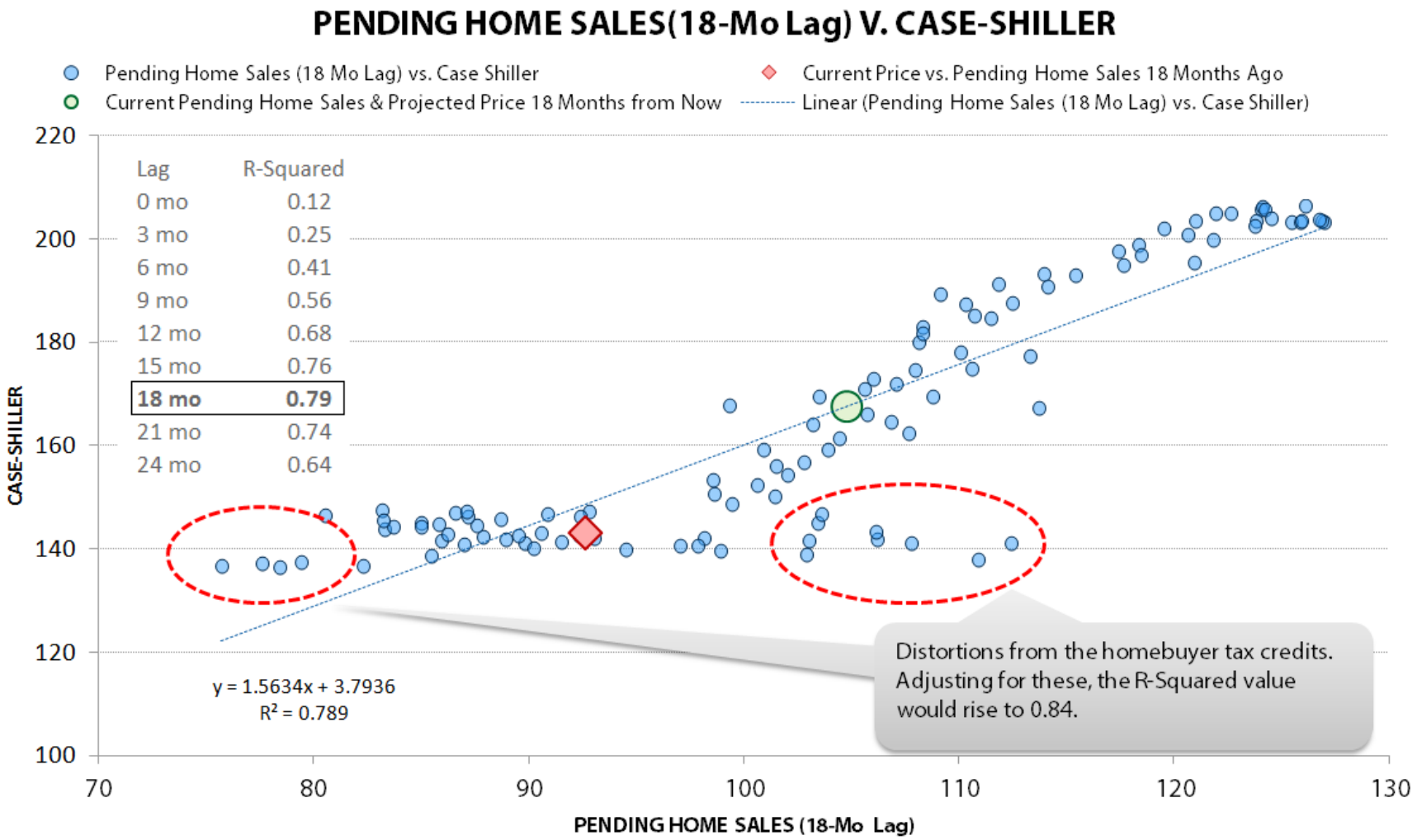


Data Source: Case-shiller, NAR

The Same Is True for FHFA

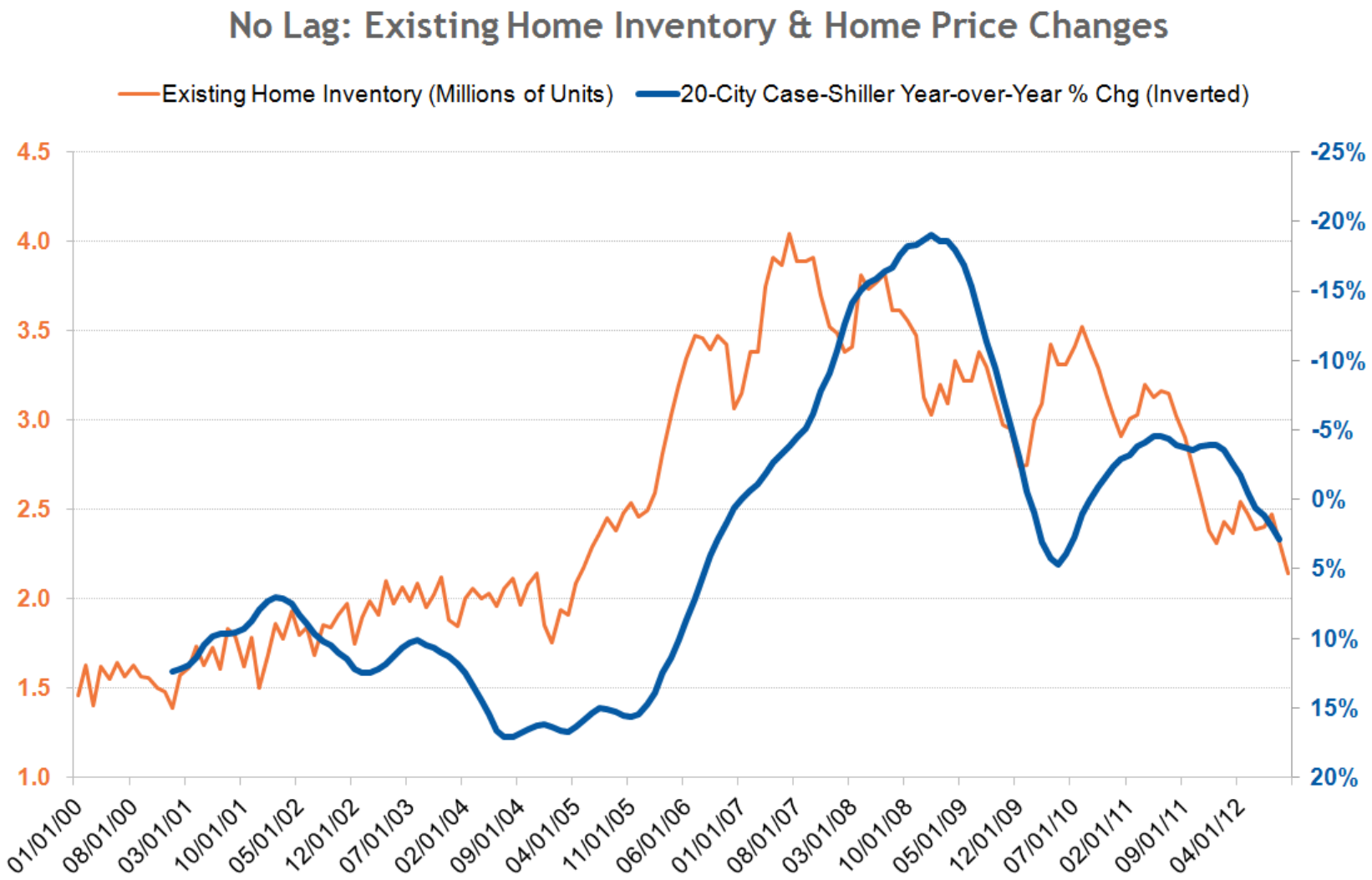


Current Demand Suggests +17% HPI Over The Next 18 Months



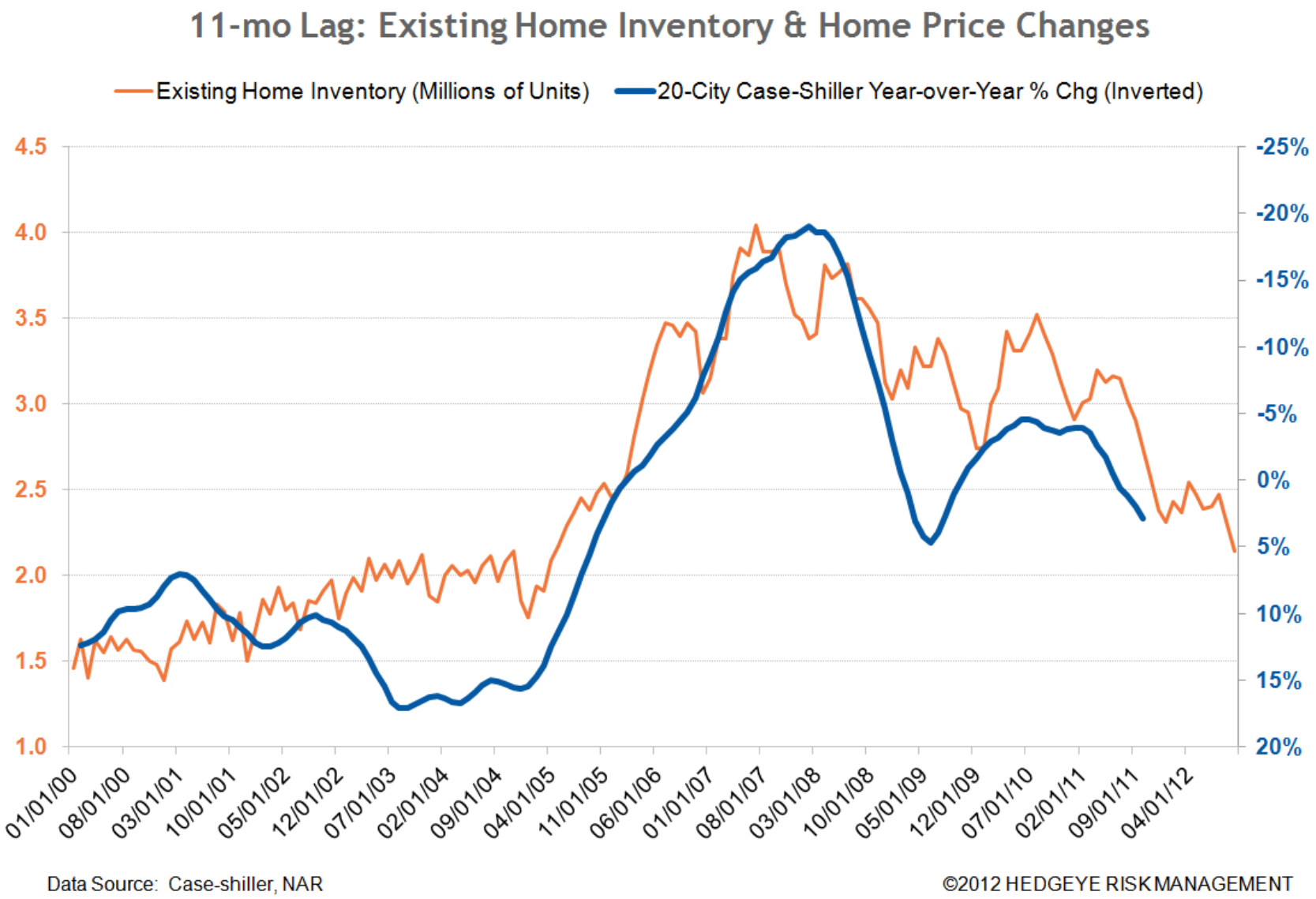
Data Source: Case-Shiller, NAR

Now, Let's Look At Supply

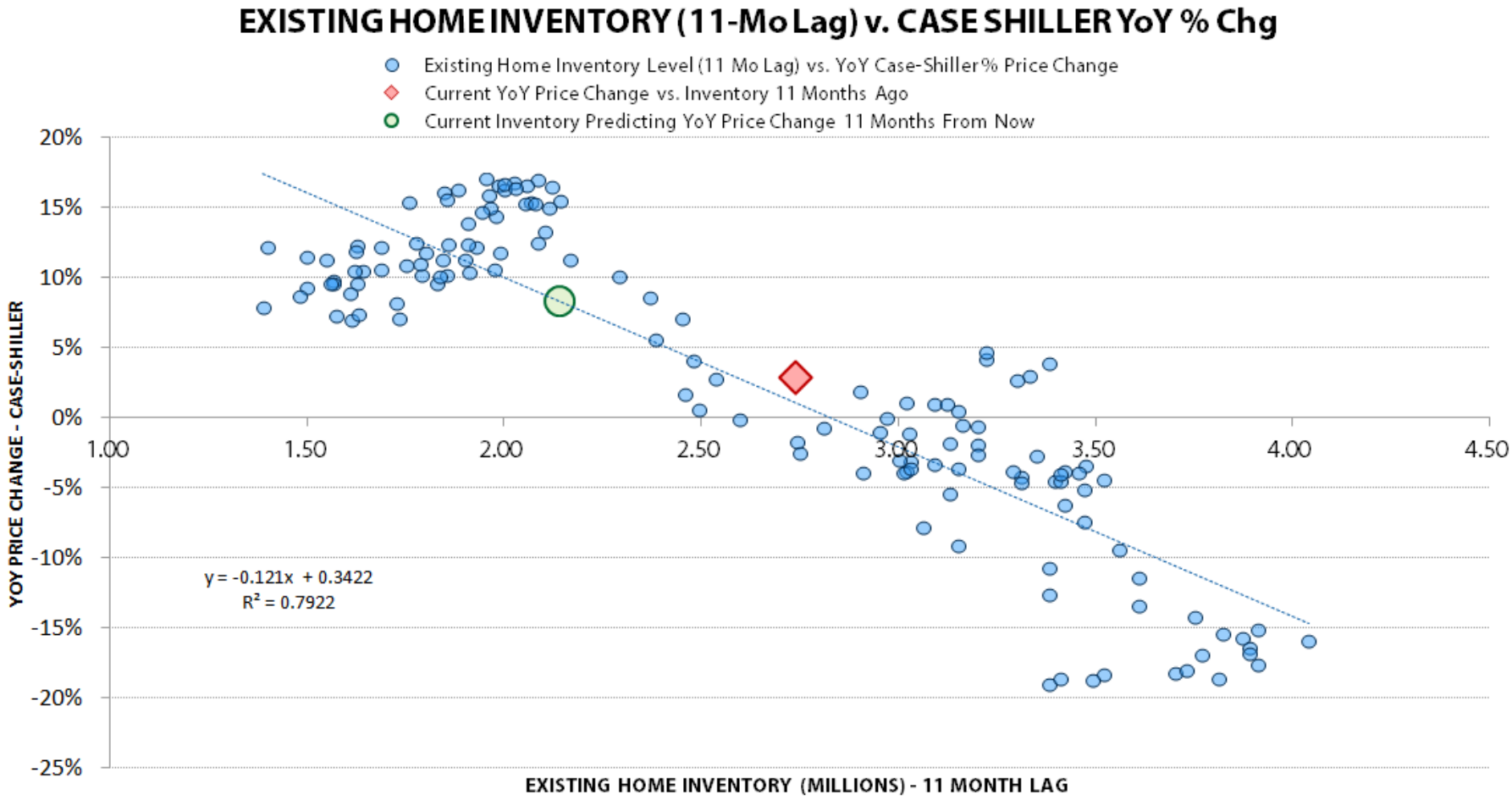


Data Source: Case-shiller, NAR

Supply Seems To Be Leading Price Changes By 11 Months

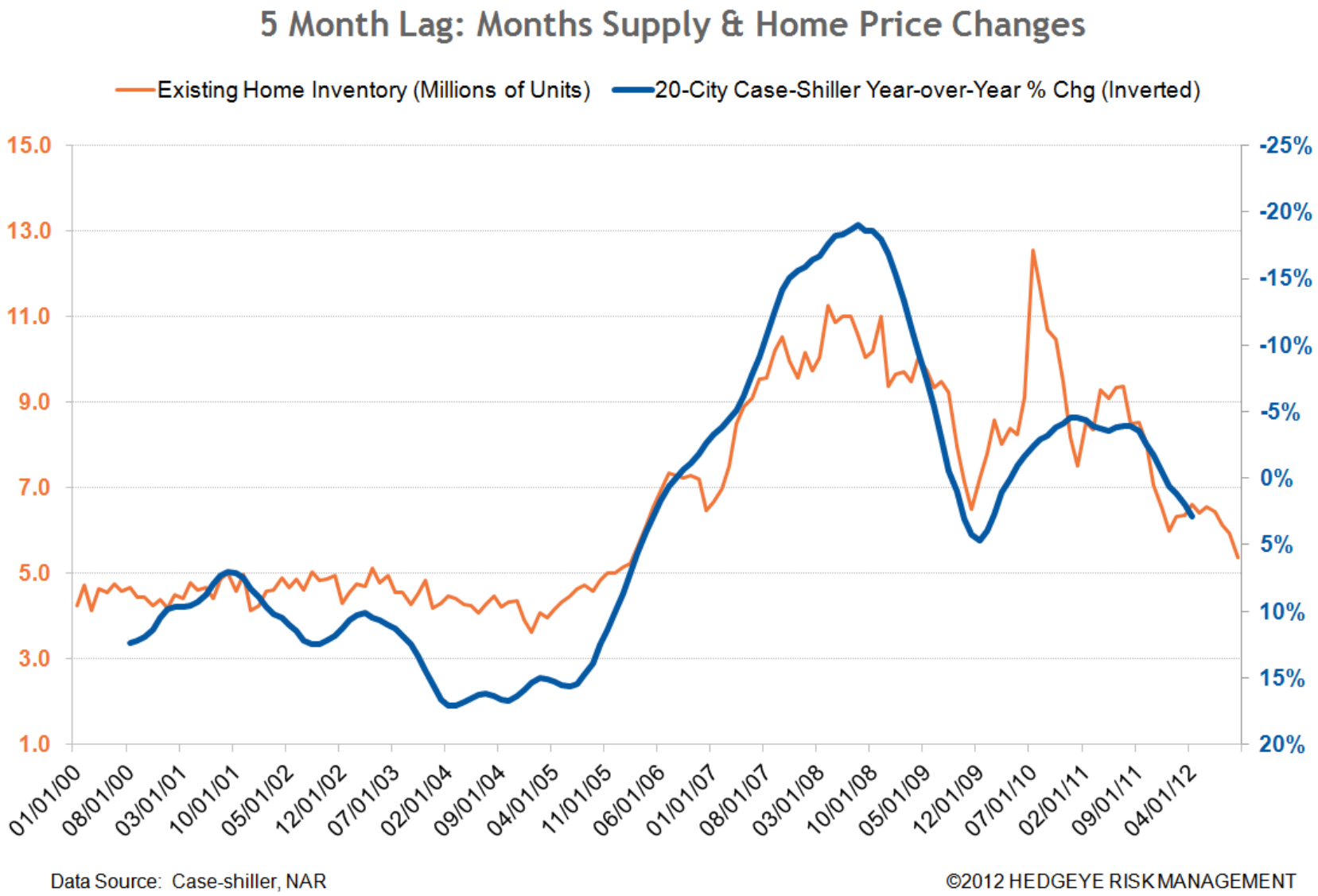


Current Supply Suggests +8.3% HPI Over The Next 11 Months

