Observation Deck

European Refi

Renuka Kumar, *Portfolio Manager*

There is no question that the issues in the euro zone are far from over and that many headwinds to economic growth remain. Sovereign governments still need to implement harsh austerity measures and control their debts and deficits, while banks are facing capital and liquidity challenges. Although Greece secured their second aid package of 130 billion euros, it remains to be seen how the stringent austerity measures will be implemented and how much time it will buy them. For our part, we continue to focus on the fundamentals.

In spite of these challenges, it is interesting to see that there has been some stabilization in European markets recently. The euro has held between its three-year low of 1.19 and high of 1.51, currently trading at 1.34. Borrowing costs have come down in Europe with the Italian 10-year note falling over 1.5 percent since the beginning of the year. Additionally, prime money funds have been increasing their exposures to euro zone banks, albeit at shorter maturities. In January, this exposure grew by $27 billion, which was the first increase in almost a year. The improved tone can largely be attributed to recent actions by the European Central Bank (ECB) to provide enhanced liquidity support. The ECB announced in December two longer-term refinancing operations (LTROs) to provide unlimited and very affordable three-year loans to banks in response to the liquidity crunch European banks were facing as they lost access to short-term funding markets. The ECB had also expanded the collateral pool, allowing banks to pledge a greater variety of assets in return, including sovereign debt which has reduced selling pressure and supported government yields.

The first operation was conducted on December 21, 2011 at an interest rate of only 1 percent and resulted in a record €489 billion in loans. The second operation was conducted on February 29, 2012 and resulted in €529 billion in loans to 800 banks. In total, the ECB has injected over €1 trillion of funds. The effect of these operations will likely be material for the banks that choose to participate. The liquidity injection is expected to solve their refinancing needs in the coming years and to reduce funding costs, spark deleveraging, and create better profitability. At this point, most of the funds have been deposited back at the ECB earning 0.25 percent; however, banks can also use the funds to pay down outstanding debt, to increase lending, or to buy sovereign bonds, which is unlikely given their already heavy exposure.

The measures to create liquidity and recapitalize the banks will better assist these institutions in weathering the ongoing debt crisis and investors — such as the money funds mentioned above — are reacting positively. Investors are dipping back in to European exposure in an effort to search for yield and diversify bank holdings, but it is also important to maintain a conservative and prudent approach to managing bank credits. The Nordic region, for example, is one sector which provides good investment opportunities. While there is still some uncertainty and risk of contagion spreading from core Europe, we continue to invest in institutions with strong fundamentals, minimal exposure to the PIIGS and able to withstand asset quality stress tests.

For now, it appears that the ECB will continue to provide liquidity support for the euro zone and we will continue to do our analysis, focusing on the fundamentals.

Markets

Treasury Rates

3-Month	0.08%
6-Month	0.13%
1-Year	0.16%
2-Year	0.29%
3-Year	0.41%
5-Year	0.86%
7-Year	1.38%
10-Year	1.97%

February Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	-0.01%
ML 12-Month Treasury	-0.02%
S&P 500	4.32%
Nasdaq	5.59%

Source: Bloomberg, as of 02/29/12

Economic Vista
Paula Solanes, *Portfolio Manager*

The start of 2012 shows some optimism for the economy. Jobs came in at 243K, the strongest number since April of 2011. Nonfarm payroll has maintained an average of 200K for the last three months, and this last month shows a broadening of sectors that added jobs. Manufacturing increased to 50K, the most in a year and service providers added 162K jobs, the largest increase since September. Professional and business services added 70K, the best number since March. Construction has picked up as more homeowners are investing in renovations. There were also jobs added in education, leisure, healthcare and hospitality. The variety of industries that added jobs instills confidence in the jobs recovery. The additional jobs coupled with people who left the labor force drove the unemployment rate down to 8.3 percent.

The University of Michigan confidence number increased to 75.3 from 75 the prior month. The increase was based on the improved job market, fewer layoffs and a rallying stock market. However, the recent uptick in fuel prices could weigh on consumer confidence going forward. Consumer credit rose to $19.3B, much higher than the estimated $7B, as more people took loans for autos and education.

Consumer prices rose less than forecast, supporting benign inflation concerns for now. The consumer price index rose 0.2 percent last month and 2.9 percent year-over-year. The year-over-year change is the smallest change since March 2011. The core measure, which excludes food and fuel increased 0.2% for the month and 2.3 percent for the last 12 months. The increase in core inflation was driven by an increase in cost of apparel, toys, tobacco and medical care.

Housing is showing signs of life. Sales of previously owned homes increased to the highest level since the first time home buyers credit. Home purchases increased 4.3 percent to an annual rate of 4.57M. Close to 25 percent of all purchases were by investors. Sales of distressed homes increased to 35 percent. Cash transactions were at about the same levels as last year at 31 percent.

Credit Vista
Melina Hadiwono, *CFA, Head of Credit Research*

The fourth quarter 2011 large bank's earnings results have largely followed the theme from 2011. Banks have seen continued improvement in asset quality metrics offset by subdued net interest margin in the back of a prevailing low interest rate environment.

Most banks recorded lower revenues in 4Q11 due to declining capital markets and lackluster loan demand. There are pockets of bright spots, such as commercial and industrial loan portfolios and auto and credit card lending in response to a growing U.S. economy and partly to European banks cutting back their lending in the U.S. Asset quality among consumer loans generally has improved and the share of all non-performing loans and net charge-offs has declined over the past two years.

As revenues remained soft, lower loan loss provisions were the primary driver of the enhanced earnings. Capital in general has improved primarily due to equity issuance and stronger earnings. At the same time, regulators have constrained banks' ability to return capital to shareholders in the form of dividend and share repurchases.

The Fed is conducting a stress test, comprehensive capital analysis and review (CCAR) for 31 U.S. banks. By January 9, banks with over $50 billion in assets were required to conduct stress tests based on various economic scenarios. The result is expected to be published by March 15. Depending upon the results, the Fed will either grant or deny requests for capital distribution. In 2012, if economy continues its measured recovery, U.S. banks will continue to see modest improvement in fundamentals as they continue to build profitability, impose tighter expense control and strive to optimize the capital levels. Nonetheless, increased pressure will come from regulatory uncertainty about the liquidity requirements under Basel III, the capital requirement for systemically important financial institutions and Volcker rule implementation.

Trading Vista
Hiroshi Ikemoto, *Money Fund Trader*

February was a relatively quiet month in the bond market, with Greece's bailout the major economic story for the month . As the equity markets strengthened, Treasuries cheapened with the twos reaching 0.30 percent late in the month after starting at 0.22 percent on February 1. The Treasury bill curve had a bear flattening with yields at 0.07 percent in one-month bills and 0.16 percent for one-year bills. Agencies remained at plus one to plus five basis points to Treasuries, depending on the part of the curve.

There was a slight relief in short-term corporate bonds. Although one-year EDSF remained at 0.50 percent, spreads widened by about five basis points for both industrials and financials as investors seemed to move to Treasury bills which now have a bit of yield. Commercial paper tightened up now that money fund managers are beginning to purchase European issuances again. Six-month paper is currently yielding about five basis points less than last month, in the 20 to 35 basis point range.

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