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Europe's Bank Funding and Spreads Not As Big A Problem As Slow Growth

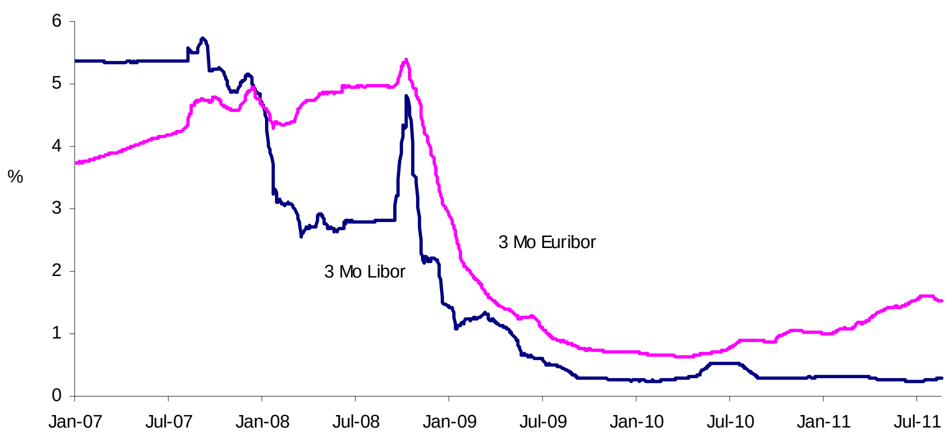
Our pieces this week have discussed several negative developments – the weak Paris summit, bad inflation data worldwide, President Obama's trial balloons to increase spending and tax expenditures rather than cut them, the disappointment over the Swiss decision not to stabilize the franc, and the anti-growth impact of the deepening barbell trade in which growth capital is diverted to idle government bonds to protect from deflation and gold to protect from inflation (see yesterday's piece on Near-Term Cautions.)

- Add to this the market distortions the Fed is causing over QE3, Chairman Bernanke's upcoming Jackson Hole speech and the contested FOMC commitment to near-zero rates through mid-2013.

- **We think those problems were enough to give markets pause after last week's rebound**. Both the U.S. and Europe are suffering growth problems with their governments often moving in the wrong direction.

In contrast, we think today's market concern about European bank funding is overdone. Most of the tension stems from the Fed/ECB spread, now nearly 1.5% and the near-zero Fed funds rate which has severely disrupted the normal functioning of the interbank market (discussed in my WSJ articles of 12/4/09 and 8/5/11.) They are causing an exodus of capital from the U.S. which should be interpreted as a growth risk more than a funding risk.

