

QUICK MARKET UPDATE

A Crisis of Confidence—Phase II

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Over the past two weeks, a crisis of confidence in global financial markets has reemerged, as the reality of Standard and Poor's downgrade of U.S. Treasury securities left many investors questioning the validity of a sustainable recovery in the U.S. The latest phase in this crisis of confidence involves potential liquidity concerns surrounding European banks that have exposure to the sovereign debt of Portugal, Ireland, Italy and Spain. While the markets continue to react negatively to the headlines and rumors, it's important to remember that this latest crisis had its origins in Europe back in 2010—not the summer of 2011—when sovereign debt concerns first graced the headlines of the financial press.

Why are investors now concerned about potential liquidity issues of European banks? The answer lies in the capital adequacy of certain large and mid-sized European banks that have reported holdings of sovereign debt of the countries listed above. While this is not necessarily news, the fact that some of these banks are located in the countries which have reported local economic weakness has most likely led to speculation over their capital adequacy. In many ways, it's a crisis of confidence not knowing whether or not these banks have sufficient capital to meet regulatory requirements. This growing uncertainty led to a recent sell-off of European bank shares, which spilled over into U.S. bank stocks and global equity markets. In our view, these risks are exaggerated, and, even in a worst case scenario, manageable as the European Central Bank (ECB) and the national bank governing authorities maintain adequate resources to meet any required demands.

Just mentioning the word "liquidity" likely sends shivers down the backs of many investors, invoking the events surrounding the collapse of Lehman Brothers in 2008. The financial press has also caught wind of this concern—now being widely touted as a "new" crisis. In this brief *Quick Market Update*, we provide several facts regarding this issue and, hopefully, assuage any fear of a repeat performance of the events of 2008.

Some Facts to Consider

Although we cannot know with certainty the outcome of the European sovereign debt crisis, and it remains to be seen whether or not the bank stress tests are effective, there are a number of facts we believe that are important to consider as investors assess the current situation. These include the following:

- *Bank capital reserve levels are closely monitored.* Responding to questions following a speech on August 18, New York Federal Reserve Bank William C. Dudley asserted that

the Fed is “always scrutinizing” banks in terms of capital levels. He also noted that “...this is standard operating procedure.”

- *European banks are well capitalized.* The most recent stress test conducted by the ECB found that all but eight of the 90 banks tested, or 91 percent, met the most recent stress test requirements. All *major* European banks passed the stress test.
- *European bank strength metrics have improved markedly since 2008.* Bank deposits have increased by nine percent, and another metric, the loan-to-deposit ratio, has declined from 108 percent in January 2008 to 100 percent in June of 2011. In this case, the lower the ratio, the more conservatively investors assess the bank’s balance sheet.
- *Short-term funding needs for the leading banks in Europe are secure.* On average, 90 percent of the projected short-term funding needs for the 24 largest European banks have been secured for the remainder of 2011.
- *Short-term funding costs for European banks are the crux of the issue.* These costs are a function of both fundamental pricing measures and perceived credit quality. Funding costs for select European banks, particularly French banks, have risen as the perceived risk of a weaker French economy compounded by exposure to sovereign debt of many European countries, including Portugal, Ireland, Italy, Greece, and Spain, may force French banks to sell assets at depressed prices to meet capital-reserve requirements.
- *The ECB has liquidity facilities open, available and (selectively) being used.* This facility provides an important level of liquidity for member banks during times of undue stress.
- *Large U.S. banks with international loan exposure are extremely well capitalized.* Large bank capitalization ratios are at or near all time highs with the average tier-one capital ratio of 9.2 percent compared to the bank regulatory guideline of six percent for well capitalized banks. This ratio, used by Federal bank regulators to measure bank strength, is defined as the bank’s core equity capital divided by their total risk-weighted assets.
- *U.S. bank deposits are 25 percent higher than they were in 2008.* In July 2011, deposits totaled \$8.4 trillion compared to \$6.7 trillion in February, 2008. The bottom line is that U.S. banks have ample liquidity.

What Next?

In summary, as we have come to learn, today’s headlines don’t always tell the whole story. While this phase of the “crisis of confidence” is not finished, it’s important that investors are armed with the facts. The challenges facing Europe are a pressing concern and likely will take longer to resolve than many investors would like, as they involve both financial and political issues. If you have any concerns about the current sovereign debt situation and its potential impact, we encourage you to review your strategy with your investment professional to ensure that your portfolio is properly structured to weather this latest storm in the capital markets.

All data in this Quick Market Update is sourced from Bloomberg Financial, LLC.

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