Observation Deck

Is Spending Here to Stay?

Renuka Kumar, *Portfolio Manager*

As we near the end of another year and the holiday season is upon us, all eyes are on the U.S. consumer, watching to see if the old ways of spending will return, leaving behind the mentality of saving more and spending less. Given that consumer spending accounts for 70 percent of economic activity, the resurgence of the consumer is expected to play a vital role in the recovery. While we have seen glimmers of hope recently, the questions many are now asking are whether this growth can be sustained, and whether there has been a fundamental shift in consumer behavior as a result of the recession.

Recent economic releases have been showing improvements in consumer activity, further raising the question of whether the expansion has staying power. Consumer spending has climbed the most in almost four years, with personal consumption growing 2.8 percent in the third quarter. Personal spending has been positive for four consecutive months, with October showing a 0.4 percent increase. U.S. same-store sales, including Walmart, rose 4.6 percent in October from a year earlier, and advanced retail sales increased 1.2 percent in October, the largest gain in seven months. The National Retail Federation estimated that holiday spending will increase 2.3 percent this year, up $10 billion from 2009 yet still below the 10-year historic average of 2.45 percent.

Despite these positive numbers, a few months of spending does not make a trend. Pressures remain on the consumer that cannot be ignored. Consumer confidence at 69.3 is well below historical averages, as consumers have been hit hard by the housing market and job losses. The national unemployment rate remains elevated at 9.6 percent, with almost 8 million jobs lost since the start of the recession, and millions of Americans could lose their unemployment benefits at the end of the month, which would further restrain spending. On the housing front, there have been 11 million home foreclosures since the start of the recession and foreclosures on even prime mortgages reached a record in the third quarter. Consumers continue to deleverage, either due to frugality or stricter lending standards, and continue to increase their savings while making conscious tradeoffs in their spending habits.

What does this mean for the recovery? It is likely that any recovery will be slow and uneven as the economy adapts to consumers who have learned to become more frugal. As for a permanent shift in consumer behavior, history has shown us that people have fairly short memories and once the means are there, the appetite for spending will return. Over the past 60 years, we have experienced 10 recessions and spending has always come back. Given the depth of the recent recession, however, it is almost certain that there will be a segment of the population where the "old ways of spending" will never return as individuals struggle to rebuild wealth. What we need for sustainable growth in the long-run is job growth, a recovery in the housing market, and the extension of credit once again. The Federal Reserve is trying to do its part to spur consumer demand, with the recent round of quantitative easing, hoping to keep borrowing costs low while raising inflation expectations, but the effects remain to be seen. For now, we will continue to watch the numbers; however, we must keep in mind that recovery will be a very slow process.

Markets

Treasury Rates	
3-Month	0.16%
6-Month	0.19%
1-Year	0.26%
2-Year	0.45%
3-Year	0.70%
5-Year	1.47%
7-Year	2.15%
10-Year	2.80%

November Total Returns	
ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.00%
ML 12-Month Treasury	-0.02%
S&P 500	0.01%
Nasdaq	-0.20%

Source: Bloomberg, as of 11/30/10

Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The major news for the month was the Federal Reserve's announcement detailing the quantitative easing program. The expectation is that the central bank will buy up to $600 billion in new Treasury securities from now to the middle of 2011. The objective is to maintain an accommodative landscape to further economic growth.

Economic data for the month continues to convey a stable and modest recovery. The secondary revision to third-quarter GDP came in at 2.5 percent, a bit higher than the initial estimate of 2.0 percent. The labor market provided an upside surprise, as nonfarm payrolls climbed 151,000 for October. This broke a four-month streak of job losses. However, the unemployment rate remained at 9.6 percent. The excess slack has continued to keep inflation in check, as the core Personal Consumption Expenditures (PCE) index was flat for October and up only 1.0 percent from a year ago. This will provide the Fed with some flexibility in its stimulus efforts. Lastly, the main focus going into the holiday season will be on retail sales. Advance retail sales for October showed an increase of 1.2 percent, the highest level since March. Hopefully, the markets will end the year with some peace and optimism for a better year in 2011.

Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The Federal Reserve in November issued guidelines for evaluating proposals by the 19 largest bank holding companies to undertake capital actions in 2011, such as increasing dividend payments or repurchasing common stock. Criteria include a bank's ability to absorb losses over the following two years under several scenarios including adverse macroeconomic conditions specified by the Fed, and how well the bank will meet international capital requirements when they take effect in the U.S., as well as any anticipated impact of the Dodd-Frank Act on the bank's business model or capital adequacy. These criteria are designed to provide a common, conservative approach to ensure that the bank holding companies hold adequate capital to maintain ready access to funding, continue operations, and continue to ensure their ability as credit intermediaries even under adverse scenarios. Regardless of whether a capital action is planned, as part of the effort to enhance supervision, the Fed is asking all large bank holding companies to submit their comprehensive capital plan by January 7, 2011, and expects to respond to capital distribution requests beginning in the first quarter 2011.

Most banks have been able to raise capital in the past two years, and reduced their dividend payout significantly to meet investor expectations and to avoid regulatory scrutiny. Given the muted economic recovery, the Fed will rigorously review these capital plans before giving approvals for capital distributions in the near term. In addition, with the upcoming rigorous Basel III requirements for systematically important banks, concerns about foreclosures issues, and ongoing asset quality deterioration, there are potential risks that still expose banks to capital shortfalls. In order to avoid regulatory interference, the banks need to maintain or exceed minimum capital requirements under a variety of stress-testing methodologies and will need to tap equity markets to support the capital distribution strategies.

Trading Vista

Paula Solanes, *Portfolio Manager*

As part of the Federal Reserve's quantitative easing program, on November 12 the Fed initiated its purchasing of Treasuries by buying $6.85 billion of Treasuries maturing between November 2014 and April 2016. After the announcement, treasury yields rose across the yield curve as investors sold. At the beginning of the month, the two-year Treasury was at 0.34 percent. By November 15 it hit a monthly high of 0.57 percent and finally closed the month at 0.45 percent. The yield on a 10-year Treasury saw a similar trajectory. At the beginning of the month the 10-year Treasury was at 2.62 percent, then hit a monthly high of 2.96 percent, and closed the month at 2.80 percent.

Corporate yields only rose by 7 basis points during this period, keeping one-year corporate levels within roughly the same range. The supply of corporates continues to be limited and spreads have not widened dramatically until the 18-month range. Commercial paper issuance continues to be constrained and levels have not risen. Agencies under one year continue to trade at slightly higher yields than Treasuries.

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