3 Mo LIBOR and Euro-Zone EURIBOR (last obs. August 18, 2011)

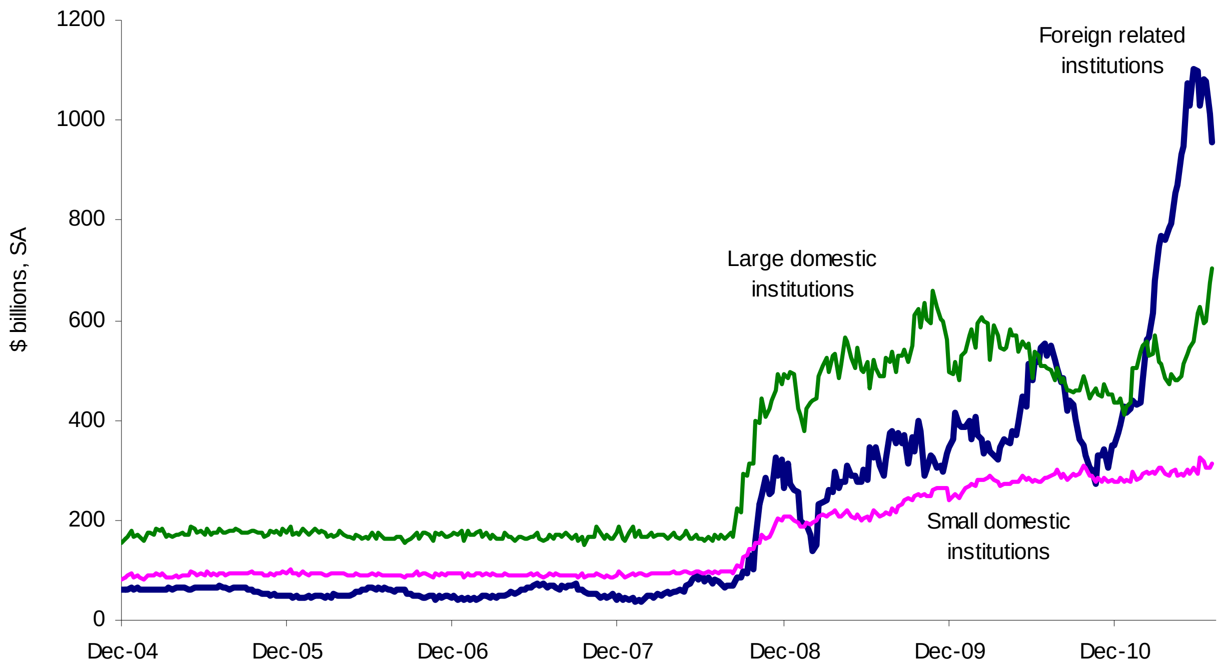


Source: Bloomberg; Encima Global

- A front page Wall Street Journal story today blared that "Fed eyes European banks; regulators scrutinize ability of institutions' U.S. units to fund themselves." We don't think there's much new in this story – worse would be a story that the Fed's not reviewing bank funding given the draw-down by U.S. money markets of their investments in European bank commercial paper. The story describes "near-daily updates (to New York state regulators) from examiners embedded in European banks' New York offices." Yikes.

- The meat of the WSJ story describes a decline in foreign bank reserves in the U.S. As the Fed conducted QE2, it borrowed heavily from banks, paying an above-market 25 basis points. Foreign-related institutions made most of the QE2 loans to the Fed. We raised this as an issue repeatedly starting with Fed Funds Rate the Key Variable, Not QE2 on April 25. With the ECB putting a floor on euro interest rates at 150 basis points, **it is to be expected that the European banks will draw down their dollar reserves. It's part of capital flight from the Fed's weak-dollar policy.**

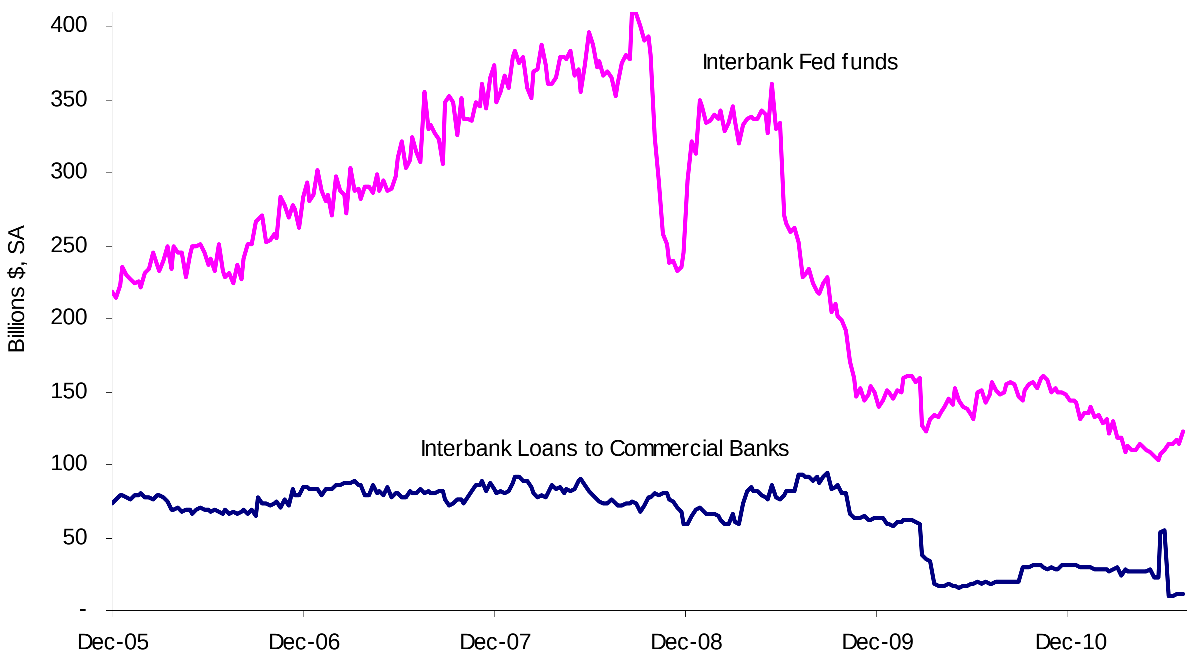
Cash at Large and Small Domestic Banks and Foreign Related Institutions (last obs. August 3, 2011)



