Observation Deck

Déjà vu

Minh Trang, *CFA, Portfolio Manager*

For the new year ahead of us, many facets of the economy look to be replicas of 2010. Though there have been improvements in certain parts, much remains the same. First is GDP growth. For 2010, GDP more than likely grew at a modest annual pace of about 2.8 percent, once final fourth-quarter numbers are incorporated. The expectation for 2011 is roughly the same, given the continuing accommodative monetary policy and the recent passage of the tax-cut extension and unemployment benefits. There may be some uneven growth quarter to quarter, but the anticipation is for a steady and modest improvement.

Given the tempered growth, the employment picture is forecasted to show little improvement. Once all the adjustments are taken into account, the economy is expected to produce about one million jobs in 2010. Though that is a considerable reversal from the previous two years, where eight million jobs were lost, it isn't enough to bring down the unemployment rate much below 9 percent. It will take considerable time to make up for the millions of jobs lost during the height of the liquidity crisis, given the anemic pace of the labor sector. The economy has yet to prove that it can sustain job creation of at least 150,000 per month, which is needed simply to keep pace with new entrants into the work force.

Without enough jobs, it will be difficult for housing to recover, as well. After a rebound last spring, due to the government tax credit, home sales have steadily dropped. Existing homes sold at a 4.68 million unit pace in November, well below the pre-bubble levels. New home sales have not fared much better, at just 290,000 in November. Compounding the problem is the mounting foreclosure of homes. About 1.8 million homes were foreclosed in 2010, and the expectation is for that number to slightly increase in 2011. It does seem that housing has hit a bottom, but any recovery may not be material enough for this year.

The substantial slack in the economy, weak housing and rent, and little wage pressure will undoubtedly keep inflation in check for 2011. In the latest readings, the core Consumer Price Index, and the core Personal Consumption Expenditures index, the Federal Reserve Bank's main price gauge, increased only 0.8 percent from the previous year. If anything, the Fed's purpose for quantitative easing through additional security purchases is to prevent the U.S. economy from falling into a deflationary spiral. It is likely that the environment of easy money will counter-balance the excess resources to keep inflation at a modest comfortable range for the year.

Integrating all these factors, the likely conclusion is that the Federal Reserve will maintain the current course of low rates and accommodative posture throughout 2011. After two years with a Fed target rate range between zero and 0.25 percent, credit remains tight as large banks have been cautious about lending. The Fed, of course, wants stronger job creation and a more normal lending environment, and pursues this by keeping rates low and implementing quantitative easing. The recent initiative of buying more Treasury debt is expected to be completed by mid year. Any tightening stance from the Fed will first include an exit strategy from the purchase program. Such a change in tactics is at least a year away.

Markets

Treasury Rates

3-Month	0.12%
6-Month	0.18%
1-Year	0.26%
2-Year	0.60%
3-Year	1.00%
5-Year	2.02%
7-Year	2.72%
10-Year	3.30%

December Total Returns

ML 3-Month Treasury	0.02%
ML 6-Month Treasury	0.04%
ML 12-Month Treasury	0.02%
S&P 500	6.77%
Nasdaq	6.34%

Source: Bloomberg, as of 12/31/10

Economic Vista

Debra Hanson, *Portfolio Manager*

The holiday season brought some uplifting economic data and hope that the economy may be turning the corner. Of course, this is old news, but the extension of the Bush tax cuts for the next two years, and a 2 percent decrease in the payroll tax for one year, should help growth. Many economists have increased their estimates for growth in 2011.

Retail sales were positive for the fifth month and according to early counts, the holiday shopping season was much better than the previous two years. Consumer credit was up, probably as a result of the consumer pulling out the credit card for holiday shopping. Chain store sales were also up strongly, gaining 5.8 percent over the previous year, according to the International Council of Shopping Centers. All of this points to the consumer coming back.

Nonfarm payrolls were much lower than expected, but still positive at 39,000. November's numbers were revised up from 151,000 to 172,000. The surprise was that the unemployment number rose from 9.6 percent to 9.8 percent. Perhaps after the larger October payrolls number, some of the discouraged workers began looking for jobs again.

Inflation continues to remain in check, with all of the indices posting fairly benign numbers both for the month and the year. Despite this, commodity prices are still on the rise, but with little impact on core inflation levels.

The good economic data and the continuing rise in the stock markets pushed up consumer confidence. The University of Michigan confidence index climbed to 74.2 in December, the highest level since June.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The U.S. banking industry has been experiencing a continued improvement in asset quality. This is an optimistic trend that mirrors the slow, yet fragile recovery of the U.S. economy. According to the FDIC's *Quarterly Banking Profile* for the third quarter 2010, the aggregate net profit was $14.5 billion for all institutions, up significantly from the $2.0 billion recorded for the same period last year. If it was not for a $10.4 billion charge for goodwill impairment from one large bank, third-quarter 2010 earnings would have reached the highest level in three years.

As revenues remained soft, lower loan loss provisions were the primary driver to the enhanced earnings. Provisions for loan losses for the third quarter 2010 were $34.9 billion, down 44.5 percent from the $62.9 billion reported a year ago – the lowest level since the end of 2007. Banks were able to reduce provisions considerably as the asset quality of their portfolios exhibited improving delinquency and default performance during 2010. Net charge-offs for nearly all loan categories also declined, from $50.9 billion in the third quarter 2009 to $42.9 billion in the latest quarter. Despite the positive momentum, delinquency and default levels were still elevated when compared to historical levels. Also noteworthy was the increase in the number of "problem" institutions in the quarter; however, these failing institutions were mostly smaller, unrated banks and not the larger, financially stable banks, as evidenced by the actual decline of total assets of "problem" institutions.

Although heading in the right direction, the U.S. economy is still in a delicate state, sensitive to negative macroeconomic developments and uncertainty around final regulatory rules. There is light at the end of the tunnel, the FDIC report shows — though faint, a light nonetheless.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With the extension of both the Bush-era tax cuts and unemployment benefits in early December, Treasury yields jumped, as many investors saw these actions as positive for the U.S. economy. The two-year note increased 10 basis points on December 8, and the 10-year increased over 30 basis points. For the remainder of the month, Treasuries fluctuated widely on light trading, with the two-year ending the year yielding 0.60 percent and the 10-year at 3.30 percent.

Surprisingly, with all the grim news coming from Europe, especially with Portugal and Ireland downgraded, and Spain, Greece and Ireland put on credit watch, the LIBOR curve was relatively flat for December. The one-year LIBOR spot curve remained at 50 basis points throughout the month, with the credit spread remaining stable at minus 5 to flat for industrial issuers and plus 5 to plus 20 for financial names. Three-month commercial paper yields were slightly higher, in the 27 to 35 basis point range.

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