Observation Deck

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Gold Hits $1,072. Is Inflation on the Horizon?

Debi Hanson, *Portfolio Manager*

Historically, gold has been a precious commodity used for trade, jewelry, medicine and decoration. In more recent times, it has been used as a hedge against inflation. There are many investors who currently believe our country is heading into an inflationary environment, pushing up the price of gold. But we do not see any data to support the position that inflation will spiral out of control anytime in the near future.

The inflation bulls point to the following to back up their belief:

Monetary Policy. The Fed has had the target rate at between zero and 0.25 percent since December 2008 and has stated that it will keep rates at the current level for some time. Does the Fed really have a choice, given the state of the economy, and more particularly, joblessness? It is hard to raise rates when so many people are unemployed or underemployed.

Rising Deficits. Since December 2008, the Federal budget deficit has tripled from $454.7 billion to a projected $1.4 trillion by year end. For the years 2010 to 2019, the Obama administration forecasts the cumulative deficits to exceed $9 trillion. This, as the size of our federal government has already increased 18 percent in 2009. And, we are now in a great debate over a government-run health care system, and still fighting wars in Afghanistan and Iraq.

Markets

Treasury Rates	
3-Month	0.05%
6-Month	0.16%
1-Year	0.35%
2-Year	0.89%
3-Year	1.40%
5-Year	2.31%
7-Year	2.97%
10-Year	3.38%
October Total Returns	
ML 3-Month Treasury	0.02%
ML 6-Month Treasury	0.03%
ML 12-Month Treasury	0.11%
S&P 500	-1.86%
Nasdaq	-3.61%

Source: Bloomberg, as of 10/30/09

Weak Dollar. The persistent weakness of the dollar has increased gold's appeal as a hedge against losses in dollar-denominated assets. At this time, there is no resounding argument that the dollar will strengthen in the near term.

Those who do not see an inflationary environment, which includes us, point to the following:

Money Supply. Historically, easy money with low rates for too long a period has raised the chance of inflation. And, the Federal Reserve has certainly increased money supply. But if banks are not lending, then there really is no "easy money." This, combined with the decrease in credit for consumers in both the residential and non-residential sectors means inflation should not be a concern.

Faith in the Fed. There is long-held faith that the Federal Reserve will raise interest rates enough, and at the appropriate time, to keep inflation at bay.

History. According to *Bear News*, "the historical record indicates that massive increases in government debt will weaken the private economy, thereby hindering rather than speeding an economic recovery."

Inflation Data. The most recent inflation data released by the government shows inflation coming down. The most recent Consumer Price Index (CPI) data released shows inflation down 1.3 percent at the headline level. The core level, which excludes food and energy, is at a benign level of 1.5 percent. It is also below the 2 percent ceiling of the Fed's comfort level for inflation.

Back in 1980, gold hit a high of $873 and the CPI was up over 13 percent. Then, gold dropped and hovered in the $300 area for years. In fact, the price of gold has not kept up with inflation. Using the government's inflation calculator, gold should be over $2,200 per ounce. Therefore, for the inflation camp gold is cheap and buying at these levels makes sense.

So, to answer the question "is inflation on the horizon?" No, and not for the foreseeable future. We would have to have a strong economy, strong labor markets, a recovery in consumer spending, a loosening of credit, lending by the banks, a continuation of growing deficits and a lack of response by the Fed. On the other hand, there is no harm in diversifying your portfolio to take advantage of rising and volatile commodity prices (just in case).

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

As we begin the final quarter of the year, there are more positive signs in the economy. In the latest Beige Book Survey, the Fed commented that it saw "stabilization or modest improvements" in many areas of the economy. One of the bright spots has been housing. Existing home sales for September came in at 5.57 million units as more first-time buyers took advantage of the $8,000 tax credit. The inventory of homes on the market has dropped to 7.8 months, the lowest level since March 2007. The initial estimate for third quarter GDP came in at 3.5 percent. Fueled by the government stimulus, this was the first positive number after four quarters of contraction. However, it is unlikely that the economy can sustain this pace in the coming quarters. Inflation has also remained benign as core Personal Consumption Expenditures (PCE) increased 1.3 percent, year-over-year.

The economy still has some headwinds to overcome. There remain pockets of weakness with rising unemployment and "weak or declining" banking activity. The jobless rate for September hit 9.8 percent, as 4.1 million jobs have been lost year–to-date. In addition, commercial real estate remains weak with growing vacancies and higher loan delinquencies. These sectors will need to show sustained improvements before the economy is truly out of the woods.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The news of over 100 banks failing this year and the Federal Deposit Insurance Corporation (FDIC) fund shortfall has understandably generated questions about the stability of banks and the adequacy of FDIC deposit insurance funds. As we move through the crisis, credit weakness has expanded rapidly into the commercial real estate sector, which has hurt regional and small community banks. Over the past decade, the banking industry has steadily increased its exposure to commercial real estate. This is a result of other areas of lending—such as credit cards, home mortgage, and home equity—becoming less attractive, and too competitive for smaller, regional banks. Conversely, large national banks have sizeable market share in those areas. On the commercial lending side, large corporations and mid-sized businesses have increasingly taken their funding needs to the capital markets via high-yield or asset-backed issuances. Consequently, there have been limited lending areas of meaningful opportunity for local banks. Since most of the commercial real estate lending and construction development loans have remained largely local, these exposures have become an even greater proportion of these small banks' loan portfolios. And while the larger regional and national banks' commercial real estate exposures are generally lower, their exposures are still elevated in some cases.

As of June 30, 2009, the number of institutions on the FDIC's "Problem List" rose to 416, with total assets of $299.8 billion, the highest level since the end of 1993. The FDIC is projecting that the deposit insurance funds will incur approximately $100 billion in failure costs over the period of 2009 through 2013.

While these are certainly challenging times, we continue to believe that the FDIC has sufficient resources to provide insurance for all insured deposits. Even if the deposit insurance funds are completely depleted (as occurred previously), the FDIC should be able to honor its deposit guarantee through its ability to borrow up to $500 billion from the U.S. Treasury Department on an emergency basis. Recently, the FDIC proposed a prepaid assessment of $45 billion financed by the industry. Ultimately, because the FDIC is mandated to maintain a reserve ratio based on the amount of insured deposits, it must recoup losses from troubled banks—mostly from the U.S. banks.

Trading Vista

Hiro Ikemoto, *Money Market Trader*

With the tight supply and strong demand for short-term debt, this month's mixed earnings season had little effect on bond prices. Financial corporate bonds maturing in a year remained plus 10 to 30 basis points over one-year LIBOR, with industrial names minus 10 to even. Two-year bonds are being offered plus 50 to 80 over the two-year Treasury for financials and plus five to 20 for industrial names. High-grade three-month commercial paper yield ended October relatively unchanged in the low-20 range.

With recent history of Treasuries going near zero, or even negative, at quarter- or year-end, there has been earlier-than-usual strong buying in the three-month Treasury bill, which matures in 2010, pushing yields down to 0.05 percent by month-end. The six-month and one-year bill ended October at 0.16 percent and 0.35 percent. The benchmark two-year Treasury was at 0.89 percent. Agency discount notes yields remained tight to Treasuries with spreads of plus one for three-months and plus eight in the one-year maturity range.

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