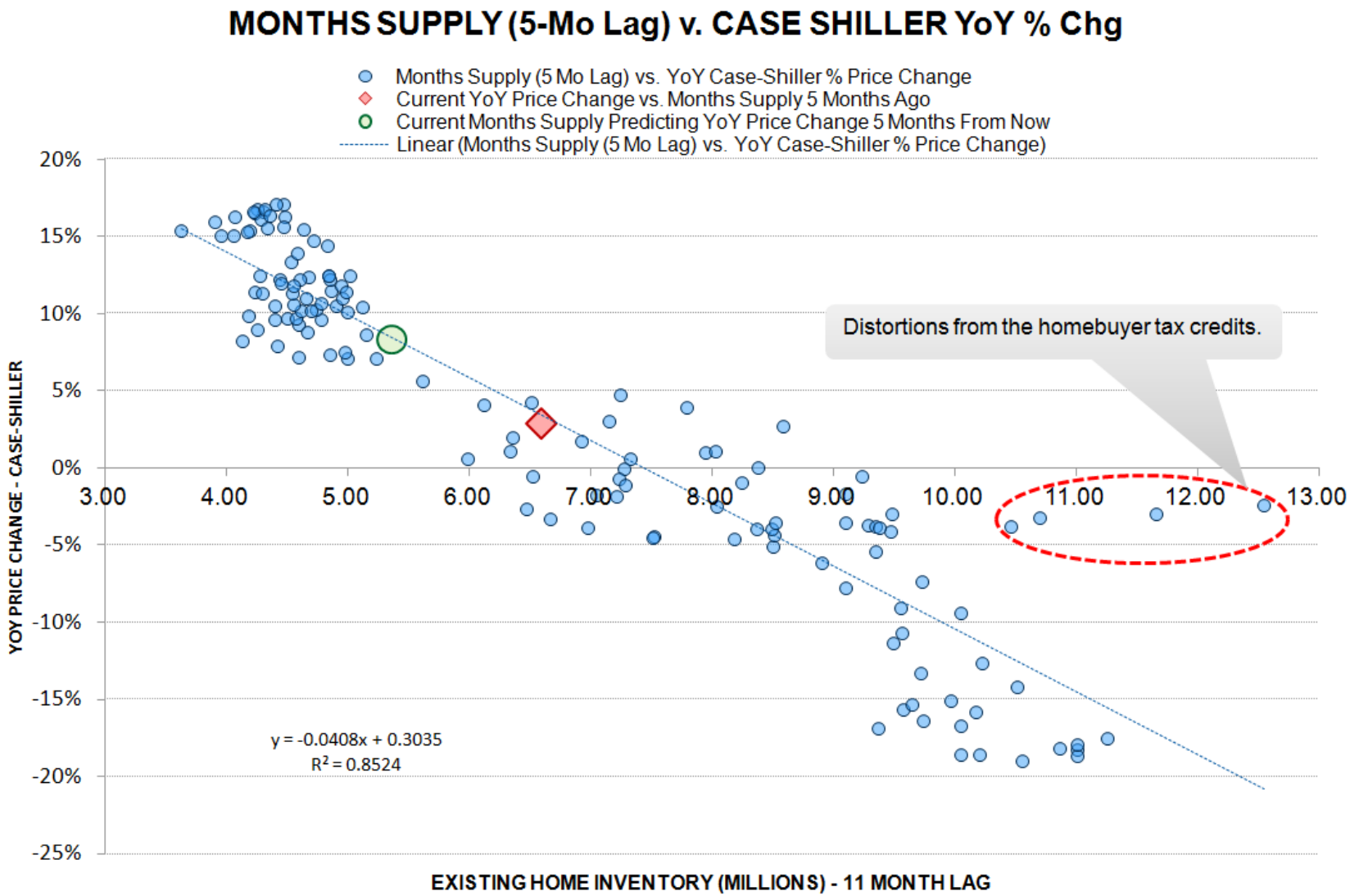


Data Source: Case-Shiller, NAR

Months Supply Leads Price by 5 Months



Months Supply Suggests +3.5% HPI Over The Next 5 Months



Data Source: Case-Shiller, NAR

To Summarize:

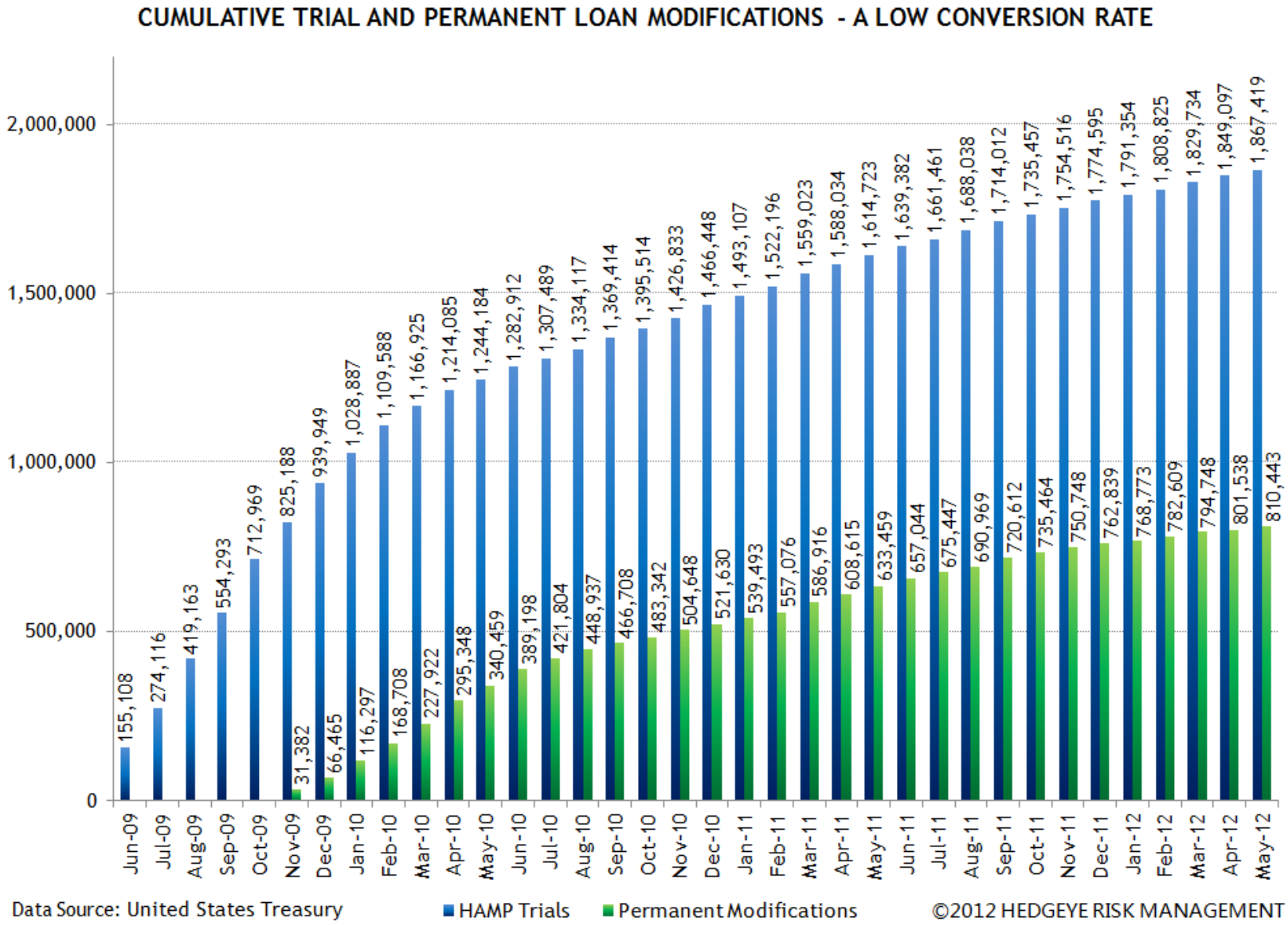
1. **Current Demand Suggests +17% HPI Over The Next 18 Months. ~0.9%/Month**

2. **Current Supply Suggests +8.3% HPI Over The Next 11 Months. ~0.8%/Month**

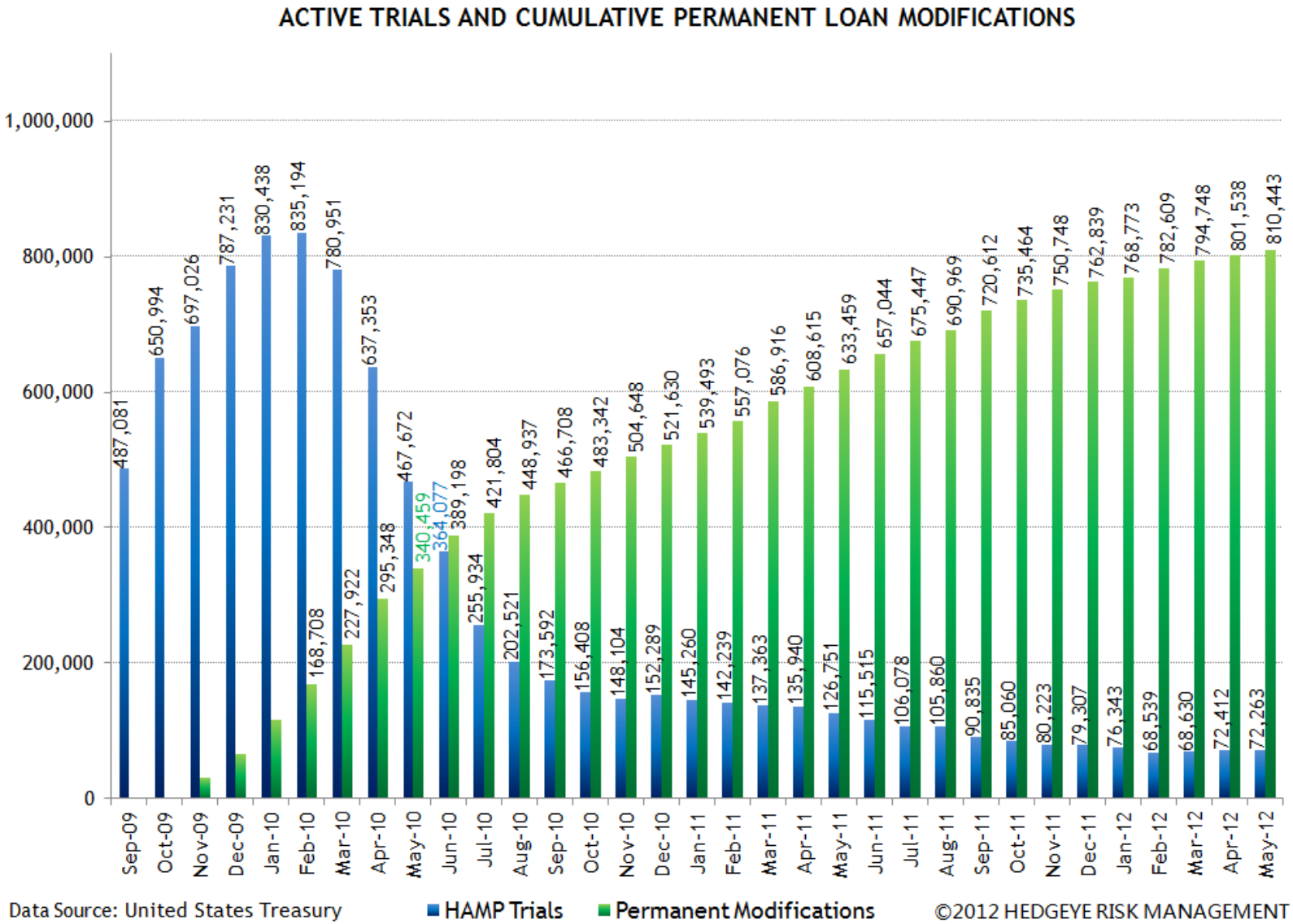
3. **Current Months Supply Suggests +3.5% HPI Over The Next 5 Months. ~0.7%/Month**

