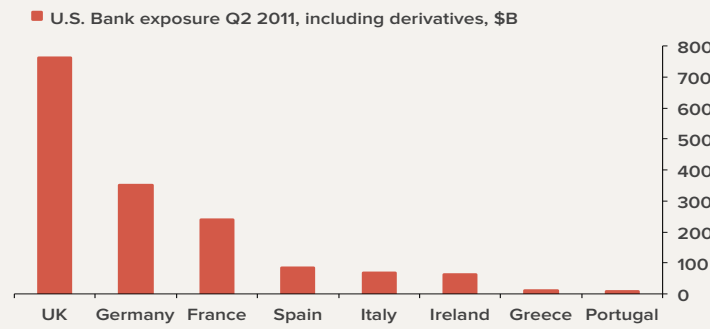




Can U.S. Banks Withstand European Failures?

The unfolding disaster in Europe is by far the biggest threat to our relatively optimistic story for the U.S. economy next year. The usual mechanism by which the woes of one country or region are transmitted to another is reduced demand for imports, but we learned after the Lehman disaster that financial sector linkages now have the capacity to do more damage, more quickly.

Direct Bank Exposure To The PIIGS Is Limited



Predicting the timing and extent of European bank failures is impossible, and the policy response within Europe to impending or actual failures is unknowable too. We do know, though, that the Italian state is in no position to recapitalize banks pushed under by losses on their holdings of the state's own debt. Who would lend money to the Italian government to finance bank bailouts necessitated by the very same government's already unsustainable debt burden?

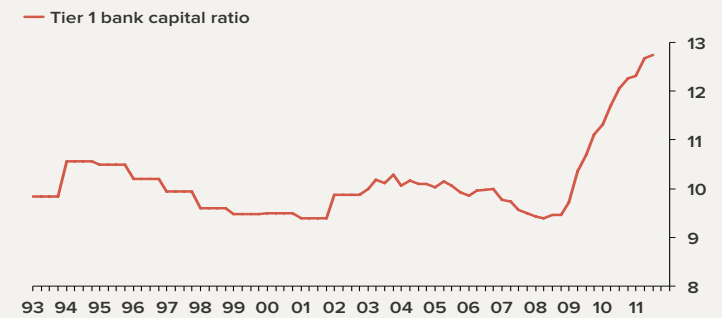
The good news from the perspective of the U.S. banking system is that its exposure to Italy is quite small. According to the Federal Financial Institutions Examination Council, U.S. banks' exposure to Italian entities, including derivative contracts, is \$68B. That's not trivial, but even if half of that exposure were ultimately to prove unre-

coverable, the losses would amount to only about 2.8% of U.S. banks' aggregate Tier 1 capital, which stood at \$1.2T in the second quarter.

Unfortunately this is not the end of the story, because the U.S. has *much* bigger exposure to the banking systems of other major European economies which, in turn, have huge exposure to Italian banks. As our first chart shows, U.S. banks' exposure to France, Germany and—especially—the U.K. easily dwarfs their exposure to Italian banks. **We cannot know what proportion of these assets, if any, will prove unrecoverable in the event of an Italian-led meltdown of the European banking system, but the overall exposure is so big that the threat is obvious.** We can only hope that in the event of existential threats, the governments of these countries would stand behind their banks with hard cash, though that would be easier for the U.K. and Germany than for France, where the sovereign's own position is questionable.

We would not want to be long of any U.S. financial stocks on the day the first significant European bank fails. *But it is important to appreciate that the U.S. banking system is in much better shape to withstand a battering from Europe than in the fall of 2008, when Lehman failed.* The banking system as a whole now holds 23%, or \$224B, more capital than in the third quarter of 2008. That's impressive, but it does

U.S. Banks Have Been Aggressively Recapitalized



HFE's Economic Forecasts

GDP	Q4 third est.	2.3%	2009 year:	-3.5%
	Q1 third est.	0.4%	2010 year:	3.0%
	Q2 third est.	1.3%	2011 year:	1.9%
	Q3 first est.	2.5%	2012 year:	3%
	Q4 forecast	>3%		

CPI	September:	0.3% (3.9% y/y); core 0.1% (2.0% y/y)
	Dec. 2011 forecast:	3.7% y/y; core 2.3% y/y
	Jun. 2012 forecast:	3.1% y/y; core 2.2% y/y

Unemployment: December 2011, 9.0%; June 2012, 8.7%
 Federal budget FY 2012 forecast: -\$1.4T (9.5% of GDP)

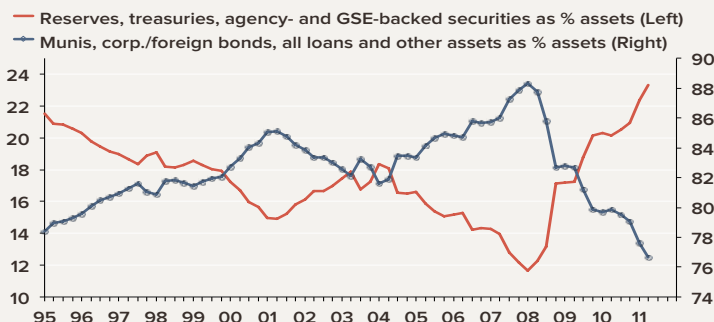
HFE's Financial Forecasts

	End-month:				
	4:30pm Friday	Dec	Mar	Jun	Sep
Fed funds actual	0.07	0.13	0.13	0.13	0.20
2-yr	0.23	0.30	0.30	0.35	0.40
10-yr	2.06	2.40	2.50	2.60	2.75
30-yr	3.13	3.40	3.50	3.60	4.00
Curve 10-2	183	110	120	125	135
Curve 30-2	290	310	320	325	360
Dow Jones IA	12154	12000	12250	12500	12500