Source: Federal Reserve; Encima Global

- Adding to the market distortions from the Fed's near-zero interest rate, the U.S. interbank market, normally a ready source of funds, has dried up (why would a U.S. bank lend dollars to a European bank for near-zero interest?)

Interbank Lending (last obs. August 3, 2011)

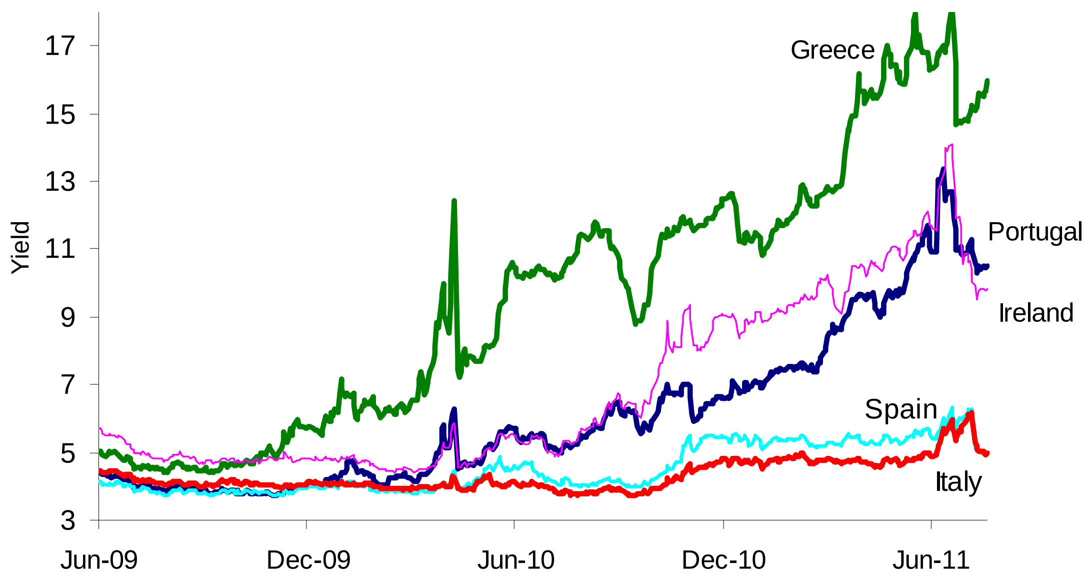


Source: Federal Reserve; Encima Global

- We think this is more of a problem for U.S. growth than for European banks. Though it has raised the overnight rate to 1.5%, the ECB stands ready to lend large amounts to European banks against a wide range of collateral. We think that's a good policy stance. It can invoke swap lines with the Fed to assure a supply of dollars.

We think Europe still has several ways to stabilize the debt situation, but is not moving fast enough. A salvage plan would have the ECB buy Spanish and Italian sovereigns now in larger quantities to cause further convergence (German 10-year yield is 2% versus 5% for Italy and Spain). The excess debt of the periphery countries could be amortized over several decades. With structural reforms including labor flexibility, lower wages for new workers and restraint on defined benefit plans, the countries could grow, move into fiscal surplus and stay in the euro.