4. Modification Tailwinds

HAMP Helped, On the Margin

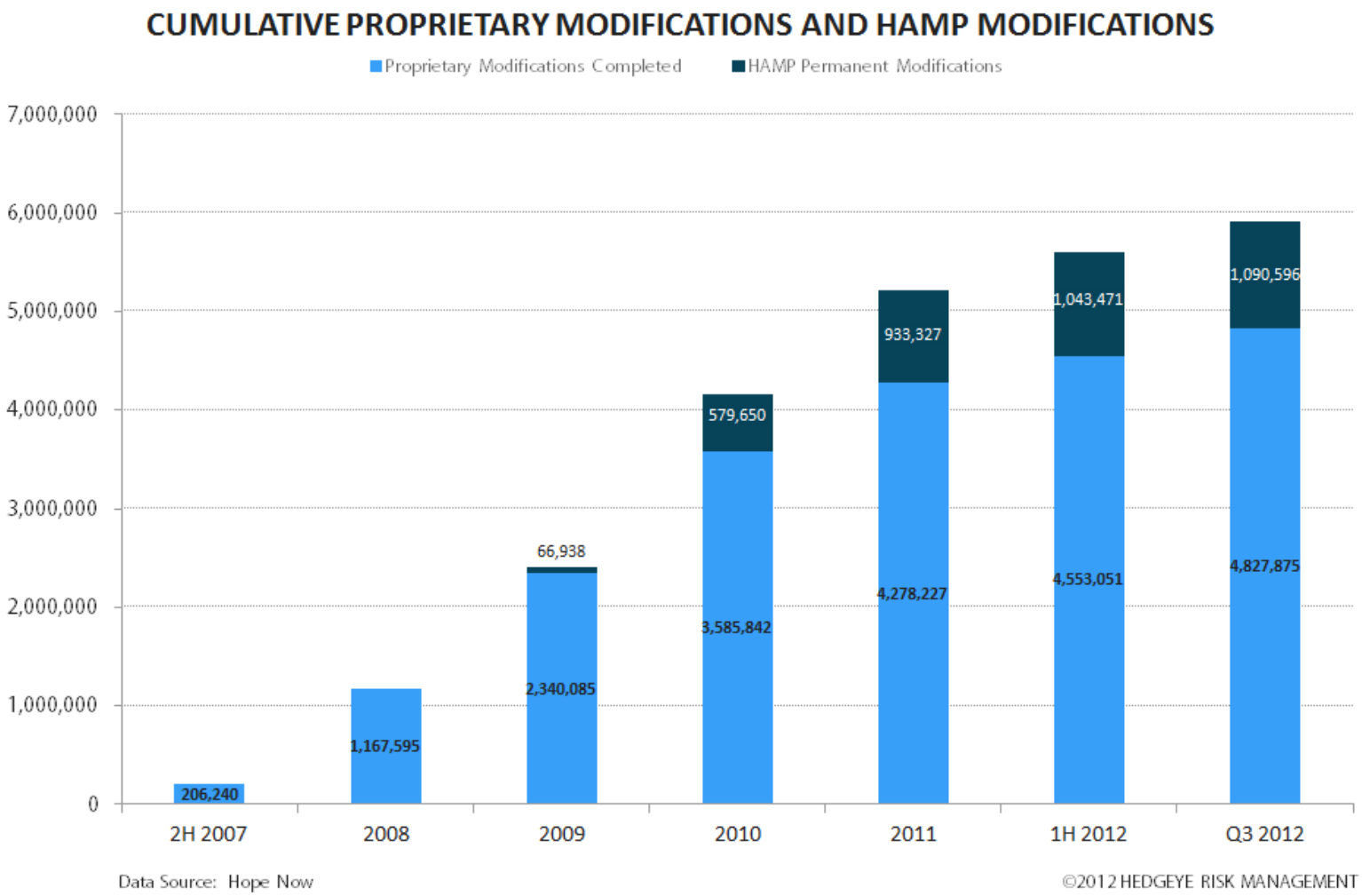


New HAMP Trials Are Winding Down

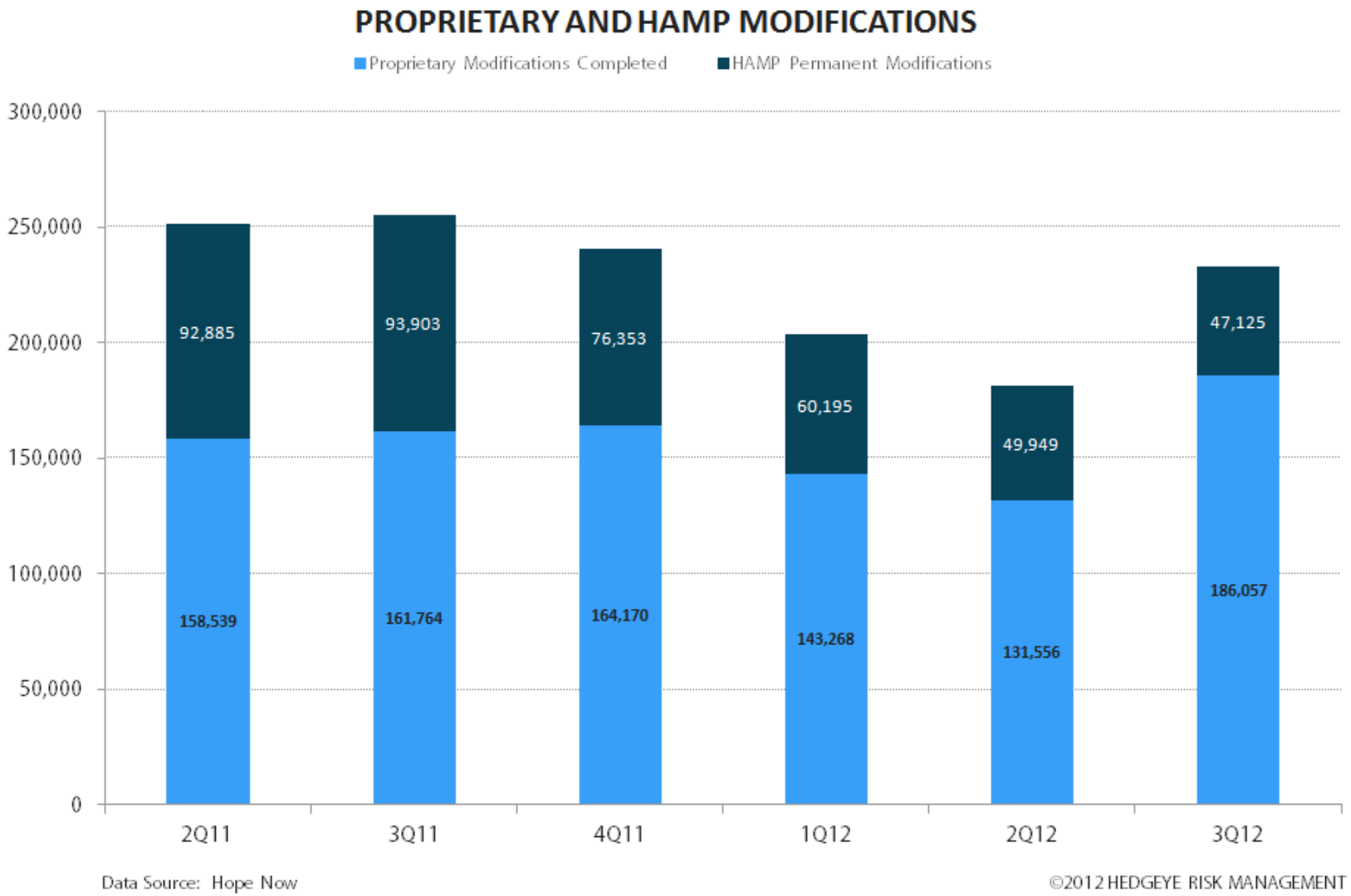


Data Source: United States Treasury

Private Sector Modifications Significantly Outnumber HAMP



And They Are Not Slowing Down



4 Reasons Why Modifications Will Be a Growing Tailwind

1. PRA (Principal Reduction Alternative) / HAMP

1. In October, 2010, HAMP was modified to allow principal forgiveness to 115% LTV in an effort to cut payments to 31% DTI
2. This change was the inaugural event that kicked off larger principal forgiveness initiatives

2. State Attorneys General Settlement:

1. Finalized March, 2012
2. Called for $25 billion to be paid by BAC, JPM, WFC, C and Ally
3. $5 billion in fines paid to States and Federal Government
4. $20 billion in mortgage modifications
5. $10 billion of mortgage modifications must be principal forgiveness
6. $20 billion must be deployed within 3 years of March, 2012; 75% within 2 years. Otherwise, penalties apply.
7. Largest benefit will be to portfolio loans on bank balance sheets. Private label investors may see some benefit.

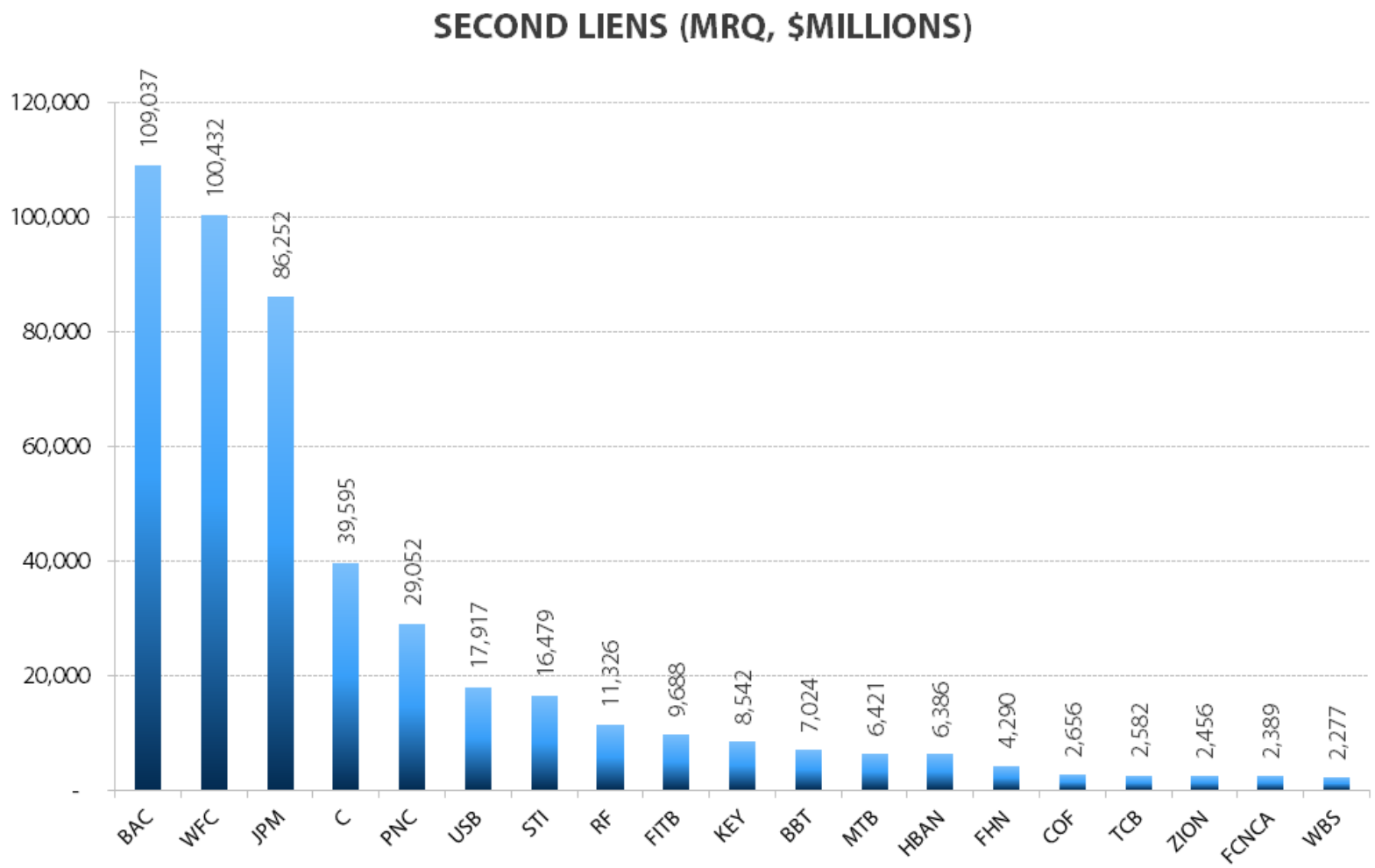
3. HARP Modification

1. In early 2012, HARP was amended to give servicers triple the financial incentive to forgive principal.
2. Under the new rules, servicers receive back from the Treasury 63 cents for every dollar of principal forgiven on loans with LTVs between 105-115%, 45 cents on every dollar for LTVs of 115-140, and 30 cents on every dollar for loans with LTVs greater than 140. These amounts are 3x what they were prior to the change.

4. GSE Modifications

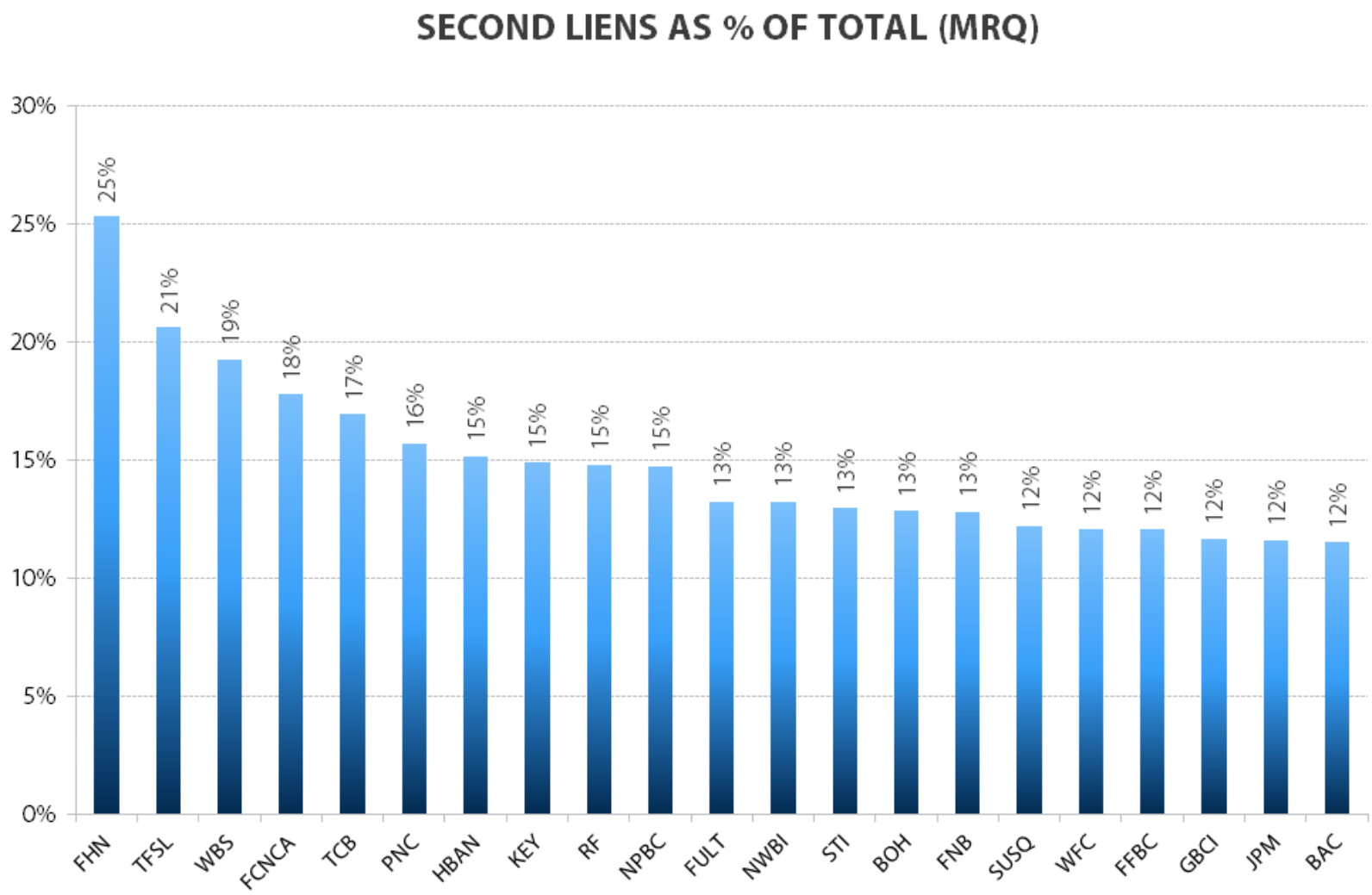
1. Principal reductions are not currently allowed at the GSEs
2. Fannie/Freddie are in conservatorship, and its DeMarco's job to conserve assets
3. FHFA Director Edward DeMarco opposes principal forgiveness on GSE loans
4. DeMarco argues that it is a negative NPV event for Fannie/Freddie to forgive principal
5. DeMarco also argues that it will benefit the Mortgage Insurers and Secon Lien Holders (the banks) at the expense of the GSEs (the taxpayers)
6. DeMarco has defended this position, but President Obama has made it clear he wants to replace DeMarco
7. When he is replaced, and principal forgiveness is allowed at the GSEs, it will be both a tailwind for housing generally, but specifically for banks with large second lien portfolios and the mortgage insurers

Banks With Large Second Lien Books Stand To Benefit



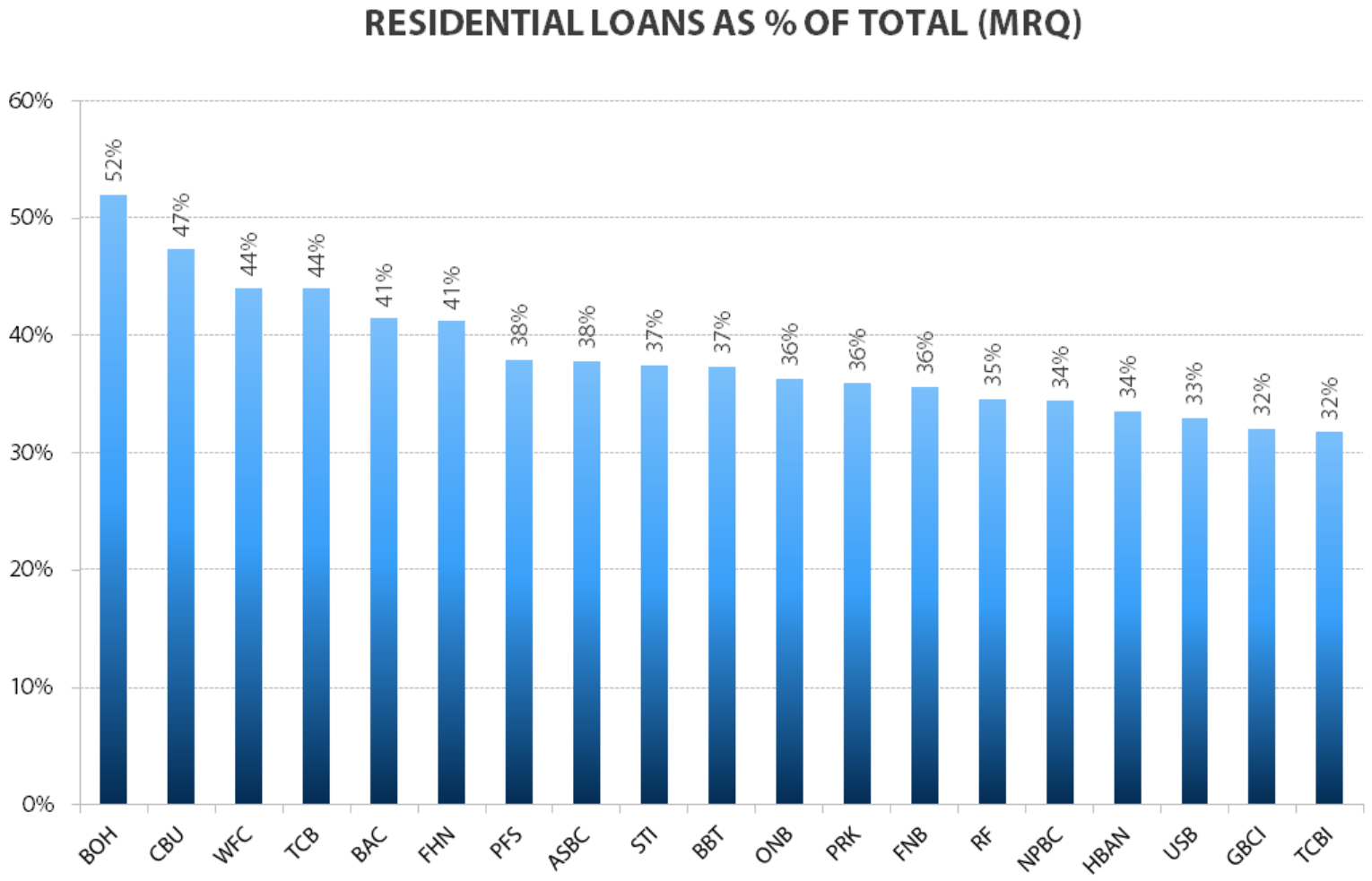
Data Source: SNL

Second Lien Books Are Very Significant For Some Banks



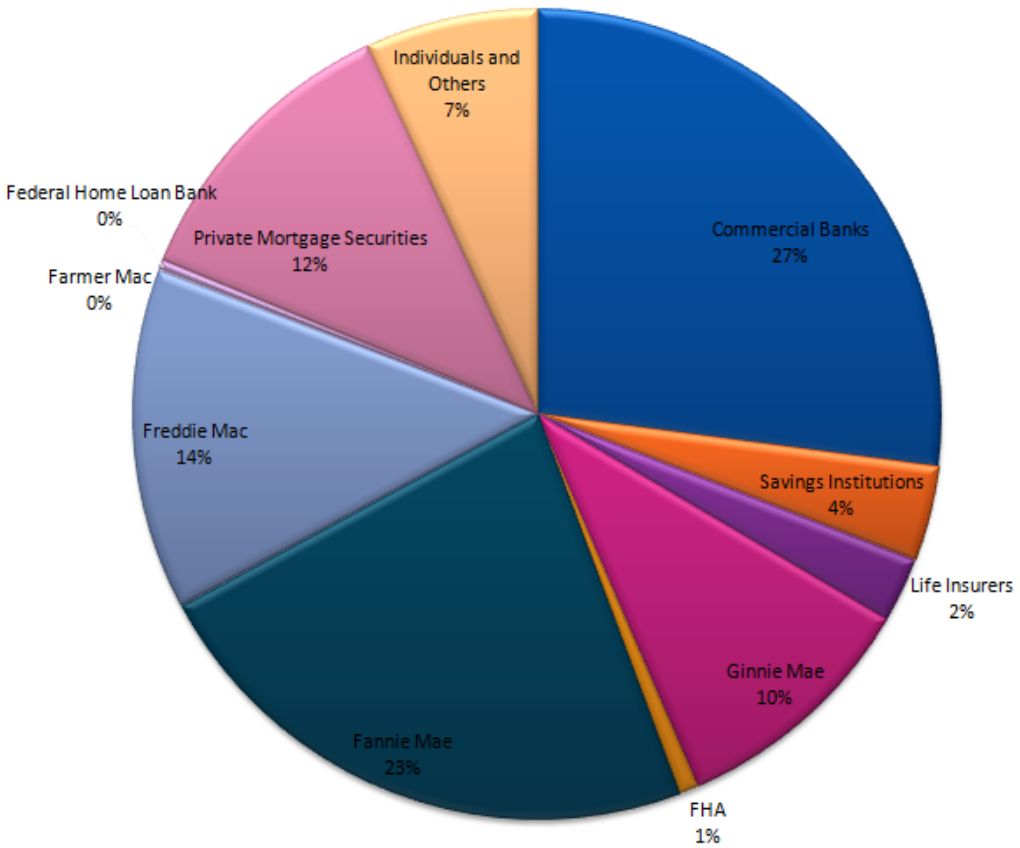
Data Source: SNL

Adding in 1st Liens, Exposures Reach 1/3 – 1/2



Data Source: SNL

Fannie & Freddie Control 37% Of The Market, So Principal Forgiveness Will Be A Major Event

