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Observation Deck

November 2010

Reflation

Judy Lee, *Portfolio Advisor*

Thirty years ago, inflation was running at a high of 13.6 percent. The Federal Reserve had to adopt aggressive measures to tighten monetary policy and fight inflation. The Fed tightened money supply and the target Fed Funds rate rose to 20 percent. The economy took a downturn and two recessions quickly followed the Fed's actions (from January 1980 to July 1980 and from July 1981-November 1982). Currently, our economy is experiencing yet another scenario where the Fed must take extreme action in monetary policy. However, this time around, the conditions are not quite the same.

Today, inflation is running at 4 percent on the wholesale level and 1.1 percent at the consumer level, including the volatile food and energy components. Excluding food and energy these numbers come down to 1.6 percent and 0.8 percent, well within the Fed's historical inflation targets. What the Fed is fighting right now is the lack of growth in the economy. The target Federal Funds rate has remained at 0.0 percent to 0.25 percent since December 2008. But this low rate range has not kick-started the economy. The Fed's next attempt, dubbed "quantitative easing," was to purchase distressed mortgage-backed securities and other financial assets, putting more money into the marketplace. To date, the measures the Fed has taken, including those initiated at the start of the financial crisis, have ballooned the Fed's balance sheet to approximately $2.5 trillion, a staggering amount more than triple the total from the beginning of the financial crisis. The Fed is expected to embark soon on a second round of quantitative easing, in its continuing effort to grow the economy, increase the price of assets and stimulate job growth.

Fed Chairman Ben Bernanke's most recent speech confirmed that the Fed is prepared to pump more money into the system, hoping to trigger inflationary pressures, and in doing so to reduce unemployment levels, and, ultimately, to create an environment where: 1) consumers feel comfortable spending again, 2) investors get out of the "flight to quality" mindframe, and 3) businesses are willing to resume normal activity by spending cash they are sitting on.

If this second round of quantitative easing (QE 2.0) results in a more normal post-recession growth period, signs of reflation could appear. Unfortunately, we have been experiencing a prolonged period of high unemployment and slow economic growth, which has resulted in deflationary pressures. If expectations are for continued benign growth, prices could come down further and consumers will be less willing to borrow and spend. However, if QE 2.0 works and we see significant growth in the economy and jobs, one of the results will be an increase in the inflation rate.

Will the reflation attempt work? Looking back on 2009's economic activity in the U.S., the first round of quantitative easing did very little to regain consumer confidence and stir up economic activity. Rebuilding consumer confidence is going to be a much more difficult task the second time around.

With a lack of consumer appetite to spend, borrow or invest, there is little chance of inflation picking up. At this point, it is hard to say that more stimulus money will create the real growth and job creation that the economy needs. The Fed seems to be optimistic, and although the size and timing of the program is undetermined, it is almost certain it will be announced and confirmed in the upcoming Fed meeting. We hope that this will be the last intervention needed to fix the economy, as the third time is not necessarily a charm.

Markets

Treasury Rates	
3-Month	0.11%
6-Month	0.16%
1-Year	0.20%
2-Year	0.34%
3-Year	0.50%
5-Year	1.17%
7-Year	1.89%
10-Year	2.60%
October Total Returns	
ML 3-Month Treasury	0.02%
ML 6-Month Treasury	0.04%
ML 12-Month Treasury	0.06%
S&P 500	3.80%
Nasdaq	5.90%

Source: Bloomberg, as of 10/29/10

Economic Vista

Debra Hanson, *Portfolio Manager*

The past month gave us a mixed bag of economic data. The good news is that we saw personal incomes rise, primarily due to the extension of jobless benefits, and spending pick up. Personal spending has been up for the past two months and retail sales in positive territory for the past three months.

Existing home sales and pending home sales were both up month-over-month at 10 percent and 4.3 percent, respectively. The S&P/CS Composite-20 showed a small increase (1.7 percent) in property values over the past year. Unfortunately, there are still pressures on home prices. In September, 347,420 homes were foreclosed, with the year-to-date number at nearly 3 million. With unemployment still a very big issue and foreclosures continuing at record levels, home prices are bound to fall further.

Unemployment and the lack of job growth is still a big problem. Non-farm payrolls dropped 95,000 in September, the fourth straight month we have seen net losses. The unemployment rate remains at 9.6 percent, with the real rate of unemployment just over 17 percent. Those are daunting figures whichever way you look at them. Unfortunately, we do not anticipate this situation changing any time soon.

Wholesale prices, including food and energy are up 4 percent year over year. This rise in the Producer Price Index (PPI) is in stark contrast to the Consumer Price Index (CPI), which is only up 1.1 percent for the same time period. This shows companies lack pricing power and are absorbing their higher costs. At the core level, both of these indices remain very low at 1.6 percent and 0.8 percent. These low inflation numbers allow the Federal Reserve to continue to keep rates low and pursue other methods of easing in an effort to spur economic growth.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

On October 21, 2010, the President's Working Group (PWG) released the much-awaited Money Market Fund Reform Report. The PWG is comprised of the Secretary of the Treasury, the Chairman of the Federal Reserve Board of Governors, the Chairman of the SEC, and the Chairman of the Commodity Futures Trading Commission. The report analyzes alternatives for the reform of money market funds (MMF), rather than recommending any, and addresses proposals that industry participants have discussed over the past two years. The report focuses on the goals of preventing runs on money funds, and avoiding constraining the ability for money funds to hold short-term financing instruments which are critical for the functioning of the economy. The report highlights that the MMF reform introduced by the SEC in January does not completely address systemic risk and the structural vulnerabilities of MMFs to runs, and urges further reform policies to mitigate the risks.

The alternatives suggested include: 1) requiring money market funds to adopt floating net asset value (NAV), 2) Mandatory redemptions in kind, 3) Private emergency liquidity facility, 4) Insurance for money market funds, 5) A two-tier system of MMFs with enhanced protections for stable-NAV money market funds 6) A two-tier system of MMFs with stable MMFs reserved for retail investors 7) Regulating stable-NAV MMFs as special-purpose banks, and 8) Enhanced constraints on unregulated money market substitutes. These alternatives were not new revelations. In the press release, the PWG notes that it requests that the Financial Stability Oversight Council (FSOC) consider the options discussed in the report and "pursue appropriate next steps." The FSOC was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which was signed into law by President Obama on July 21, 2010. We anticipate that SEC will publish a request for comment on further MMF regulation soon. We believe that the funds we utilized for our clients are well positioned and we will continue to monitor developments closely.

Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

Quantitative easing has been all the news in recent weeks in the bond market. Treasury yields gyrated throughout October with investors reading their interpretations into every single word each Federal Reserve Board president has said over recent weeks. The speculation and anticipation revolves around how much the Fed will infuse. The rumored numbers have ranged from $100 billion to $2 trillion. The yield on the 10-year Treasury fluctuated from 2.39 percent to 2.61 percent, and ending at 2.60 percent in October. Yields on the two-year Treasury were less volatile, with a range of 0.34 percent to 0.42 percent, and ending the month at 0.34. In the two-year and in corporate and agency sectors, spreads remained unchanged, with corporate bonds plus twenty to plus 60 to Treasuries and agencies plus five to plus 12.

With the Federal Reserve Open Market Committee meeting on November 2 and mid-term elections going into the final stretch, we should get more clarity on what the Fed will do to in the coming months. Hopefully, that will bring some stability back to the markets as we head into the holiday season.

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