Dollar: EU crisis drives safe-haven cash to U.S. Loonie and Ozzie to recover on safety. Yen strong despite domestic mess.

not tell the whole story, because banks have shrunk their loan books substantially and improved the mix of their assets in favor of safer instruments like deposits at the Fed, Treasuries and agencies. As a result, the increase in their capital ratios has been much bigger than the absolute numbers suggest. At the post-Lehman low, FDIC data show the Tier 1 risk-based capital ratio for the U.S. was 9.5%, but it is now at a record high of 12.7%.

Banks Have A Much Less Risky Mix Of Assets Than In 2008



The shrinkage of banks' loan book has also been accompanied by improvements in its quality. At the time of the Lehman bust, loan delinquencies were rocketing, eroding capital and making it impossible for banks to predict their future loss rates with any confidence. *Now, however, delinquency rates have dropped substantially from their peaks—less so for home mortgages than other assets—so banks can estimate their potential losses with greater certainty.* This has already helped facilitate a strong rebound in lending to commercial and industrial companies, and we think that will continue, though we can't rule out a brief interruption as European institutions fall.

Finally, we can be sure that if the worst comes to pass, the Fed knows what to do. In the event of a crisis, U.S. banks would face much less acute funding pressure than their European counterparts because they will not be in the middle of the storm and are much less reliant on wholesale markets. Markets would likely exert pressure on banks all around the world, but the Fed would step in to ensure solvent institutions were able to operate by supplying as much liquidity as needed. ***We don't want to pretend here that U.S. banks have nothing to fear from the European nightmare, but we think the system is well-defended by both its own resources and the Fed.*** Europe's banks won't kill America's, but they can wound.

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This Week's Funding

Mon	Announcement—4-week bills (Nov. 15) Auction—\$29B 3-month, \$27B 6-month bills
Tue	Auction—\$25B 52-week bills (settles Nov. 17) Auction—4-week bills
Thu	Announcement—3-month, 6-month bills (Nov. 21) Announcement—2-year notes (Nov. 21) Announcement—5-year notes (Nov. 22) Announcement—7-year notes (Nov. 23) Auction—\$11B 10-year TIPS (settles Nov. 30)

This Week In Brief

Note: "**SS**" prefix denotes Snapshot for these data.

Monday, November 14

- No significant data released.

Tuesday, November 15

- **SS: Producer Prices (10)/8:30 EST**

The index should drop **0.2%**, depressed by energy, with the core up **0.2%**. **Consensus: Headline -0.1%, core 0.1%.**

- **SS: Retail Sales (10)/8:30 EST**

Total sales should rise **0.5%**, with sales ex-autos up **0.4%**. Our core measure—ex-autos, gas and fuel—should rise a robust **0.7%**. **Consensus: Total sales 0.3%, ex-autos 0.2%.**

- **Empire State Survey (11)/8:30 EST**

The index is undershooting relative to the ISM; we see scope for a rebound to about **zero** from **-8.5**. **Consensus: -2.2.**

- **Redbook Chain Store Sales (11/12)/9:00 EST**

A rebound after last week's snow-hit **3.1%** year-over-year?

- **Business Inventories (9)/10:00 EST**

Inventories should rise just **0.1%**, compared to an average **0.4%** gain in the previous three months. **Consensus: 0.1%.**

Wednesday, November 16

- **MBA Mortgage Applications (11/11)/7:00 EST**

Little change from last week's 13-week high of **183.1?**

- **SS: Consumer Prices (10)/8:30 EST**

The headline index should rise **0.1%**, held down by lower gas prices, but the core should rise **0.2%**, reverting to trend after a soft September. **Consensus: Headline 0.0%, core 0.1%.**

- **TIC Flows (9)/9:00 EST**

Long-term flows rebounded to an eight-month high of **\$57.9B** in August; the 12-month average is **\$39.9B**.

- **SS: Industrial Production (10)/9:15 EST**

Total production should rise **0.1%**, held down by a decline in utility output, with manufacturing up **0.3%**. Capacity use should rise marginally, to **77.5%** from **77.4%**. **Consensus: Production 0.4%, capacity use 77.6%.**

- **NAHB Survey (10)/10:00 EST**

Little change after the surprise four-point jump to a 17-month high of **18** in September? **Consensus: 18.**

Thursday, November 17

- **SS: Initial Jobless Claims (11/12)/8:30 EST**

Claims dipped to **390K** last week, but we still fear a post-snowstorm jump, so we look for about **400K** this week. The trend, though, seems now be falling. **Consensus: 395K.**

- **SS: Housing Starts (10)/8:30 EST**

Starts should slip back to about **630K** after September's jump to **658K**, but permits should nudge up to about **600K** from **598K**. **Consensus: Starts 606K, permits 600K.**

- **SS: Philadelphia Fed Survey (11/10)/10:00 EST**

After the huge gains of the past two months we expect little change from October's **8.7**. **Consensus: 9.0.**

Friday, November 18

- **SS: Index of Leading indicators (10)/10:00 EST**

The index should rise **0.7%**, boosted by the rebound in stocks, rising M2, the positively-sloped curve, lower jobless claims and the lengthening workweek. **Consensus: 0.6%.**