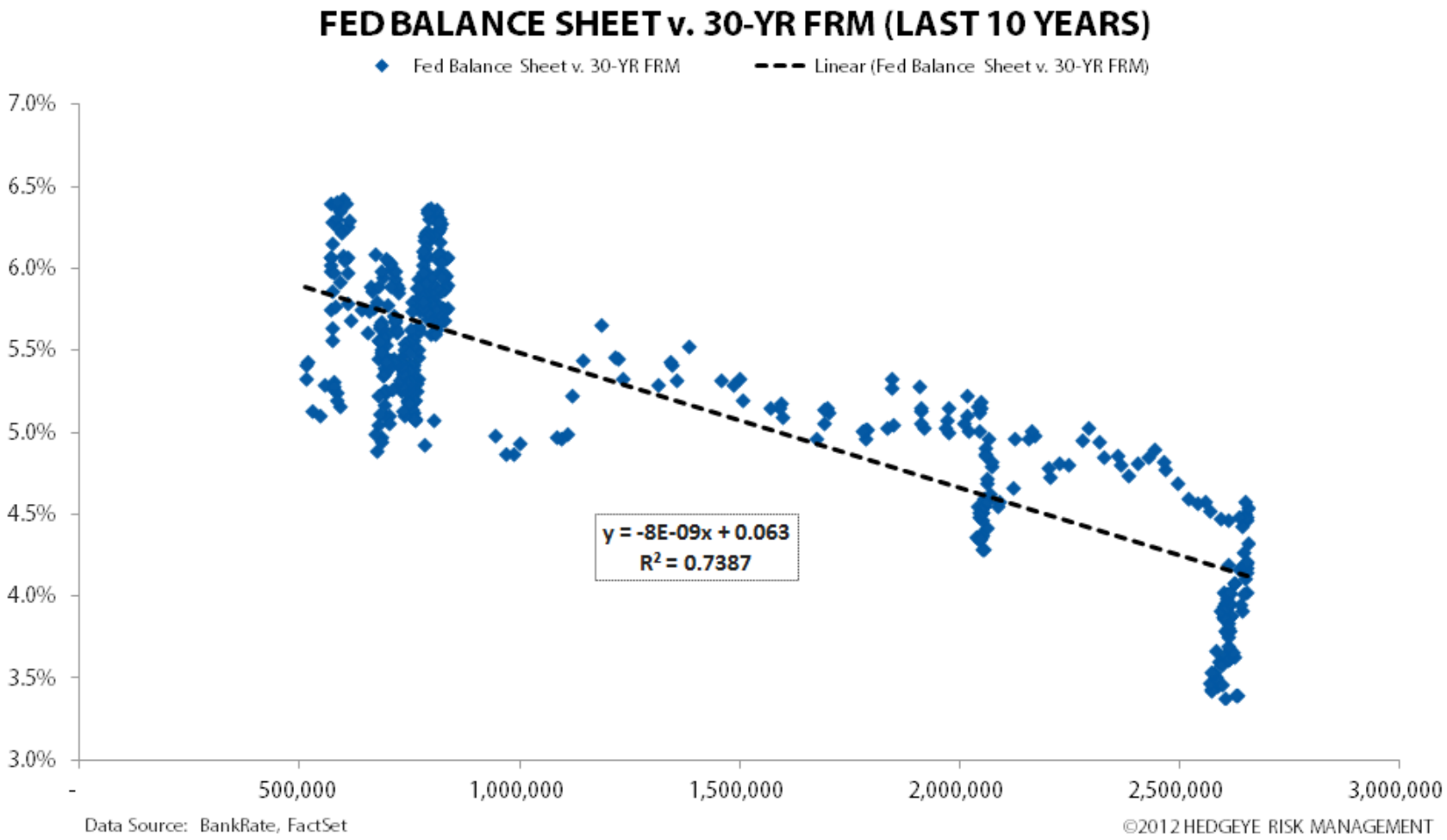


Data Source: Federal Reserve

5. Rate Tailwinds

1. Federal Government Austerity Necessitates More QE
2. Quantitative Easing Lowers Long Term Rates
3. Therefore, Expect Mortgage Rates to Continue to Fall

(Incidentally, this chart suggests mortgage rates would be at ~6.3% without the Fed)



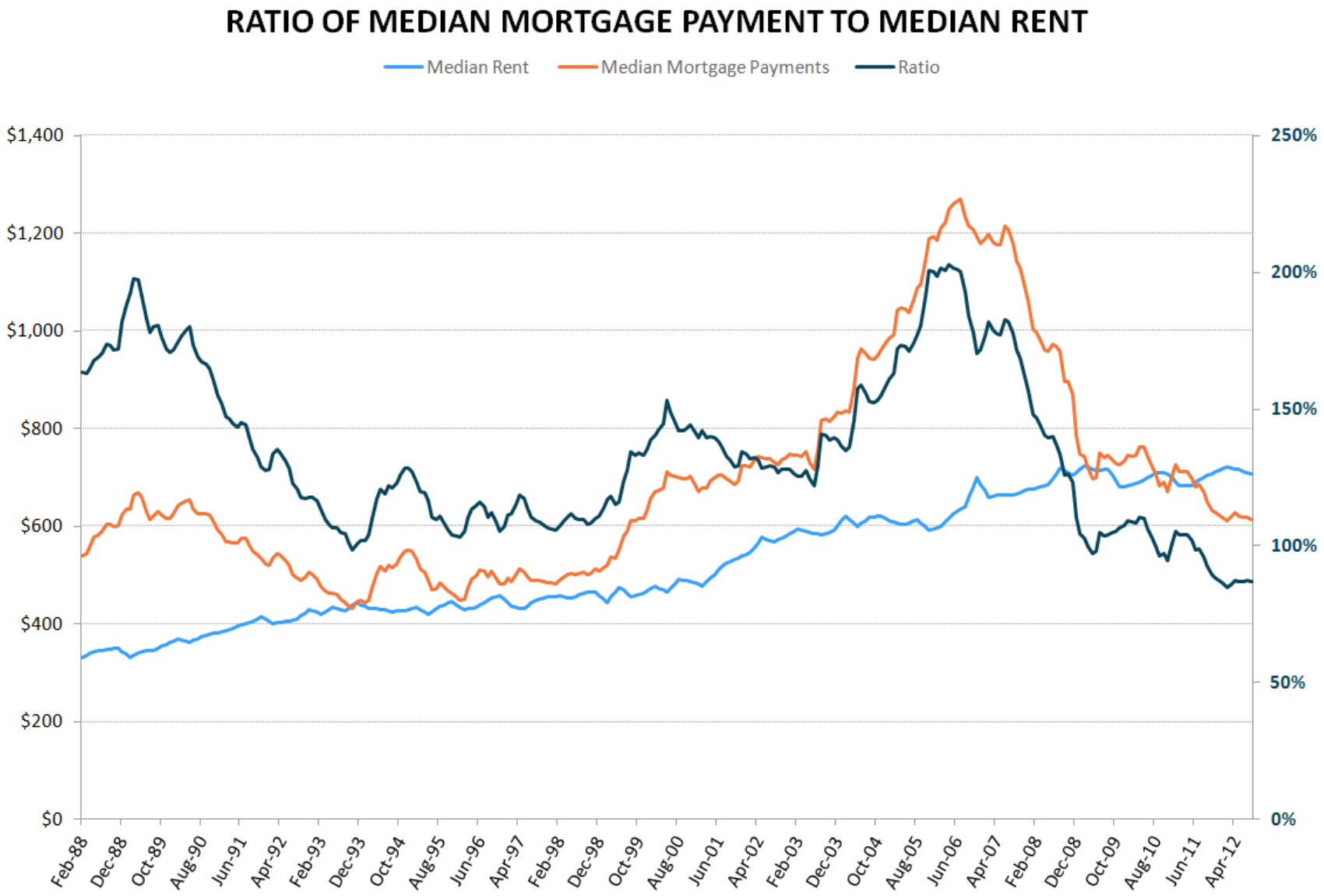
Lower Rates Enhance Affordability More Than You Might Think

Affordability Dynamics

Assumptions:			
$178,600	*Median Home Price, October 2012*	*2010 Average 30 Year FRM*	*4.79%*
$50,054	*Median Household Income, 2011*	*2011 Average 30 Year FRM*	*4.46%*
$4,171	*Median Household Monthly Income*	*2012 YTD Average 30 Year FRM*	*3.69%*
$1,168	*Monthly Mortgage Pmt @ 28% DTI*	*Current 30 Year FRM, 12/4/12*	*3.40%*

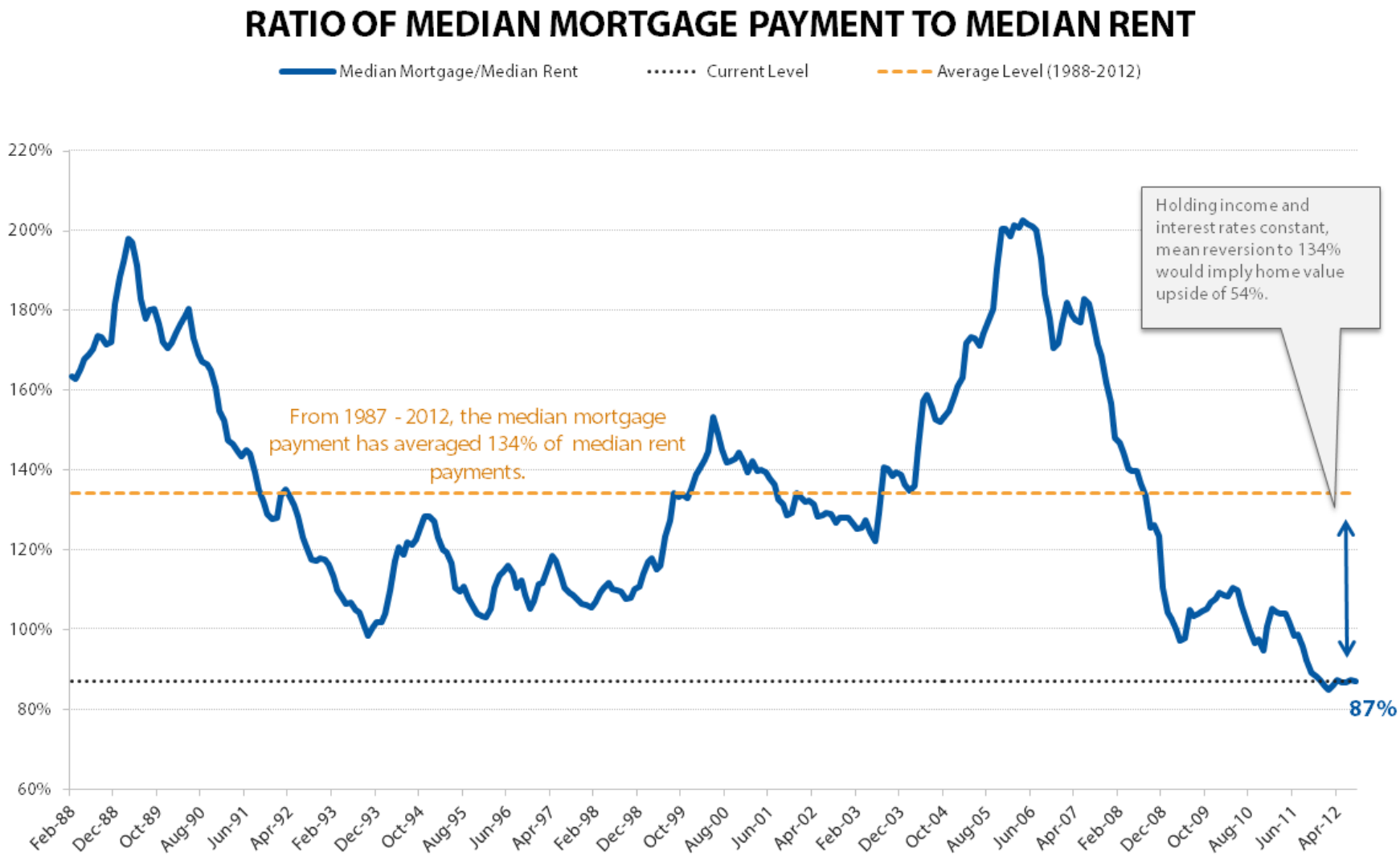
30-Year Fixed Rate Mortgage	Purchasing Power With a $1,168 Monthly Payment	$ Change in Affordability	% Change in Affordability	Relevance
1.00%	$363,117	$140,256	62.9%	
1.50%	$338,412	$115,551	51.8%	
2.00%	$315,981	$93,120	41.8%	
2.50%	$295,587	$72,726	32.6%	
3.00%	$277,020	$54,159	24.3%	
3.40%	**$263,354**	**$40,493**	**18.2%**	**Current 30Yr FRM: 3.40%**
3.50%	$260,091	$37,231	16.7%	
3.69%	**$254,053**	**$31,192**	**14.0%**	**2012 YTD Avg 30Yr FRM: 3.69%**
4.00%	$244,635	$21,775	9.8%	
4.46%	**$231,588**	**$8,728**	**3.9%**	**2011 Avg 30Yr FRM: 4.46%**
4.50%	$230,503	$7,643	3.4%	
4.79%	**$222,861**	**$0**	**0.0%**	**2010 Avg 30Yr FRM: 4.79%**
5.00%	$217,563	($5,298)	-2.4%	
5.50%	$205,697	($17,163)	-7.7%	
6.00%	$194,800	($28,060)	-12.6%	
6.50%	$184,779	($38,082)	-17.1%	
7.00%	$175,548	($47,313)	-21.2%	
7.50%	$167,034	($55,827)	-25.1%	
8.00%	$159,169	($63,692)	-28.6%	
8.50%	$151,893	($70,968)	-31.8%	
9.00%	$145,152	($77,709)	-34.9%	
9.50%	$138,898	($83,963)	-37.7%	
10.00%	$133,086	($89,775)	-40.3%	

