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ECONOMIC TALKING POINTS

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The Knock Out Blow: European Debt Defaults and Triple-Digit Oil Prices

It's over! An important chapter in the 60-year history of European economic integration is coming to an end. A new more ominous chapter is about to begin. We now believe the European governments and the ECB do not have the resources to avert a default by Italy, Greece, and very likely Spain and Portugal too. Nor can the IMF make up Europe's shortfall. Simply put, the Eurozone --- as it is currently structured --- is confronting a problem larger than it is capable of solving. Perhaps this failure should not be all that surprising, for never in the 22 years of the single currency system have European leaders really shown much willingness to cede domestic political interests for the long-term survivability of the Eurozone.

For example, rules that limit fiscal deficits were chronically ignored --- even by Germany --- and not a single country ever paid a price for these violations as stipulated in the region's Growth and Stability Pact. Even today, as the debt of Greece and Italy threaten to drag down the entire Continent, local politicians are dithering on reforms and austerity measures. Last, but certainly not least, Germany continues to resist changing the model of the ECB and give it lender of last resort status for fear it would ***ultimately*** risk igniting inflation. The economic unraveling

of Europe is both serious and surreal.

One thing is certain. The fallout from a default by Italy and Greece will not be limited to Europe. The damage is expected to spill to the US and derail its tepid recovery. I suspect the calm public demeanor of US Treasury and Federal Reserve officials belies a terrifying fear they have that the global economy is about to be dragged into another financial meltdown. So grave is this threat that we have warned clients in recent weeks to hunker down, ride out this historic storm, move out of risky assets and focus on preserving capital.

What are the key dynamics at play here?

Broadly speaking, there are three danger points: (1) the crisis in Europe; (2) the vulnerability of US banks to a European debt crash; (3) and the separate risk of triple-digit oil prices as Israel and Iran appear inexorably headed toward war.

(1) Let's begin with Italy. The stats are frightful. Europe's third largest economy has $2.6 trillion in debt, more than Greece, Spain, Portugal and Ireland combined. This debt accounts for 120% of the country's GDP, a level that is utterly unmanageable given Italy's inability to devalue its own currency, the lack of economic growth which shrinks tax revenues, and the high cost of borrowing.

Italy has to borrow more than $300 billion in the private capital markets between now and the end of next year just to cover maturing debt, but can't in light of the prohibitive cost of funding. Yields on 10-year Italian debt surged above 7% yesterday, a crippling rate for an economy that is lying prostrate. While the benchmark yield has slipped a bit today after the country raised 5 billion euros in 12-month bills (at 6.08%, which by the way is the highest in 14 years!), we expect the 10-year note yield will soon climb above 7% again. Italy's government is just not showing the urgency needed to deal with their crisis. Yes, Berlusconi agreed to resign ---but he said he would do so only after the country's Parliament passes the austerity package. The problem is Italian lawmakers haven't yet completed writing the legislation so a vote may still be weeks away. This lack of urgency and bickering are infuriating Eurozone leaders and pushing private investors to slash holdings of Italian, Greek and Spanish debt. (Berlusconi is understandably reluctant to give up his position as PM since once out of government he loses immunity in a number of corruptions trials.)

A default by Italy would have disastrous consequences for the entire Continent, but perhaps none more so than for France, the second largest economy in Europe. The fate of Italy and France are in many ways conjoined. French lenders are the largest foreign holders of Italian public and private debt, with more than $416.4 billion worth of exposure (more than twice German banks' exposure). This puts in jeopardy France's own AAA credit rating.

(2) For the US, the fallout of a European economic implosion will be more serious than Treasury officials have led on. First, the US economy will suffer a hit in foreign trade at a time when Americans exports are one of the few bright spots keeping the country out of recession. Second, while U.S. regulators have said American banks have only minimal direct exposure to the troubled European countries, the actual risk may be much higher. That's because earlier this year U.S. banks increased sales of insurance against credit losses to holders of Greek, Portuguese, Irish, Spanish, and Italian debt. Just how much could American banks be on the line for? According to the Bank for International Settlements, US lenders offered guarantees --- essentially credit default swaps ---to owners of this debt in the amount of $518 billion! The folks at the Federal Reserve and the Treasury are thus anxiously monitoring events in Europe, well aware of that a cascade of sovereign debt defaults in Europe could do serious damage to US financial institutions.

Is there any solution that might help resolve the sovereign debt crisis and hold Europe back from ruin?

Yes. The ECB must take a lesson from the Federal Reserve and the Bank of England. With the Eurozone's survival in question, the ECB must do whatever is necessary to stabilize the sovereign debt market, even it if means printing money, buying troubled government debt and expanding its balance sheets. It really has no other choice. Some ECB members, along with Germany, have argued that such action is not possible given the current mandate. Moreover, they argue the central bank would immediately lose its independence if it were to take such steps. Both concerns have some legitimacy. But to argue that the ECB's mandate is immutable even as the Eurozone is about to crash and burn is an act of colossal folly. This is an emergency that demands flexibility and discretion by all in Europe. Whether the ECB likes it or not, the institution is the de facto lender of last resort.

So far, however, it has staunchly rejected this view and that is perplexing. It's all the more reason we have urged investors to lock up capital gains and shift to a more defensive position until the dust settles.

Another hot spot compounds the global economic outlook.

(3) Though all eyes are currently transfixed on Europe, there is another looming threat. Israel and Iran are now locked in a trajectory that will likely lead to a military confrontation now that the IAEA has concluded for the first time that Tehran is working on building nuclear weapons. We first raised the danger of a war between these two countries in a special report more than two years ago and detailed then how it could affect global growth and oil prices.

Iran remains absolutely determined to secretly build nuclear military capability despite the economic sanctions. Israel is no less committed to preventing such a reality.

While the White House is prepared to further tighten the economic noose around Iran, Israeli leaders no longer believe (and probably never did) that economic pressure against Iran would work. That's because China and Russia regularly veto any Security Council measure against Iran that has teeth. The result: As tensions in the Middle East build toward a military clash, oil prices (this morning at $97 a bbl.) will cross well into triple-digit territory in the coming months.

Bottom line:

This is a precarious way to end 2011, and certainly a foreboding curtain riser to 2012. For even if the European sovereign debt crisis doesn't shove the West into recession, sharply higher oil and gasoline prices could be the knockout blow that will bring all fragile economies down.

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