

Action Plan: European Debt Crisis & Banking Risk

Action Plan – Much of Europe will probably have flat growth or a mild recession for the next few years. The U.S. and parts of Asia are where the most growth is expected. A European recession should have little effect on U.S. exporters since the EU's share of U.S. exports is now only 18%, vs. 25% in 1999.

Banks have the highest risks and the failure of a major U.S. bank could cause another "Lehman" crisis. The U.S. Fed has stepped in to assure that the banks most at risk are strong, by requiring capital plans be approved based on extremely rigorous new stress tests.

Investments should be reviewed to take advantage of likely growth economies vs. those in risk of recession. As always, I recommend funds with positive Alpha (outperformance vs. risk taken), that have consistently over the long-term outperformed the "dumb" indexes or ETFs. I also recommend alternatives without the risks of the stock or bond markets.

U.S. Leads Major Global Markets with Best Crisis Performance

Index	YTD
S&P 500	-7.87%
FTSE 100	-12.46%
Shanghai	-15.24%
DAX	-20.56%
Nikkei 225	-20.23%
Hang Seng	-23.21%
BSE SENSEX	-23.47%
CAC 40	-24.91%

As of November 25, 2011

Chart:, Advisor Perspectives 11/26/11

The best performing major global index, the S&P500¹ in late November lost most of its 11% Gain in October – the best monthly gain in nearly 20 years. By early December the market rebounded again.

In October there was hope that Greece would get bailed out and markets focused more on record-breaking U.S. corporate earnings, continuing strong retail sales, and all-time high revenues. The U.S. economy has gone from recovery into expansion - since GNP is now greater than its pre-recession level.

Stocks overall, still have a long way to go to recover to pre-recession levels, and are not even back to May 2011 market highs. Sadly, stocks are still being held captive by the drama in Europe and seemingly on a roller-coaster ride with very light volume.

In late November various investment strategists say "the smart money is positioning for growth next year." (Advisorone 11/21/11) Warren Buffet has stepped up his investing. The market is at compelling low valuations. Most economic indicators point to continued growth.

The market seems to want to go up, whenever there isn't more perceived bad news and inaction by European leaders. The U.S. economy continues its slow self-healing, even with the jobs crisis and the expected continued stalemate in Congress.

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Europe Fears Dominate Global Markets

In November the concerns about Europe grew. The issue is the credit markets, as interest rates on sovereign debt for Italy, Spain and Portugal broke above the key 7% level which is considered unsustainable for countries to pay. Greece has long been locked out of the credit markets with rates above 30%. In early December rates dropped again.

As interest rates in troubled Europe soared, they keep plunging for U.S. debt, reaching historical lows again on most maturities. Demand for "safe haven" U.S. debt continues to be far more than new debt auctioned by Treasury.

Many think Treasury should speed up 10-30 year debt issues - especially for needed infrastructure spending - since it can borrow at almost no cost today vs. expected future potential higher rates.

A U.S. "debt crisis" is probably 10-20 years out – though it has to be addressed – but today faster growth to create more jobs is the crisis in the U.S., not debt. With the failure of Congress to act, even if nothing happens there will be a \$7 trillion deficit reduction over 10 years including \$4 trillion from the expiration of the Bush Tax Cuts mostly for the wealthy in 2013.

Bank Stocks Led Decline- Take Huge Risks

Globally bank stocks have led the European crisis decline. The direct exposure to troubled debt is mostly limited to a few European banks. However, it is unknown the extent of banks' exposure to derivatives on European debts.

Banks should be required to disclose their derivative holdings and have limits on their risky, highly leveraged security trading. Many U.S. traders enjoy

millions in compensation to trade with basically the risk taken by U.S. taxpayers.

The largest U.S. banks as of 9/30/11 had increased their holdings of derivatives to nearly \$250 trillion, and with Republican support are battling against required disclosures and other provisions of the Dodd-Frank Act to reduce taxpayer risk.

New York Times 11/26/11 reports: "It is painfully obvious that the (2008) financial crisis, which brought us to the brink of international economic collapse, was in large part the result of a 'shadow' or nontransparent financial market. The Dodd-Frank act requires that 'business as usual' must change. **Not if Wall Street can help it. And it is throwing money at Washington to ensure that its views are heard.**" The article points out derivative trading is based on private deals not publically reported. Dealers make a staggering \$50 billion annually from their transaction fees.

It is very profitable for banks to keep the current system: the risk of bank failure if they guess wrong is on the taxpayers. It is unknown to what extent U.S. banks have exposure to European debt derivatives - or derivatives on derivatives, or derivatives on derivatives on other derivatives.

This risk banks take for potentially huge profits at the risk of the taxpayer resulted from the repeal of provisions of the Glass-Steagall Act by the Gramm-Leach-Bliley Act in 1999 which effectively removed the separation that previously existed between investment banks (which issue securities) and commercial banks (which accept deposits). The deregulation also removed conflict of interest prohibitions between investment bankers serving as officers of commercial banks.

Fed Sees Risk – New Stress Tests Required

Today U.S. banks overall are stronger than most European banks, having repaid TARP with a large profit to taxpayers. Other than their derivative and trading risks, U.S. banks are very strong.

Reuters 11/22/11: "U.S. bank earnings reached a more than four-year high in the third quarter, but regulators are warning that the industry faces challenges that include the risk of the European debt crisis washing up on U.S. shores." The chairman of the FDIC points out: "U.S. banks have limited direct exposure to Europe, but there is a risk of contagion if the situation gets worse. Close attention is being paid to what we see as the possible avenues for contagion, particularly in regard to the derivative markets."

In light of the European risk and unknown exposure to derivatives, the Federal Reserve is requiring a more extensive stress test, especially on the largest banks that have the highest trading risks. They will be forced to raise additional equity if they fail the

test, or have to curb their high-risk activities. The 31 bank holding companies subjected to stress tests are required to submit their 2012 capital plans by January 9, and will have their plans approved or rejected by the Federal Reserve by March 15, 2012.

These tests feature a set of economic assumptions to simulate the maximum stress banks should be able to survive without a taxpayer bailout. These tests assume a worst case, highly unlikely 4% decline in the U.S. gross domestic product, 13% unemployment, a further 21% decline in home prices, and a 52% decline in equity prices.

Those are conditions that mimic not only the financial crisis conditions in 2008 but also on some levels — particularly in the associated capital requirements the Fed thinks will be needed for the banks to survive — take the industry back to the Depression-era 1930s. (CNBC 11/25/11) Those that oppose this testing (the banking industry) warn that having to increase capital will hurt lending. But banks' lending is so limited anyway, this seems a minor issue.

More importantly, investor confidence based on the positive U.S. fundamentals should improve with the confidence that the banks will not again bring us to a 2008 financial crisis which took us into the deepest recession since the Depression.

Without the worry of a banking crisis, markets have the potential to rebound significantly, reflecting the record corporate earnings and positive U.S. economic expansion. There are many investors sitting on record amounts of cash because of their fear of the market. This cash could burst into the equity markets once investor confidence is restored. This could be a huge amount of fuel for the market to have a strong recovery and return to more historical valuation norms.

A recovery in bank stocks - once confidence is restored - could also lead the market higher. Sample Bank Stock Losses: (Data Morningstar year-to-date 11/25/11)

Bank of America:	- 61%
Morgan Stanley:	- 51%
Citigroup:	- 51%
Goldman Sachs:	- 47%
JPMorgan Chase:	- 31%
Wells Fargo:	- 23%

¹Investors cannot directly invest in indices. Past performance does not guarantee future results.

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