Mortgage Payments Have Fallen By Half



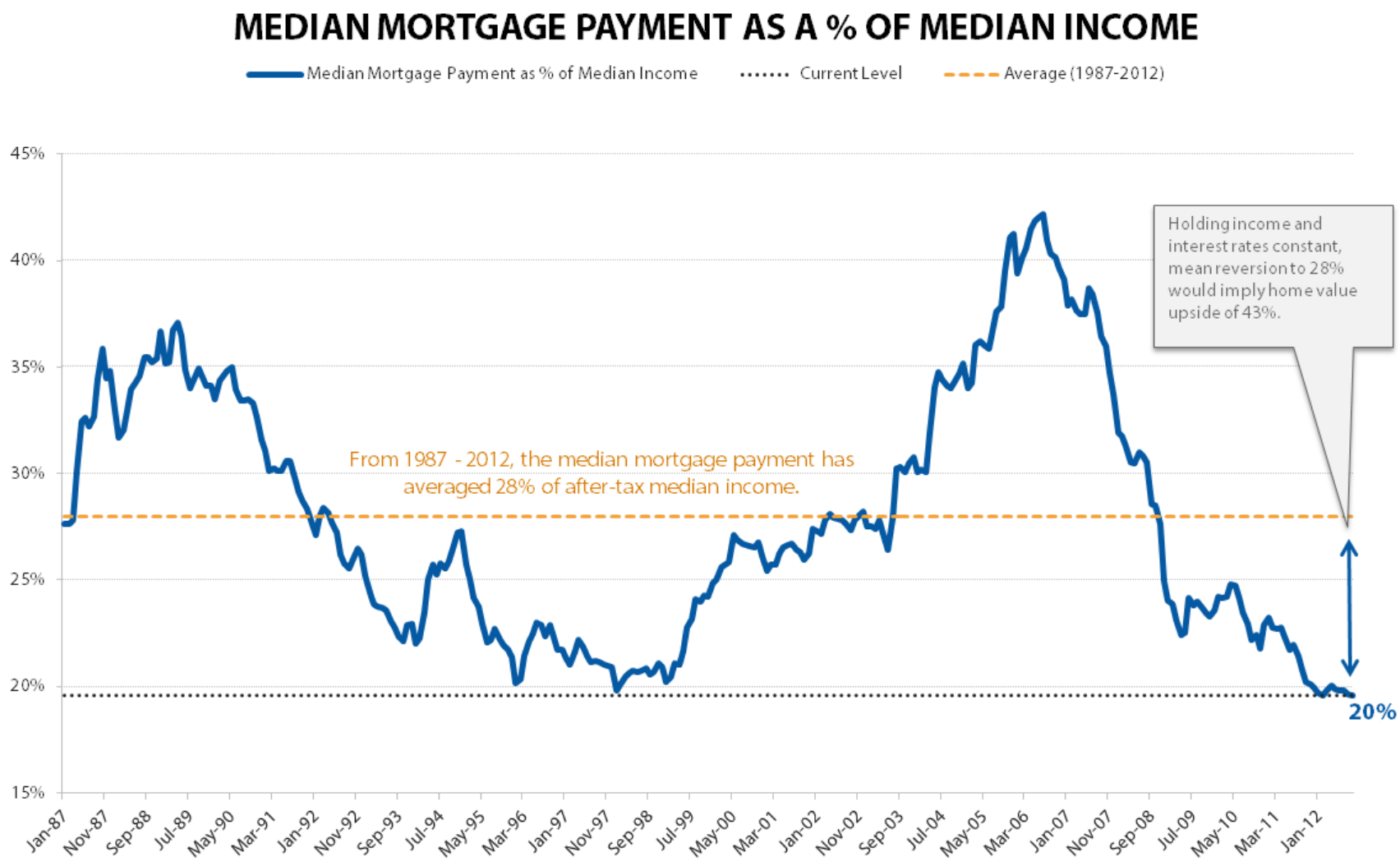
Data Source: Census Bureau, Case-Shiller, BankRate

Affordability Measure #1: Mortgage Payments Vs. Rent



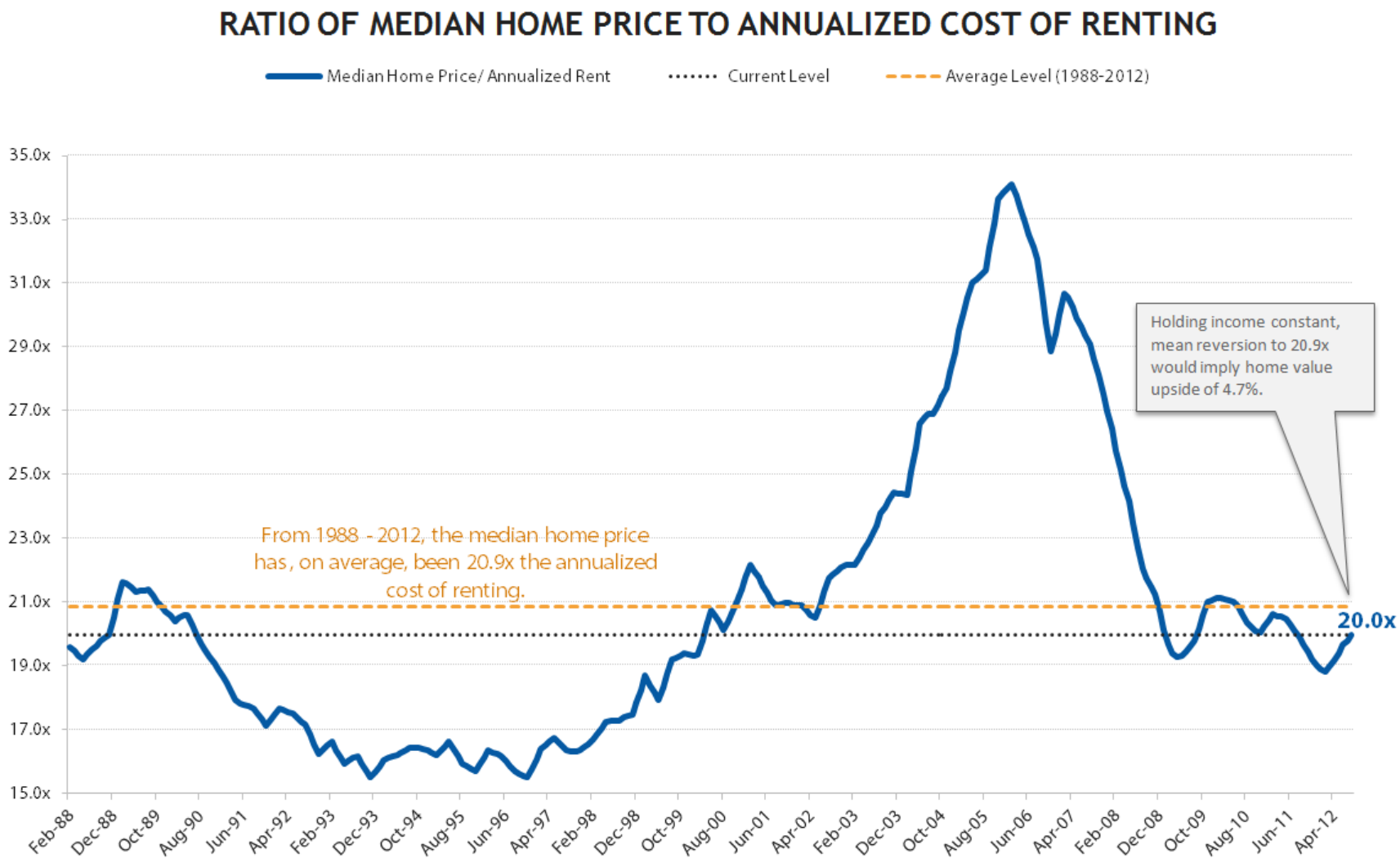
Data Source: Census Bureau, Case-Shiller, BankRate

Affordability Measure #2: Mortgage Payments As % of Income



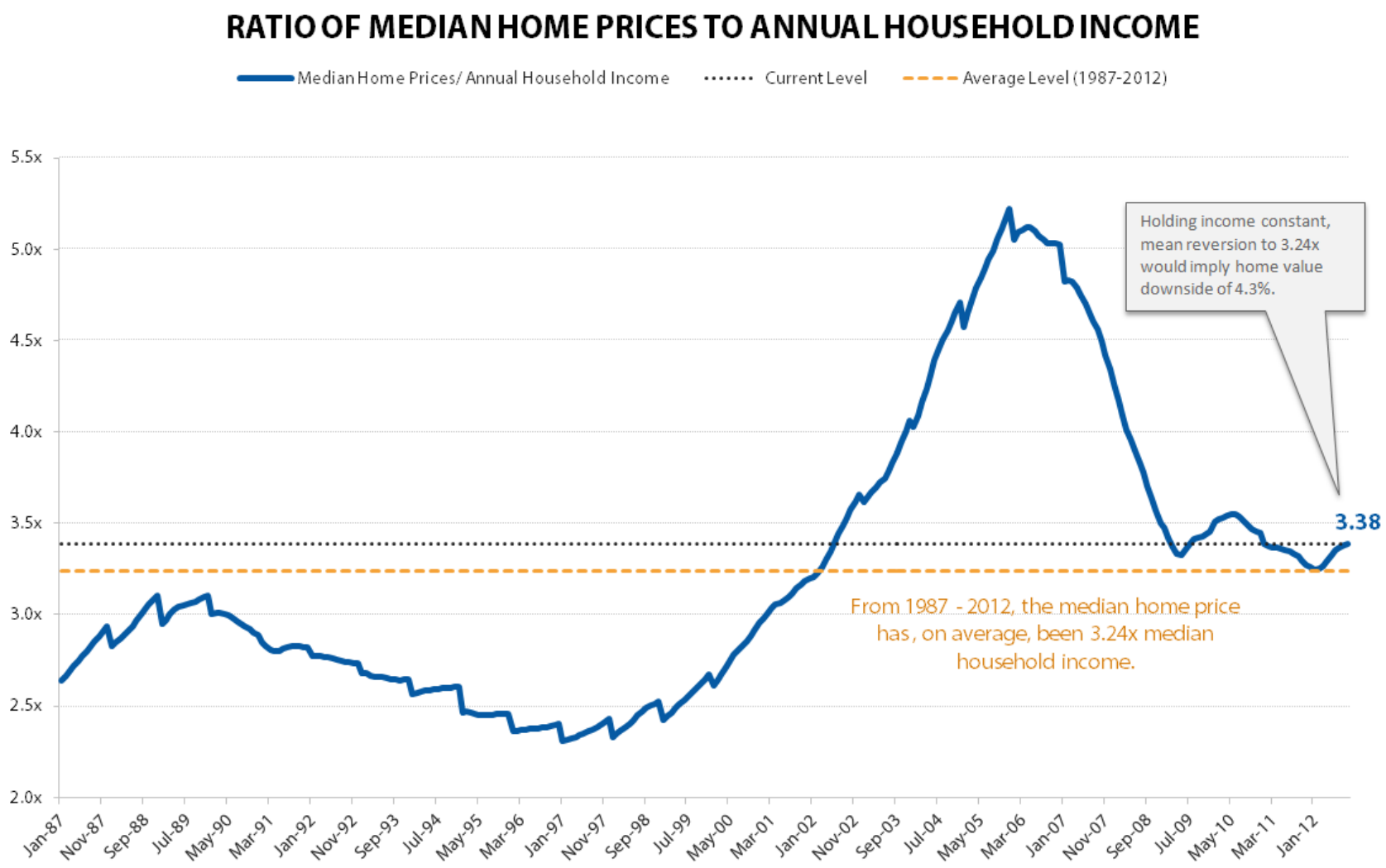
Data Source: Census Bureau, Case-Shiller, BankRate

Affordability Measure #3: Home Prices Vs. Annualized Rents



Data Source: Census Bureau, Case-Shiller, BankRate

Affordability Measure #4: Home Prices Vs. Income



Data Source: Census Bureau, Case-Shiller, BankRate

To Summarize:

1. **Affordability Measure #1: Mortgage Payments Vs. Rent. (Upside of 54%)**

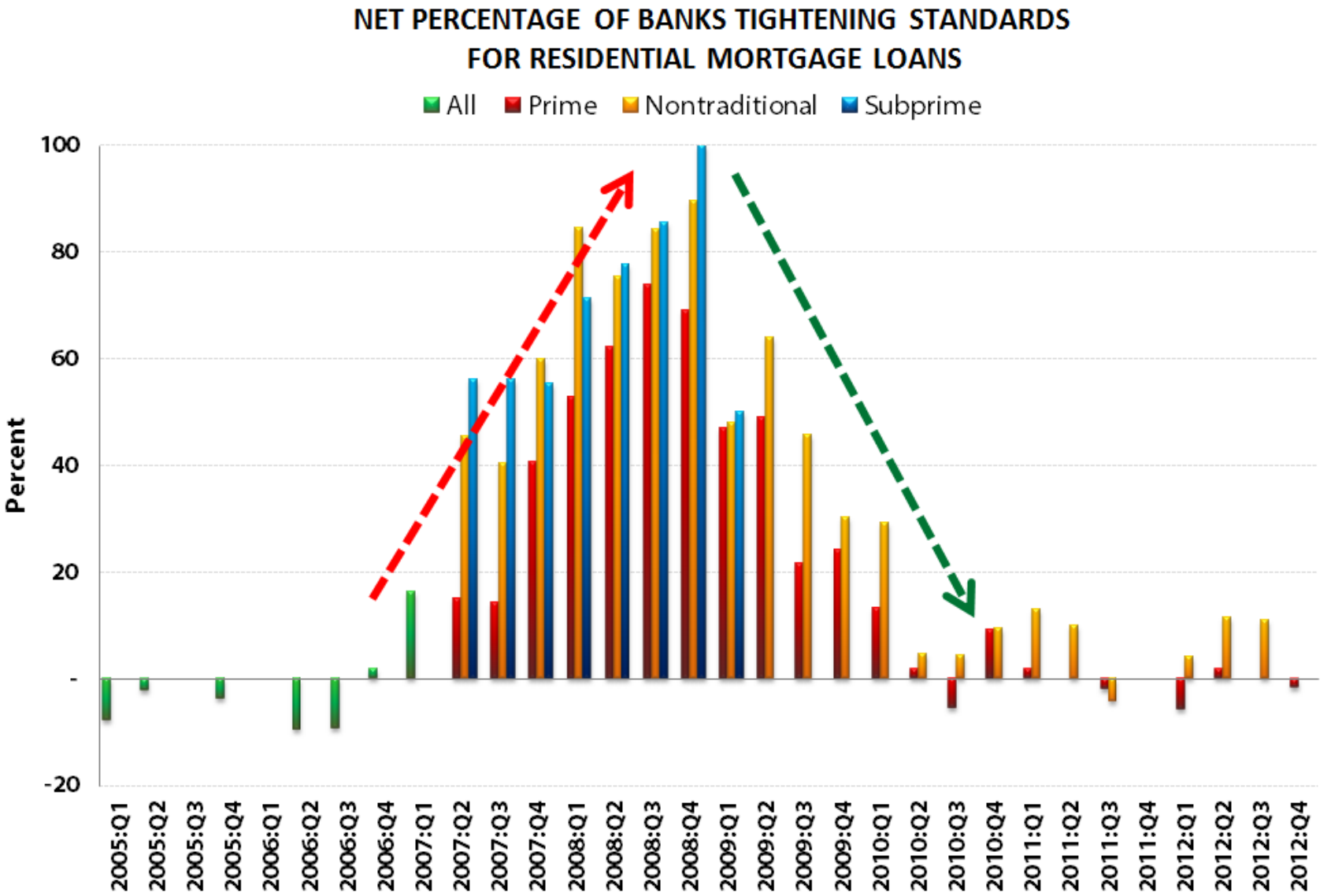
2. **Affordability Measure #2: Mortgage Payments As % of Income (Upside of 43%)**

