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Observation Deck

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Studying the Greeks

Debi Hanson, *Portfolio Manager*

What a difference a stimulus makes. As we entered this global recession/credit crisis a few years ago, governments around the world came up with plans to support their banking systems and stimulate growth in their respective economies. The amount of money each country spent was different; the goal was ostensibly the same — stability and eventually, resumed growth. We are now seeing the results of spending without fiscal context in Greece and a few other EU countries. While the differences probably outnumber the similarities between Greece and the U.S., we still need to take heed. One key advantage is that we are one country with a currency and monetary policy that more or less cooperate. European countries may share a currency, but their fiscal policies couldn't be more diverse, and there's the rub.

Greece, with its budget deficit of 12.7 percent, gets much of the headlines, but you should consider the issues in Spain, Portugal, Dubai, California and Ireland as essentially the same problem: spending money without a realistic ability to pay it back. While these problems have been festering for some time, global stocks and bonds have taken a noticeable hit, as has the Euro. Why now? All sovereign entities have tremendous flexibility in hiding their liabilities, and the ability to tax one's way out of debt is unique to them. For Dubai, Greece and California to be considered legitimate bankruptcy concerns points to a problem rising to a level of severity we have rarely, if ever, seen. Greece, along with the others, is required to reduce its deficit to a maximum of 3 percent to remain a member of the EU. Greece has already announced large cuts in spending and will raise taxes — but the problem has been revealed, and the market rightfully wants to know which nations (and states) face the same problems.

The U.S. as a whole is not immune to this issue. Currently our deficit is running over 10 percent of GDP and is projected to rise to 11 percent next year. This means is that for every dollar our government spends, 40 cents will either have to be borrowed or printed. We have long been the "flight-to-quality country," and this crisis has only reinforced that status. Those who have doubted the U.S. status as a "safe haven" relative to the rest of the world have once again gone quiet.

But the same rules that apply to Greece apply to us: We need to spend loaned money with an eye toward paying it back. In both absolute and relative terms, our domestic spending to combat the "great recession" far exceeds any precedent in our history, including the Great Depression. We will need to put our spending in check at some point, and equally important, we need to see a return on the investment. At this time or in the near future, we do not believe that there will be an impact on short-term interest rates, despite the real risk that Treasuries will ultimately have to pay more to reward new investors in such an indebted nation. Our view remains that short rates will not move dramatically unless we see the Fed begin to meaningfully tighten monetary policy, a development we do not see occurring in 2010. In the meantime we are keeping client portfolios away from most sovereigns and the banks affiliated closely with them, and you can forget California munis as well.

Markets

Treasury Rates	
3-Month	0.12%
6-Month	0.18%
1-Year	0.29%
2-Year	0.81%
3-Year	1.33%
5-Year	2.30%
7-Year	3.05%
10-Year	3.61%
February Total Returns	
ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.01%
ML 12-Month Treasury	0.04%
S&P 500	3.09%
Nasdaq	4.37%

Source: Bloomberg, as of 02/26/10

Economic Vista

Ninh Chung, *Portfolio Manager*

The unemployment rate unexpectedly declined to 9.7 percent in January, with net positive hiring in manufacturing, for the first time in three years, and in healthcare, and temporary staffing. According to the U.S. Labor Department, more than 500,000 Americans found work. Additionally, productivity surged as employee output per hour increased 6.2 percent annually in the fourth quarter. Sluggish hiring, combined with increased productivity, has boosted corporate profits, with little pressure to hire new workers, as stagnant consumer demand can be fulfilled by the slack in corporate capacity.

The prolonged uncertainty in the job market has shaken consumer confidence, as reflected by a slump in the Conference Board's index, to 46, the lowest level in 10 months. The low reading perhaps can also be attributed to recent drops in stock values. Major stock indices are down by about 1.5 percent this year.

Lastly, the Federal Reserve raised the discount rate by 0.25 percent to 0.75 percent in February. The move is in line with the closure of other extraordinary credit programs as the Fed moves closer to normalization of its operations. The move should not be considered a tightening move with regard to overall credit conditions.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The ballooning of budget deficits for a number of G-20 sovereigns has become an ongoing concern, with IMF numbers showing a rise of 20 percent in the ratio of aggregate debt to GDP for the G-20 from 2007 to 2009. Against the background of the recent escalation in sovereign risk, the rating agencies have been moving to increase the focus on various countries' fiscal houses. On a number of occasions, Moody's and S&P have commented on the AAA ratings of countries such as the U.S. and the U.K., highlighting concerns that the overhang from the financial crisis could result in a sustained period of reduced productivity and sub-par growth that would make current fiscal paths inconsistent with the highest ratings.

Recent turbulence in European debt markets among the so-called PIGS (Portugal, Ireland, Greece and Spain) has caused much consternation among market participants. Current rapid movements in credit spreads have contributed to worries about contagion in the area, underscoring a lack of clarity on how the problem will be solved. Moody's commented that European sovereign ratings will likely be scrutinized even more closely than usual, as European governments have seen some of the most dramatic deteriorations in their debt metrics. A key factor that has prevented economic meltdown has been low interest rates. As a result of the low rates, debt affordability has not deteriorated near as much as it would otherwise. However if the markets were to switch concerns about fears in inflation and market rates were to rise significantly, more highly indebted countries could find their ratings tested.

In the near term, while these heavily indebted countries may be supported by EU or IMF, the main question would be, "Will the countries that have adopted counter-cyclical policies during the downturn formulate and successfully implement exit strategies?" Ultimately, the governments themselves are responsible for their own fate. Going forward, withdrawing the stimulus, both monetary and fiscal, will have to be carefully managed or these heavily indebted countries risk undermining market confidence and triggering a rise in bond yields that could transform many countries' currently manageable debt into unmanageable millstones.

Trading Vista

Minh Trang, *CFA, Portfolio Manager*

The bond market was somewhat quiet the first half of the month until the FOMC announced on February 18 that it was increasing the discount rate from 0.50 percent to 0.75 percent. The discount rate is the interest rate charged to depository institutions that borrow from the Fed. The Treasury market initially sold off on the news, but tightened up by month end. The two-year yield began at 0.85 percent and ended the month at 0.81 percent. The one-year level remained relatively flat, from 0.30 percent to 0.29 percent.

Trading levels outside of Treasury securities remain tight. One-year and two-year government agency debt traded at plus 7 basis points and plus 10 basis points over comparable Treasuries, respectively. Six-month commercial paper traded at 0.25 to 0.28 percent, and one-year corporate notes traded at 0.45 to 0.50 percent.

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