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ECONOMIC TALKING POINTS

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It's Risk-off When Visibility On Europe's Future Is Zero

It is striking how much has changed in Europe since last week's bailout framework was introduced.

We have been hearing from an assortment of clients this morning and most have expressed a readiness to put their spending, investment and hiring plans on hold given the latest bombshells from Europe and the real spillover risks for US banks. With economic growth here running below a 2% pace this year, let's face it, there's not much of a safety buffer left to absorb a seismic European financial shock.

Clearly, Europe is approaching a breaking point. Greece's Papandreou government is about to collapse. A referendum on the bailout/austerity package is now up in the air. The next tranche of 8 billion euros for Greece has been cancelled, which means the country's credit lifeline has been severed. The odds of a hard, disorderly default has jumped to better than 50-50. Should this occur, it would trigger payouts on credit default swaps --- and that raises yet more questions whether counterparties have sufficient funds to meet their obligations. European banks, instead of facing a 50% loss on the Greek bonds they hold, may now lose it all and that will put US financial institutions at risk as well.

Moreover, for the first time, frustrated European leaders have begun talking openly about Greece exiting from the single currency system.

If all this was not enough, heads snapped again this morning when the ECB announced a quarter-point cut in the benchmark short-term rate, bringing it down to 1.25%. During a press conference, the new ECB president Mario Draghi acknowledged that Europe now faces serious downside risks. Implicit in the ECB rate cut, I believe, was also a message that the central bank would no longer be wearing blinders that solely focus on inflation. Not with European economic conditions so turbulent. Not when the region and perhaps the international economy is so close to another financial meltdown.

For the moment, nothing seems to be going right regarding Europe's sovereign debt crisis.

• France's Sarkozy's visit with Chinese President Hu Juntao was not successful. China remains reluctant to invest in Europe's bailout fund with conditions on the Continent so fluid. Ultimately, China has no choice but to play a role in keeping Europe afloat, but they will certainly extract a heavy price before releasing funds.

• Another critical battlefront focuses on the sovereign debt of Italy and Spain. This morning, Italy's 10-year yield jumped to 6.39%, a euro-era record, widening the spread over German bunds to 462 basis points. Spain's 10-year yield leaped 10 basis points to 5.53%.

• News sources say that Italy's Berlusconi arrived for the G-20 meeting in Cannes empty handed with respect to new austerity measures. There were reports that he would come with plans to speed up on some of the reforms Italy agreed to.

• The fracturing of the Eurozone is no longer a taboo subject among European policymakers. The cost of keeping Greece inside single currency system is proving to be too high. Germany, Europe's largest economy, saw its unemployment rate rise in October for the first time in two years. Manufacturing in the 17-nation Eurozone contracted for the third time last month, adding more statistical evidence that the region is headed for recession. Our forecast calls for virtually no growth in 2012.

Bottom line:

With Greece ungovernable, Italy's Berlusconi under pressure to resign, and the

Eurozone economy apparently contracting, patience has clearly run out for key European leaders. We could well be approaching a momentous turning point in the history of European integration, a change that will likely have implications for the global economy.

For now, the situation is so precarious and the potential consequences so large, the smart play is to be defensive. There really is no prudent alternative when the visibility on Europe's future is zero.

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