3. **Affordability Measure #3: Home Prices Vs. Annualized Rents (Upside of 5%)**

4. **Affordability Measure #4: Home Prices Vs. Income (Downside of 4%)**

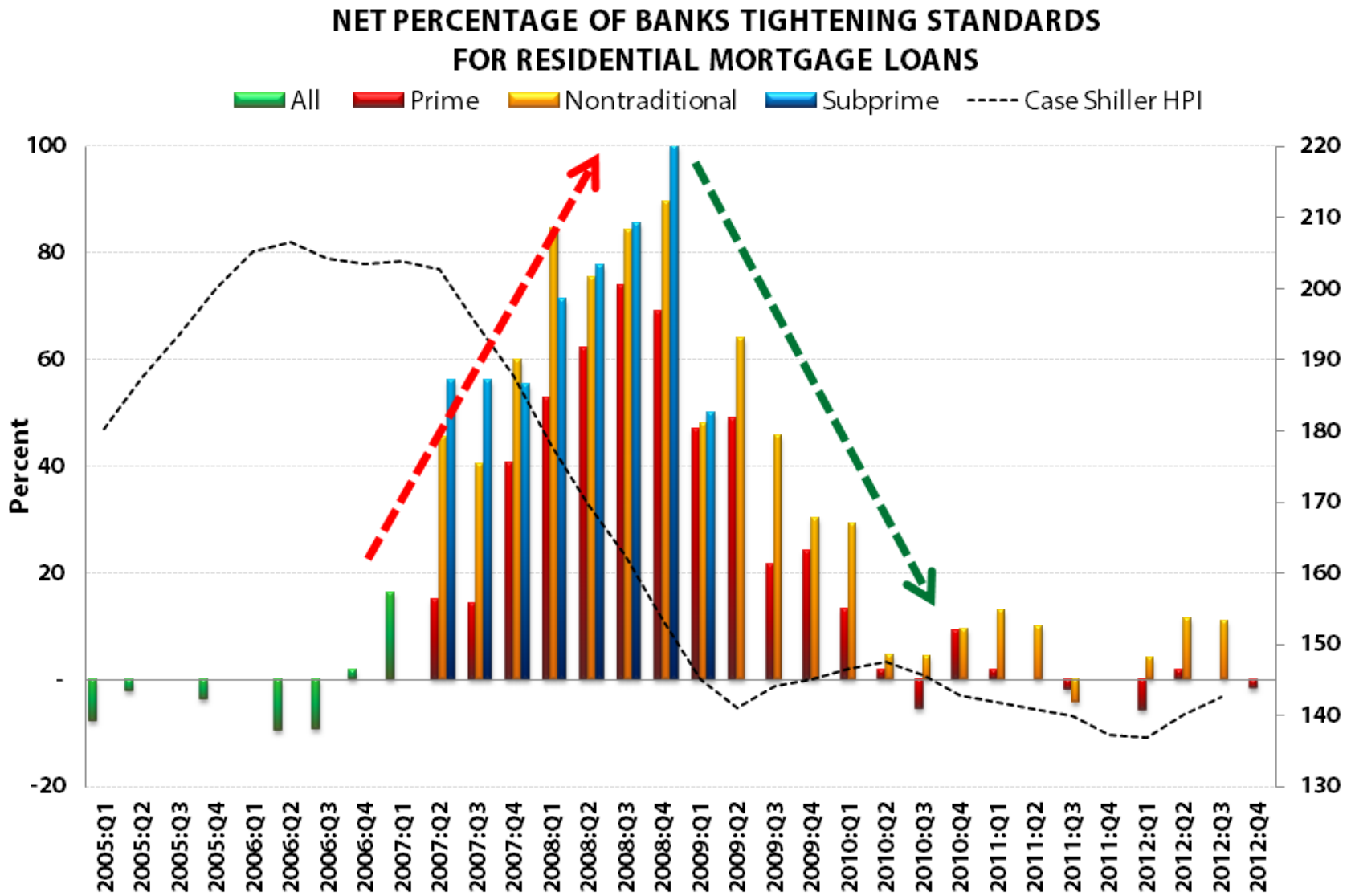
6. Credit Tailwinds

As Housing Improves, Banks Will Start Easing Credit



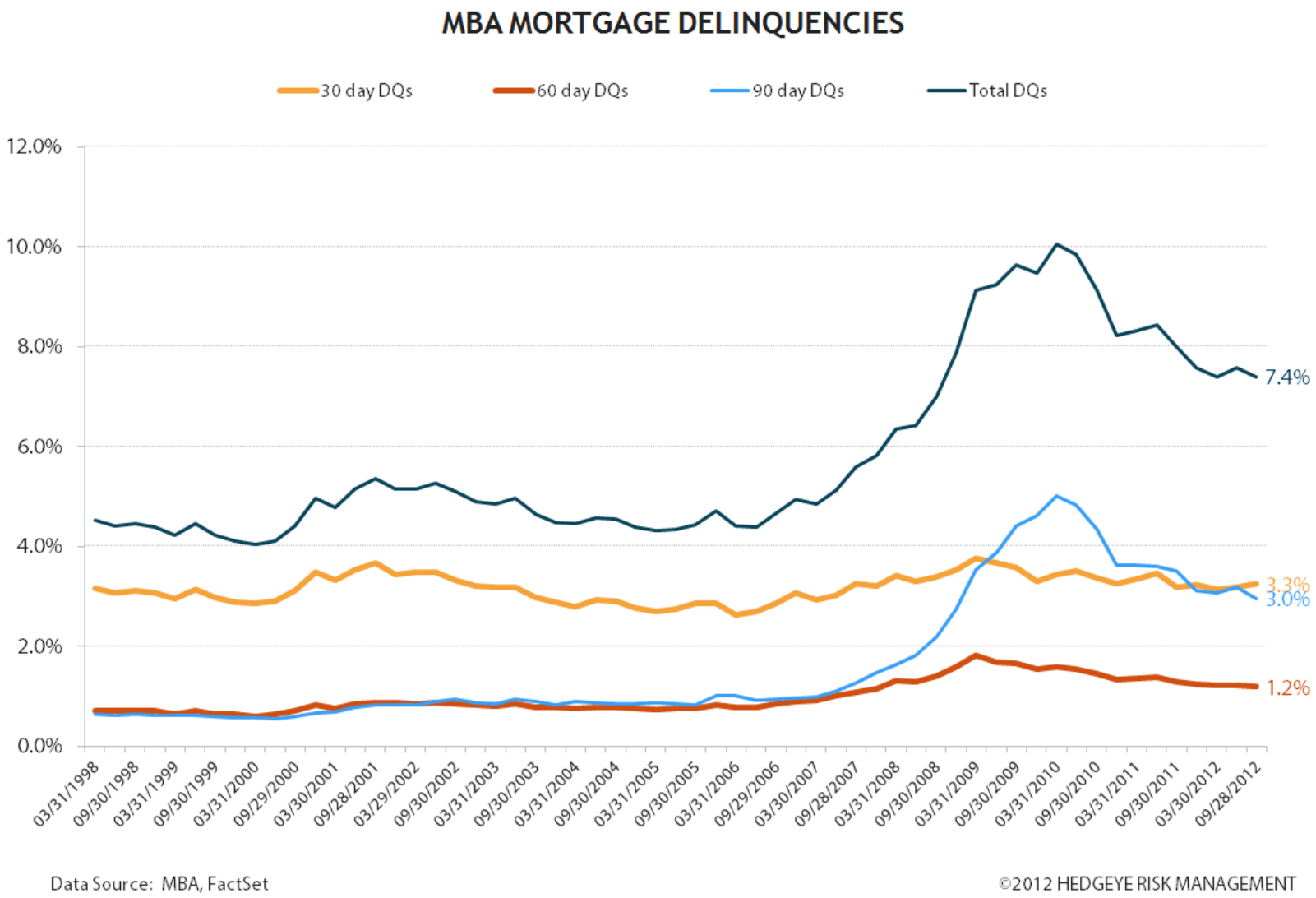
Source: Fed Senior Loan Officer Survey

Bank Credit Policy Is Reactive

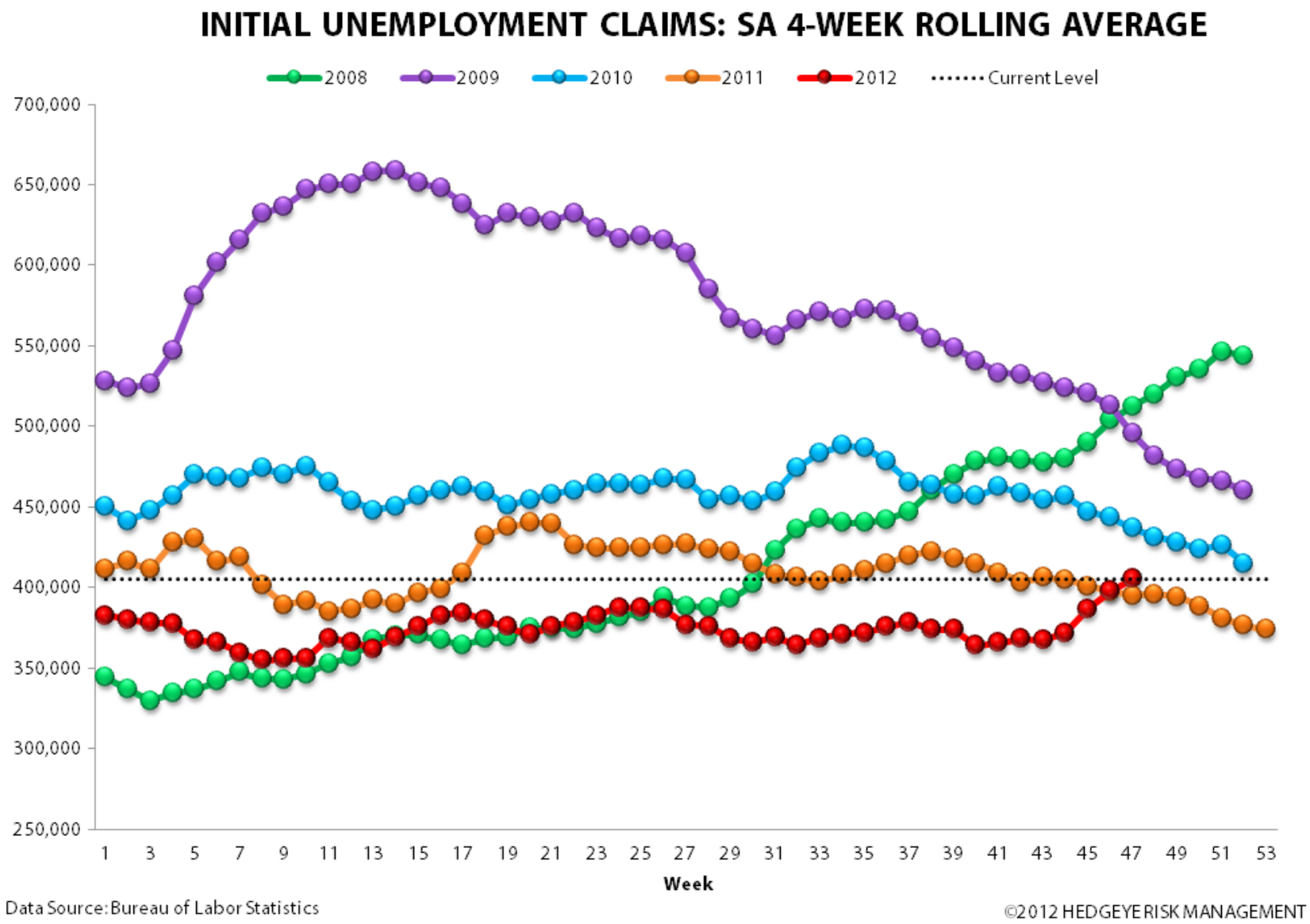


Data Source: Fed Senior Loan Officer Survey

As Mortgage Credit Metrics Improve, Banks Will Lend



The Employment Environment Is Improving



We're Also At the Early Stages of Re-Qualifying Some Borrowers

Impact to FICO Score	Consumer A	Consumer B	Consumer C
Starting FICO	~680	~720	~780
Subsequent FICO Score after:			
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sales/Deed-in-lieu/settlement (no deficiency balance)	610-630	605-625	655-675
Short sales (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Estimated Time for FICO to Fully Recover			
Starting FICO	~680	~720	~780
Time to recover:			
30 days late on mortgage	~9 months	~ 2.5 years	~3 years
90 days late on mortgage	~9 months	~ 3 years	~ 7 years
Short sales/Deed-in-lieu/settlement (no deficiency balance)	~ 3 years	~ 7 years	~ 7 years
Short sales (with deficiency balance)	~ 3 years	~ 7 years	~ 7 years
Foreclosure	~ 3 years	~ 7 years	~ 7 years
Bankruptcy	~ 5 years	~ 7-10 years	~ 7-10 years

Note: Estimates assume all else held constant over time (e.g. no new account openings, no new delinquency, similar outstanding debt.

Source: FICO® Banking Analytics Blog

"Animal spirits" is the term John Maynard Keynes used in his 1936 book The General Theory of Employment, Interest and Money to describe emotions which influence human behavior and can be measured in terms of consumer confidence.

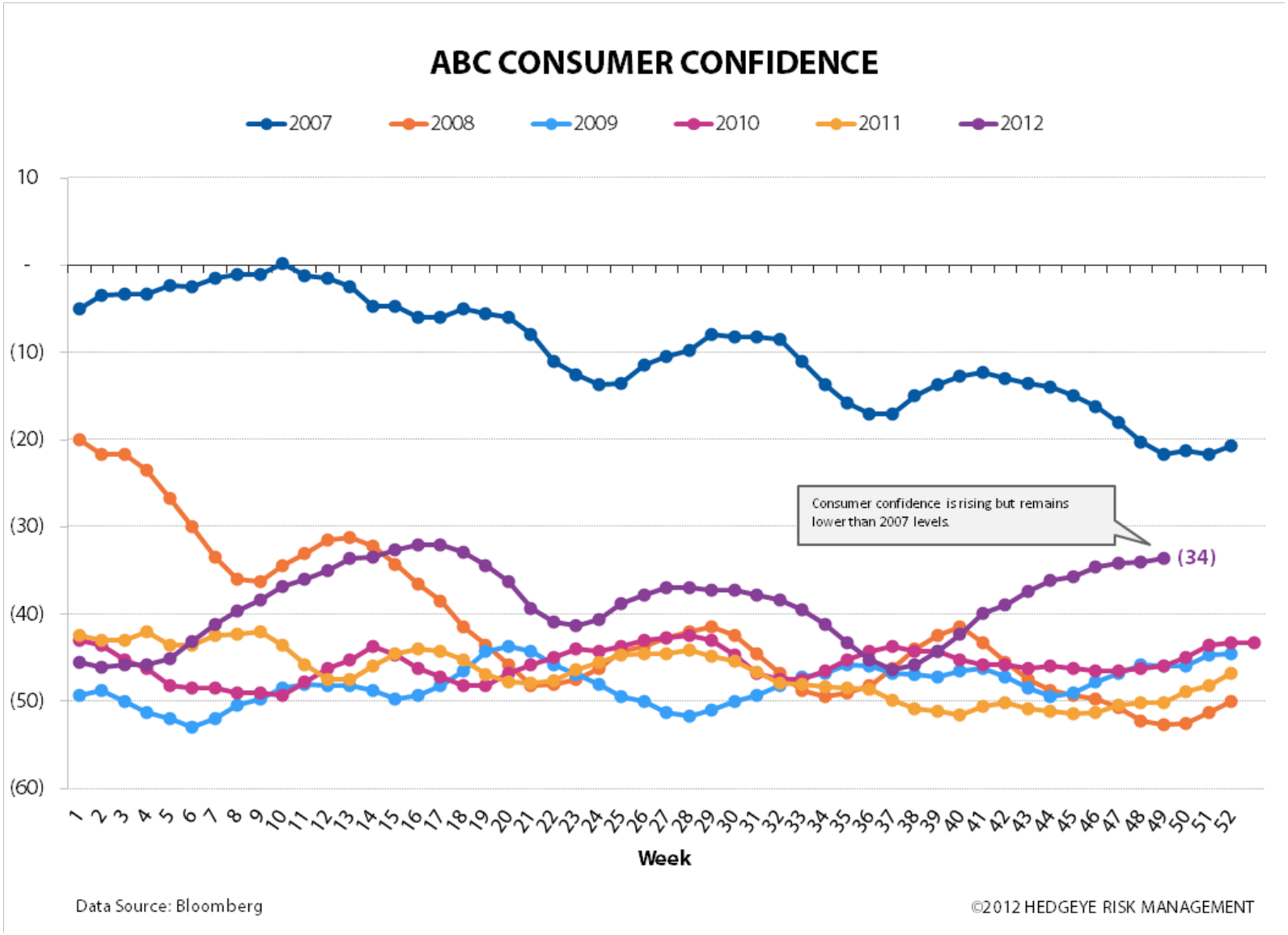
- Wikipedia

7. Animal Spirits

“Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.”

- John Maynard Keynes

Consumer Confidence Is Showing Early Signs of Breaking Out



8. Headwinds

A Tale of Two Taxpayers: The Mortgage Interest Deduction

Half of homeowners don't itemize. If you don't itemize, you don't get the mortgage interest deduction.

2012 Standard Deduction Levels	
Standard Deduction: Single Filer	$5,950
Standard Deduction: Head of Household	$8,700
Standard Deduction: Married Filing Jointl	$11,900

Scenario 1	
Median Income Earner	
Annual Household Income	$50,054
Median Home Value	$178,600
20% Down Payment	$35,720
Mortgage Amount	$142,880
Mortgage Rate	4.00%
Monthly Payment (30Yr FRM)	$682
Monthly Principal	$206
Monthly Interest	$476
Annual Interest	**$5,714**

	Deduction		
	Standard	Itemized	Savings
Single	$5,950	$5,714	-$236
Head of HH	$8,700	$5,714	-$2,986
Married Joinly	$11,900	$5,714	-$6,186

After-tax Savings at 35% Rate	
Single	-$236
Head of HH	-$2,986
Married Joinly	-$6,186

Monthly Savings	
Single	$0
Head of HH	$0
Married Joinly	$0

As % of Total Monthly Housing Payment	
Single	0%
Head of HH	0%
Married Joinly	0%

Scenario 2	
High Income Earner (Jumbo Cap Loan - $417k)	
Annual Household Income	$116,867
Home Value	$521,250
20% Down Payment	$104,250
Mortgage Amount	$417,000
Mortgage Rate	4.00%
Monthly Payment (30Yr FRM)	$1,991
Monthly Principal	$601
Monthly Interest	$1,390
Annual Interest	**$16,678**

	Deduction		
	Standard	Itemized	Savings
Single	$5,950	$16,678	$10,728
Head of HH	$8,700	$16,678	$7,978
Married Joinly	$11,900	$16,678	$4,778

After-tax Savings at 35% Rate	
Single	$3,755
Head of HH	$2,792
Married Joinly	$1,672

Monthly Savings	
Single	$313
Head of HH	$233
Married Joinly	$139

As % of Total Monthly Housing Payment	
Single	-16%
Head of HH	-12%
Married Joinly	-7%

Scenario 2	
High Income Earner (Jumbo Cap Loan - $729k)	
Annual Household Income	$204,308
Home Value	$911,250
20% Down Payment	$182,250
Mortgage Amount	$729,000
Mortgage Rate	4.00%
Monthly Payment (30Yr FRM)	$3,480
Monthly Principal	$1,050
Monthly Interest	$2,430
Annual Interest	**$29,164**

	Deduction		
	Standard	Itemized	Savings
Single	$5,950	$29,164	$23,214
Head of HH	$8,700	$29,164	$20,464
Married Joinly	$11,900	$29,164	$17,264

After-tax Savings at 35% Rate	
Single	$8,125
Head of HH	$7,163
Married Joinly	$6,043

Monthly Savings	
Single	$677
Head of HH	$597
Married Joinly	$504

As % of Total Monthly Housing Payment	
Single	-19%
Head of HH	-17%
Married Joinly	-14%

QM / QRM

1. **The CFPB is in the process of defining a Qualified Mortgage, or "QM". As a reminder, the QM was born from Dodd-Frank, and requires that lenders make a "reasonable and good faith determination that the borrower has the ability to repay the loan at the time the loan is made."**