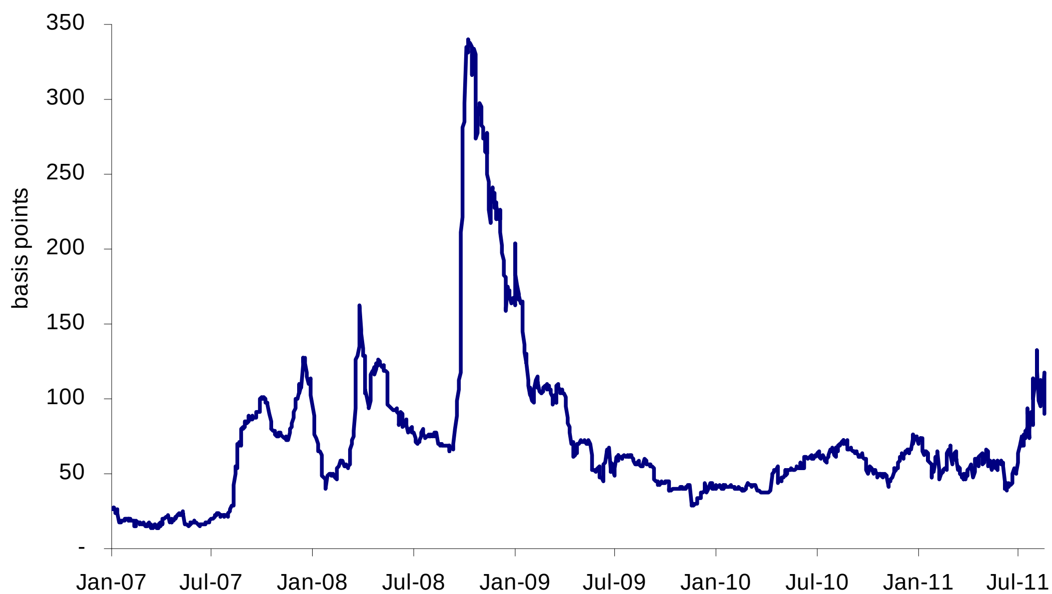
Selected European 10 Yr Bond Yields (last obs. August 18, 2011)



Source: Bloomberg; Encima Global

- Given the slow-motion bailout, interbank euro lending has been under strain because banks don't have confidence in each other or the periphery governments. The 'Geuribor' spread between Euribor and German T-bills rose to 132 basis points on August 4 from 40 bps in June and has subsided to 90bps. This is the German equivalent of the TED spread and reflects pressure in the European financial system.

GEURIBOR Spread – Euro IBOR less 3 Mo German Bills (last obs. August 17, 2011)



Source: Bloomberg; Encima Global

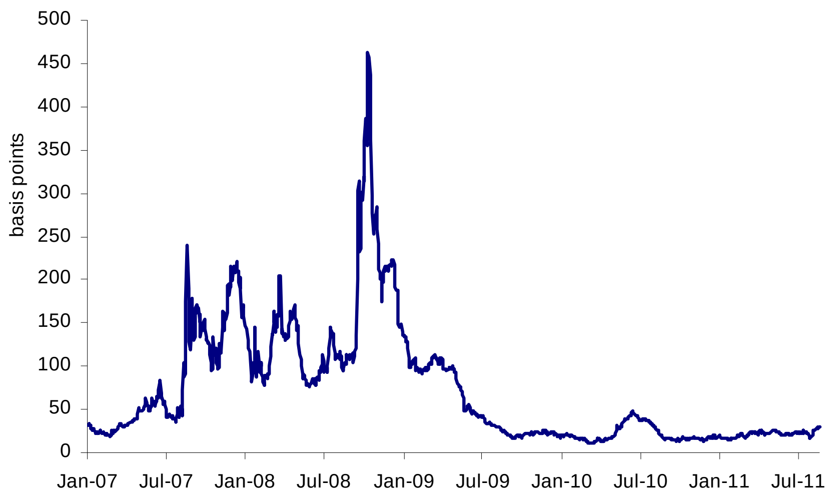
- A more sophisticated version of the Geuribor spread is the Euribor-OIS spread (mentioned in today's Financial Times article about euro-zone stress.) The spread compares euribor to the Overnight Indexed Swap market. The OIS generally tracks the effective ECB overnight rate, and deviates from German T-bill rates during severe risk aversion. This spread hasn't subsided the way Geuribor has, having peaked at 69.7bps on August 10 and still at 66.7.