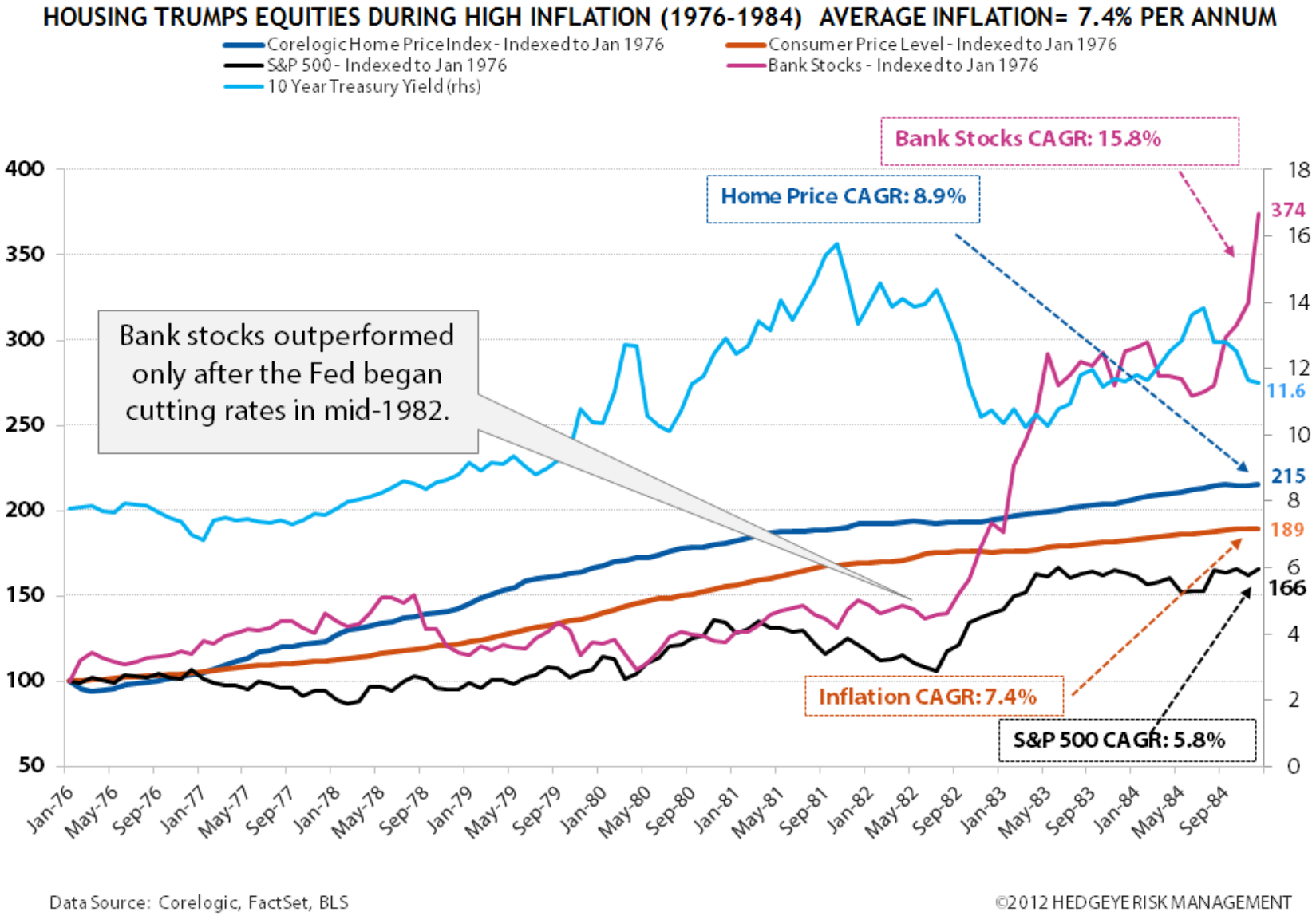
2. **A “QM” will have the following criteria:**
   1. **A term not more than 30 years and must be fully amortizing**
   2. **Have a fixed rate, or if variable, then the borrower is underwritten at the highest possible floating rate for the first five years of the loan**
   3. **Cannot have points and fees that exceed 3% of the total loan amount**
   4. **All taxes and insurance must be included in calculations and all sources of a borrowers income must be verified and documented**
   5. **A maximum DTI (debt-to-income) ratio can be imposed (TBD)**
   6. **“Safe harbor” vs. “rebuttable presumption” (TBD)**

3. **Under Title XIV of the Dodd-Frank Act, the effective data for the QM is January 21, 2013. However, under some circumstances, it's possible for the implementation date to be delayed by a full year from that January 2013 date. For its part, the CFPB has said publicly that they expect to finalize their work by year-end 2012.**

4. **One of the most contentious issues revolves around a legal concept of whether a QM mortgage should carry an implicit "safe harbor" or only a "rebuttable presumption". The industry is pushing for the safe harbor, which means that if a loan meets the QM criteria, then the underwriter is indemnified against future liability.**
   1. **There has still not been a decision made on whether the QM will carry an implicit “safe harbor” or not**
   2. **There has been recent speculation that the CFPB may provide safe harbor for only some QM loans.**

5. **QRM**
   1. **Contains the skin-in-the-game provision**
   2. **Loans that don’t meet the QRM requirements will have to be partially retained (5%) by the underwriter**
   3. **The catch is that the QRM definition cannot be any broader than the QM definition.**

High Inflation



Data Source: Corelogic, FactSet, BLS

9. Two Top Ideas: BAC & TCB

TCB: Regional Bank In Recovery & Stealth Housing Play

Overview: TCF Financial (Symbol: TCB) is a Midwest regional bank based in Minnesota, which operates primarily throughout Minnesota, Illinois, Michigan, Colorado and Wisconsin. TCF has 430 branches and just under $18 billion in total assets. The company offers retail and commercial banking as well as equipment financing, inventory financing and indirect auto finance.

Key Points:

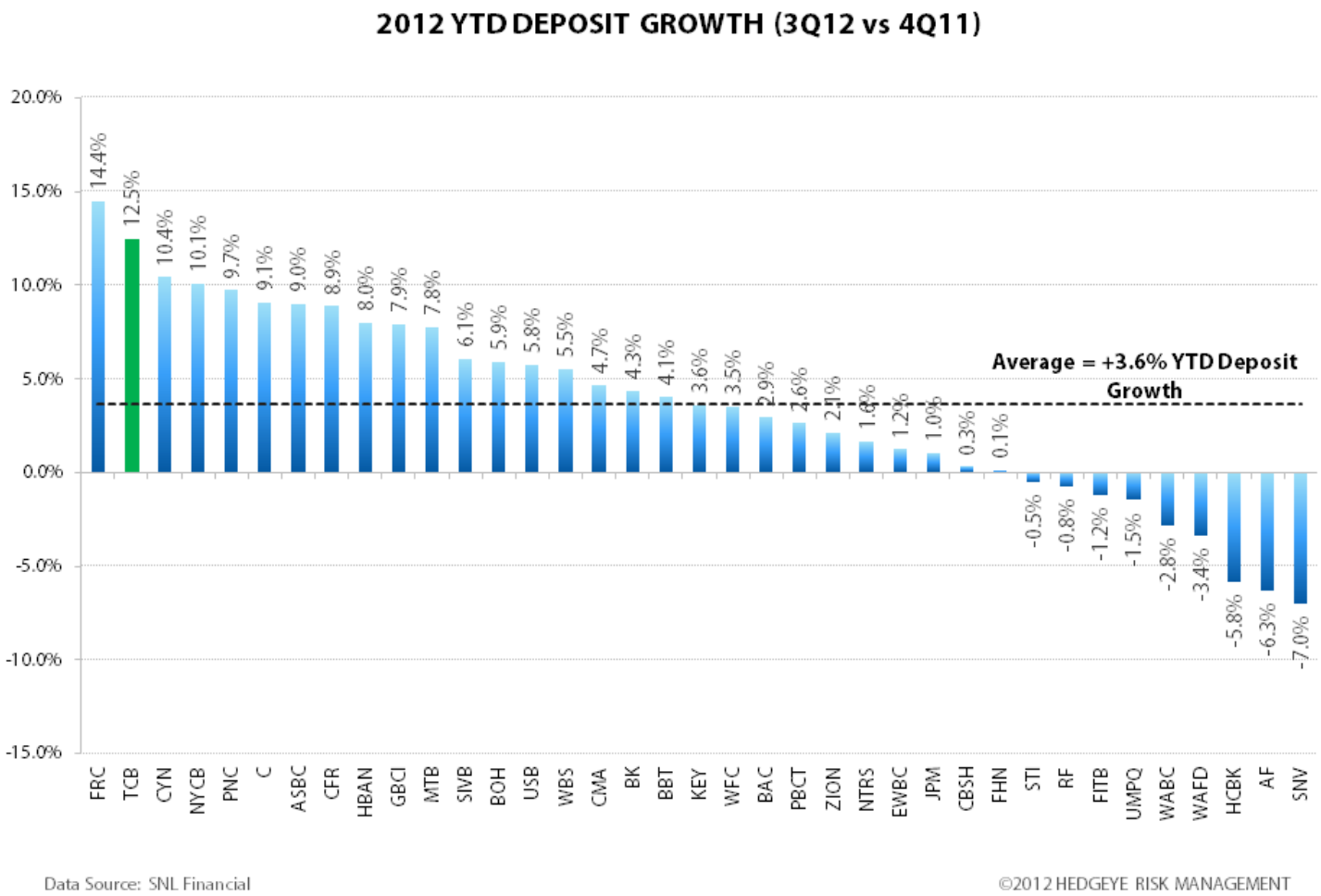
•**Rebuilding Year Coming to an End.** 2012 was a self-proclaimed rebuilding year for TCF following a long slog through 2011. In anticipation of that, we were decidedly bearish 20 months ago when we published a detailed report calling for investors to short TCF. The stock dropped >40% over the next six months. Looking ahead, we think the bad news is over, and this stock now offers compelling value.

• **Improving Fundamentals.** TCF is finally getting stronger. The company is among the best performing banks from a deposit and loan growth standpoint year-to-date.

•**Housing Tailwinds.** TCF's loan footprint is heavy on residential real estate in hard-hit Midwestern areas. That was a core element of the bear thesis in 2011/2012, but those same areas are today some of the best performing distressed real estate markets in the country.

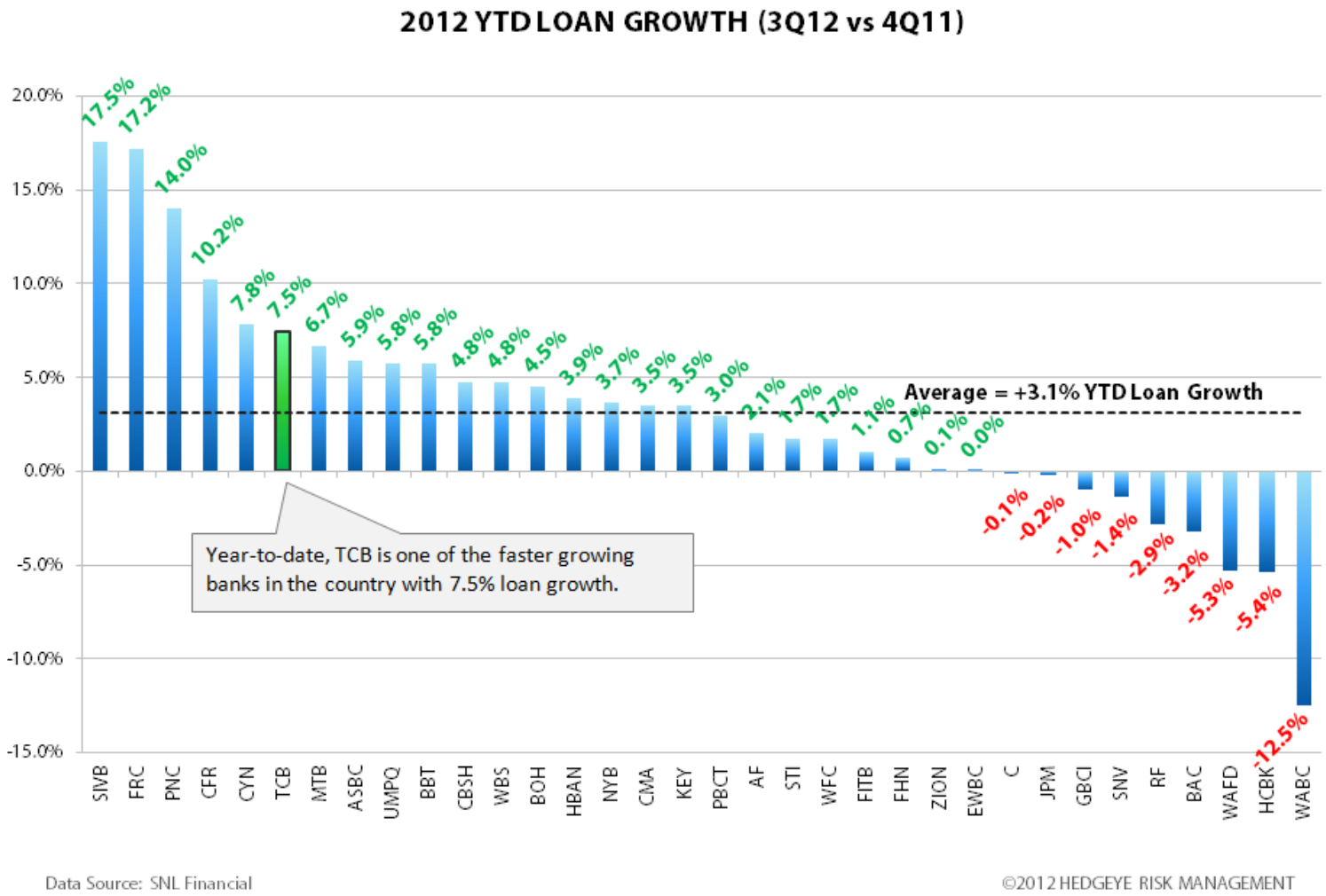
•**Potential Sale.** While not core to our thesis, an undeniable reality is that TCF's CEO, Bill Cooper, is 68 years old, making him very aged by bank CEO standards. The probability of a takeout is rising.

Deposit Growth At TCF Is Strong



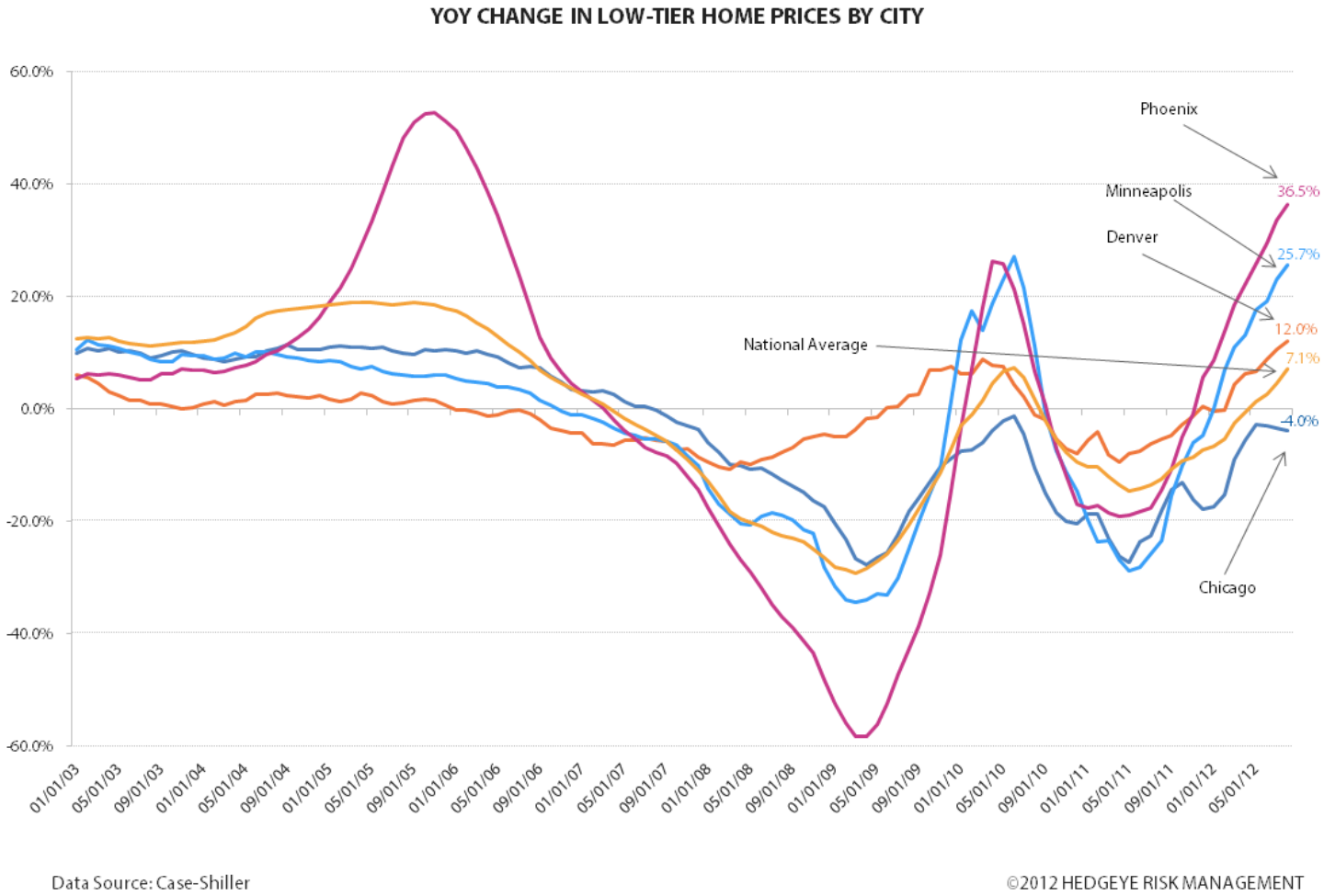
Deposit growth has long been held as the most important metric for bank investors. TCF's deposit growth YTD has been relatively strong.

Loan Growth At TCF Is Good



While the traditional focus of regional bank investors has long been deposits and deposit growth, increasingly, the market is putting a premium on loan growth in a world where little growth exists.

Home Prices Are Rebounding In The TCF Footprint



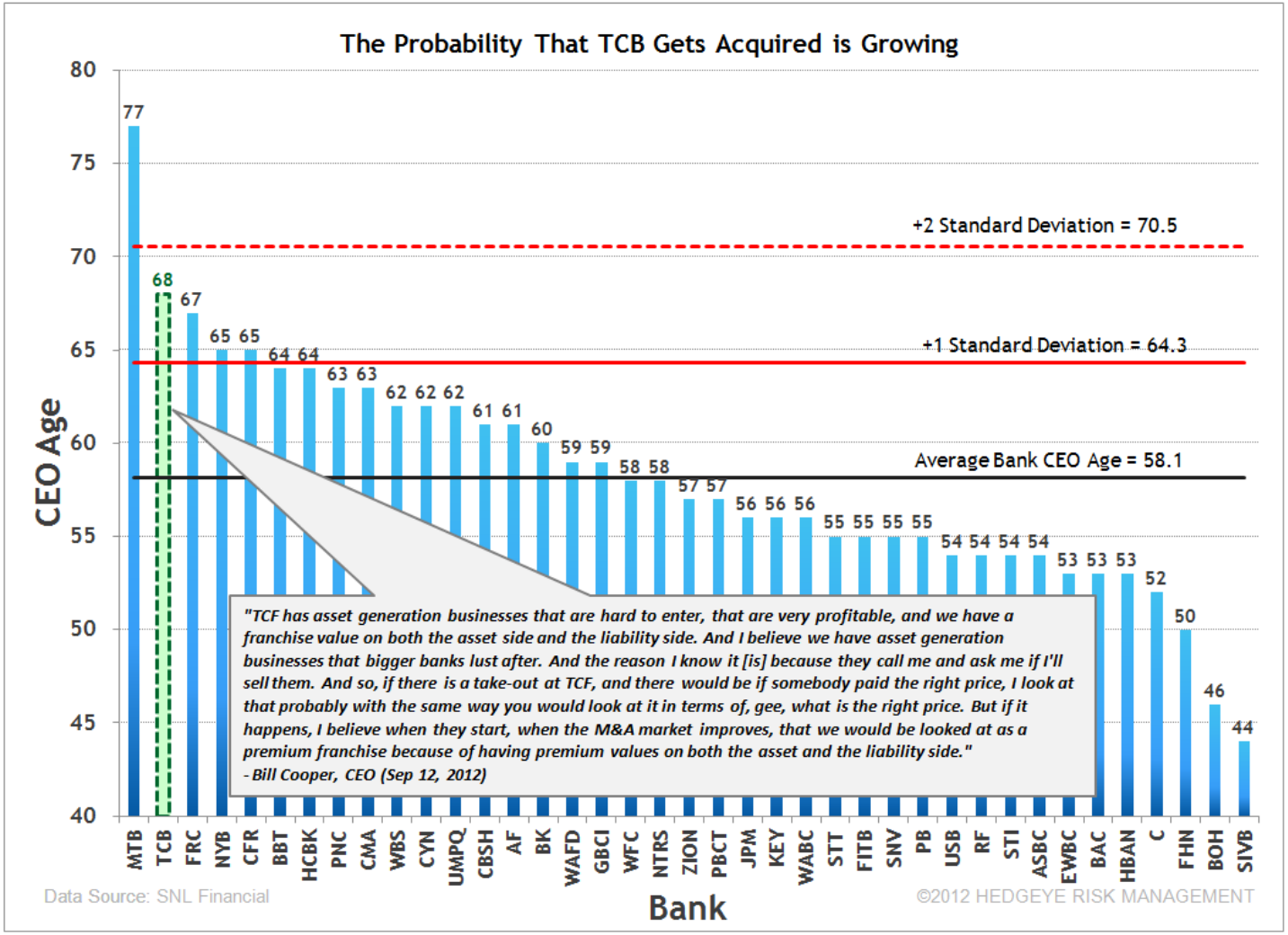
TCF stands to benefit from the rebound in low-tiered home prices. Almost 40% of their residential mortgage exposure is in Minnesota, which is among the strongest performing distressed markets in the country, up 25.7% YoY.

… As Is The Broader Economy

	Consumer Real Estate Loans	% of Total	YoY Home Price Change as of Aug-2012	YoY Home Price Change as of June-2011	% Of Homes In State That Are Underwater**	% Of Homes In State Between 95-100% LTV**	Unemployment Rate (%)	Unemployment Rate Chg YoY (%)
Minnesota	2,707,600	39.58%	4.7%	-9.6%	17.2%	5.1%	5.8%	-0.5%
Illinois	2,073,200	30.31%	-2.3%	-11.5%	25.8%	4.7%	8.8%	-1.3%
Michigan	856,700	12.52%	5.3%	-8.4%	32.8%	4.8%	9.3%	-0.9%
Colorado	586,200	8.57%	6.9%	-3.0%	18.2%	6.7%	8.0%	-0.2%
Wisconsin	434,800	6.36%	0.1%	-5.7%	15.5%	4.8%	7.3%	-0.1%
Arizona	49,200	0.72%	18.2%	-11.9%	39.7%	5.0%	8.2%	-1.2%
Indiana	22,400	0.33%	2.6%	-2.1%	9.5%	3.9%	8.2%	-1.0%
Florida	2,600	0.04%	6.9%	-7.7%	42.7%	4.1%	8.7%	-1.7%
New York	2,100	0.03%	5.8%	2.4%	8.1%	2.6%	8.9%	0.6%
Ohio	2,000	0.03%	0.3%	-9.0%	24.1%	5.7%	7.0%	-1.6%
California	39,900	0.58%	5.5%	-6.0%	29.0%	4.4%	10.2%	-1.5%
Pennsylvania	500	0.01%	1.4%	-3.4%	9.4%	3.8%	8.2%	0.2%
Texas	200	0.00%	4.8%	-1.5%	8.8%	4.5%	6.8%	-1.1%
Other	63,400	0.93%	na	na	na	na	na	na
Total	**6,840,800**	**100.0%**	**2.6%**	**-9.1%**	**21.8%**	**5.0%**	**7.4%**	**-0.75%**
National Trends			**4.6%**	**-5.7%**	**22.3%**	**4.7%**	**7.9%**	**-0.63%**

TCF's weighted loan footprint has seen home prices reverse from -9.1% YoY in June 2011 to +2.6% YoY in August, 2012.

A Takeout Is Becoming Increasingly Likely



Bill Cooper, TCF's CEO, is relatively old by bank CEO standards, and is open to selling the company. The above chart includes comments he made recently to this effect.

TCB: Summary, Upside/Downside & Risks

Summary: Regional banks in general are well positioned to take advantage of recovery in the housing market. They benefit directly from increased mortgage banking activity as well as through improved credit performance from inflated collateral values and improved cure rates. TCF's footprint of distressed property has seen some of the strongest distressed home price appreciation in the country, which will roll through their earnings on a lag. The company is also generating strong deposit and loan growth while holding margins and expenses steady. There's also the potential for a takeout.

Upside: We estimate that TCF can earn $1.37 in 2014, slightly ahead of the $1.20 consensus is expecting. This should equate to a return on tangible capital of 15%. Today, regional banks are trading at a multiple of 1.61x tangible capital for a return on tangible capital of 15%. We forecast tangible capital will end 2013 at $9.29 and end 2014 at $10.69, resulting in valuation of $15 and $17 over the next 12 and 24 months, or +37% and +56%, respectively.

Downside: Downside should be capped at tangible book value of $8.49 or roughly 23% lower. We presume this based on TCF's ability to earn its cost of capital going forward, which should enable it to at least trade at tangible book value.

Risks:

• **Recession.** Like most financials, TCF is a cyclical negatively exposed to downturns in the economy, particularly as it relates to credit quality. If the Fiscal Cliff negotiations result in materially stepped up taxes and/or reduced spending, the odds of a recession increase.

•**Margin Pressure.** As the Federal Reserve continues to pressure the long end of the yield curve, driving long-term rates lower, this puts ongoing pressure on the net interest margin of spread lenders like TCF. A recent balance sheet restructuring has put the company in a favorable position in this front, but further curve compression will still adversely affect them.

BAC: Executing Its Turnaround & An Obvious Housing Play

Overview: Bank of America (Symbol: BAC) is a domestic money center bank. With a market cap of nearly $113 billion, Bank of America is one of the largest banks in the world. It provides a range of services for small and middle market businesses as well as large institutions, consisting of a full range of banking services, asset management, investing, and other risk management services. BAC has 5,540 branches and roughly $2 trillion in total assets.

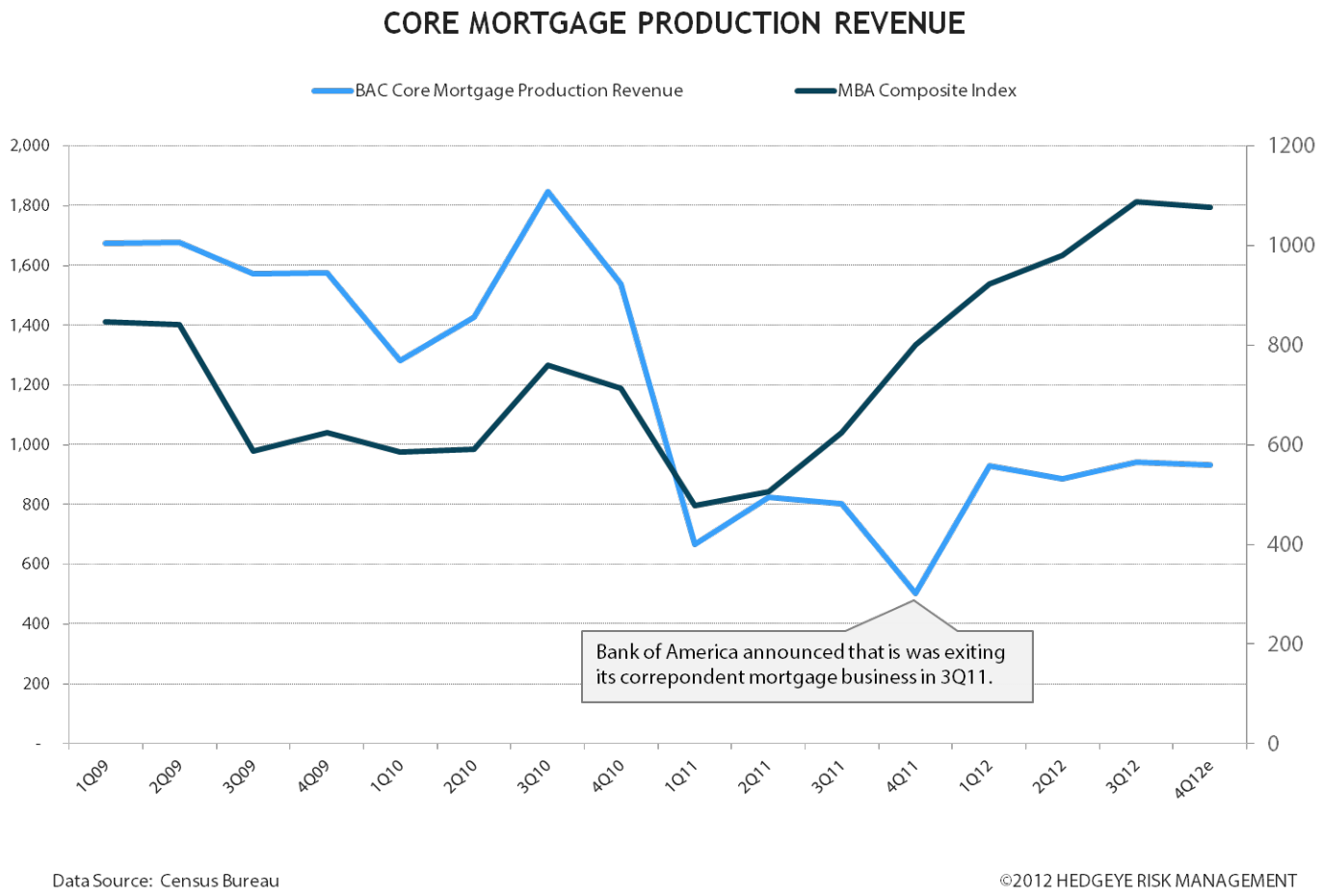
Key Points:

•**BAC's Total Potential Liabilities are Less Uncertain .** 2011 was a brutal year for Bank of America as fear regarding PLMBS repurchase claims cut the stock in half. 2012 has been markedly different. Early in the year, Bank of America quietly won a few crucial court victories that effectively capped its liability on the PLMBS side. Today, there is growing angst around GSE repurchase liabilities, as both Fannie and Freddie have stepped up their requests in recent quarters. To BAC's credit, a full settlement with Freddie Mac a little over a year ago is now looking like a major coup. Fannie Mae claims are still growing, but we expect will ultimately be manageable.

•**Housing Tailwinds.** Housing has begun to rebound in 2012. The company is well positioned to benefit on multiple fronts, including growing mortgage banking activity, reflating collateral values, and falling delinquency rates. The company's legacy Countrywide PCI (purchased credit-impaired loans) book is very sensitive to changes in real estate values. They're carrying roughly $28 billion in loans at 74 cents on the dollar, so every 1% improvement in HPI benefits them here by ~280 million. There's also the improvement in cure rates that comes with rising HPI.

•**QE3.** Money center banks were the 14th best performing subsector during QE1 and QE2. During QE3, money center banks have been the 5th best performing subsector. We expect quantitative easing to provide an ongoing tailwind.

Mortgage Activity Continues to Climb



- Mortgage application volumes (refi & purchase applications) have surged over the last several quarters. So far in the fourth quarter mortgage applications are running 34.3% higher YoY.

QE Continues to Provide a Money Center Tailwind

QE 1 Performance : 3/18/09 - 4/14/10	Absolute	Relative v XLF
Mortgage Insurers	758%	677%
Multi-line Insurers	299%	217%
Aircraft Leasing	218%	137%
Credit Card	192%	110%
Alternative AM	183%	102%
Financial Guaranty	165%	84%
Student Lenders	164%	83%
Life Insurers	157%	76%
Payday Lenders	134%	53%
Regional Banks	124%	43%
Payment Processors	121%	39%
Mutual Funds	109%	27%
CA-Asian Banks	106%	24%
Moneycenters	96%	14%
Thrifts	93%	12%
Texas Banks	90%	9%
P&C Insurers	78%	-3%
Small Brokers	66%	-15%
Large Brokers	52%	-29%
Mountain State Banks	52%	-29%
Exchanges	36%	-45%
Online Brokers	32%	-49%
Market Structure	30%	-51%
Mortgage Default	29%	-53%
CA&HI Banks	27%	-54%
Trust Banks	25%	-56%
Mortgage REITs	21%	-61%
Insurance Brokers	15%	-66%
Pacific Northwest Banks	14%	-68%
Construction Banks	-13%	-94%
Title Insurers	-19%	-100%

QE2 Performance : 8/31/10 - 2/21/11	Absolute	Relative v XLF
Alternative AM	69%	42%
Mutual Funds	49%	22%
Texas Banks	38%	11%
CA-Asian Banks	46%	20%
Payday Lenders	43%	16%
Small Brokers	43%	16%
Aircraft Leasing	42%	15%
Exchanges	38%	12%
Insurance Brokers	38%	11%
Multi-line Insurers	35%	9%
Online Brokers	40%	14%
Credit Card	35%	8%
Life Insurers	34%	7%
Moneycenters	30%	4%
Regional Banks	28%	1%
Trust Banks	27%	0%
Large Brokers	24%	-3%
Market Structure	23%	-4%
Student Lenders	21%	-6%
Mountain State Banks	21%	-6%
P&C Insurers	21%	-6%
Pacific Northwest Banks	20%	-6%
Thrifts	20%	-7%
Financial Guaranty	17%	-9%
Payment Processors	17%	-10%
Mortgage Insurers	15%	-11%
Mortgage Default	14%	-13%
CA&HI Banks	13%	-14%
Mortgage REITs	7%	-19%
Title Insurers	4%	-22%
Construction Banks	1%	-26%

QE3 Performance: 6/1/12 - 12/4/12	Absolute	Relative v XLF
Title Insurers	67%	49%
Construction Banks	43%	11%
Mortgage Default	42%	24%
Mortgage Insurers	35%	18%
Moneycenters	34%	16%
Alternative AM	33%	15%
Large Brokers	29%	11%
Student Lenders	26%	8%
Multi-line Insurers	22%	4%
Life Insurers	21%	3%
Payment Processor:	20%	2%
Insurance Brokers	19%	1%
Mutual Funds	19%	1%
Credit Card	18%	1%
Pacific Northwest B	18%	0%
P&C Insurers	16%	-2%
Small Brokers	16%	-2%
Trust Banks	16%	-2%
CA-Asian Banks	15%	-3%
Thrifts	12%	-6%
Mountain State Ban	10%	-8%
Financial Guaranty	9%	-9%
Aircraft Leasing	9%	-9%
Regional Banks	8%	-10%
Exchanges	7%	-11%
Texas Banks	6%	-12%
Online Brokers	4%	-14%
CA&HI Banks	1%	-16%
Mortgage REITs	-1%	-19%
Payday Lenders	-2%	-20%
Market Structure	-10%	-28%

- Bank of America stands to benefit from quantitative easing from monetary authorities. In the last two quantitative easing programs money center banks were the 14th best performing subsector. During QE3 money center banks have been the 5th best performing subsector.

BAC: Summary, Upside/Downside & Risks

Summary: Similar to TCB, Bank of America is also well positioned to take advantage of recovery in the housing market. BAC benefits directly from increased mortgage banking activity as well as through improved credit performance from inflated collateral values and improved cure rates. Global monetary stimulus (LTRO, QE3) has also helped Bank of America get back on solid footing. We expect to see a continuation of these positive trends in 2013.

Upside: Bank of America is currently trading at 78% of tangible book value. Upside potential should first be viewed in the context of discount reflation. We think the market will increasingly come to realize that the firm's risk has decreased, which should reduce it cost of capital. This will, in turn, lead to a higher multiple.

Downside: Bank of America has traded at an average P/TBV of ~70% (over the last two years), this implies downside of 10%, which would take the stock to $9.44.

Risks:

• **Recession.** Bank of America is a cyclical and is exposed to downturns in the credit cycle. If the Fiscal Cliff negotiations result in materially stepped up taxes and/or reduced spending, the odds of a recession increase.

•**Margin Pressure.** The Fed further opened the monetary spigots earlier this year when they announced QE 3. The main effect of this program has been to flatten the long end of the yield curve. Over the last several quarters bank margins have been under pressure.

•**Deterioration in Europe.** Bank of America has significant exposure to European counterparties. This is the reason that the LTRO, passed at the end of 2011, had such a positive impact on BAC at the beginning of this year. If the fundamentals in Europe deteriorate further, expect BAC to move lower.

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