Euribor – OIS spread (last obs. August 18, 2011)

Source: Bloomberg; Encima Global

- In contrast, the dollar TED spread -- the difference between the rate banks pay each other for dollar loans and the interest rate the U.S. government pays on Treasury bills – stands at 30bps (with T-bill rates at 0 today) and is not showing strain within the U.S. banking system. The TED spread suffered an uptick during the 2010 soft patch but less uptick in the 2011 August turmoil.

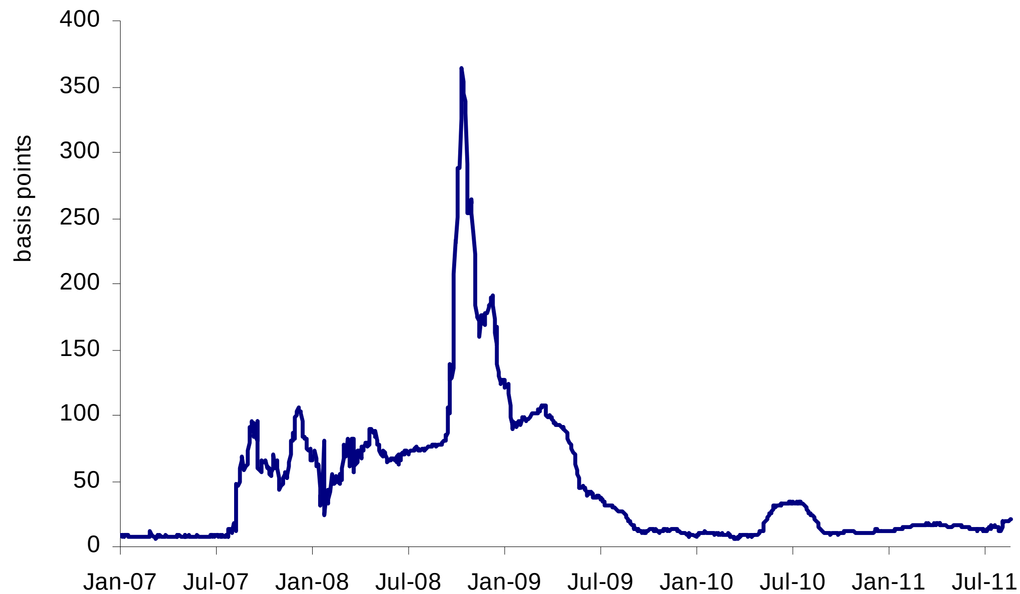
TED Spread – Eurodollar LIBOR less 3 Mo US Treasuries (last obs. August 18, 2011)



Source: Bloomberg; Encima Global

- The Libor – OIS spread has risen to 21 bps from low teens in June. Thus, both the Ted spread and the Libor-OIS spread are showing none of the systemic problems that occurred in 2007-2008 or the tightness in the 2010 soft patch, whereas Europe is seeing a spike.

Eurodollar LIBOR less OIS (last obs. August 18, 2011)



Source: Bloomberg; Encima Global

From a global growth standpoint, we think the major issue is whether any euro country departs the euro (which would cause a catastrophic run on euro deposits in other euro countries.) As long as that ending is avoided (German Chancellor Merkel has ruled it out), then we think global growth rates will only soften, not dip.

- We don't think Europe's debt crisis endangers the global financial system the way Lehman's bankruptcy filing did. Lehman had been very clearly identified as too big to fail, as reflected in its equity price immediately prior to the bankruptcy. Even though it wasn't defined as a bank in the U.S. regulatory process, it had borrowed through deposit-taking banks operating in the interbank market and through commercial paper marked at 100 cents on the dollar by money-market funds. Its liabilities totaled well over $600 billion, large by Greek standards. When it filed bankruptcy, the commercial paper and interbank markets immediately froze solid, causing a meltdown of the global financial system. We don't see the equivalent in the European crisis and are more worried about the growth and structural reform issues.