Observation Deck

European Disunion

Minh Trang, *CFA, Portfolio Manager*

The European sovereign debt crisis continues to be one of the main headlines throughout 2011. Though the problem was once thought to be isolated to Greece and that country's fiscal ineptness, it is clearly much more complicated and widespread. In recent months, the situation has escalated outside of Greece in both the political and financial arenas. To rein in irresponsible government spending, the European Central Bank (ECB) had required more stringent austerity measures for EU members. The austerity proposals, however, have not been very popular and political leaders in the region continue to face greater unrest. Most recently, the prime ministers of Greece and Italy were forced to step down — both lacking the confidence of their respective parties and the populace.

Unfortunately, the financial discord that started in Greece has deeper and more damaging implications. The core of the issue and the major concern is the solidarity of the European Union and the financial interdependencies of the 17 union members. The fear is not so much over a Greek default of its $300 billion debt, but the repercussions that event will have on the region and the global economies. The domino effect has rippled slowly into Italy and Spain, where the 10-year sovereign yields of those countries are trading near 7 percent. This compares to 2 percent for the U.S. Treasury, which continues to be an investor's haven for safety. In addition, the euro has fallen from its high of $1.45 to a current $1.34 against the dollar.

To contain the fear of contagion, the ECB has announced and instituted multiple measures to shore up capital needs among European banks. These measures include buying up sovereign debt on the open market, establishing the EFSF to provide up to €440 billion in lending capacity, partnering with the IMF, and launching a dollar swap agreement with other major central banks to shore up liquidity. In addition, the ECB lowered its benchmark rate to 1.25 percent, after raising it mid-year. The goals behind these maneuvers are to control borrowing costs, increase liquidity, fortify the banks and boost investor confidence.

It is still unclear how effective these actions will be in calming the financial distress in the euro zone. However, prudent managers have reduced or eliminated their investments in the region. Even prime money funds have continued to scale back their exposure. This includes avoiding financial securities in the affected countries and limiting to entities with minimal indirect ties. Given the interconnectivity of the global financial markets, it is very difficult to completely eliminate all exposure to the region. Fortunately, there are many sectors that continue to do well and have limited risk to Europe. For example, many U.S. corporations produced strong profits in the latest quarter, particularly industrial companies with diverse revenue streams. Outside the U.S., institutions in Canada and Australia have also experienced steady growth with stable balance sheets and consistent management.

Obviously, there's no silver bullet to resolve this complex issue, and European officials are applying various remedies to curb the spread of the problem. The changing political landscape and differing economies certainly add layers to finding a smooth solution, and the possibility of a euro zone recession only increases the challenge. What that means is that investors will need to be more diligent and thorough in finding the right investment mix to provide adequate return. More importantly, managing credit risk and limiting sector exposure will help minimize pitfalls as this situation plays out.

Markets

Treasury Rates

3-Month	0.00%
6-Month	0.05%
1-Year	0.11%
2-Year	0.25%
3-Year	0.40%
5-Year	0.95%
7-Year	1.52%
10-Year	2.07%

November Total Returns

ML 3-Month Treasury	0.00%
ML 6-Month Treasury	0.01%
ML 12-Month Treasury	0.03%
S&P 500	-0.22%
Nasdaq	-2.18%

Source: Bloomberg, as of 11/30/11

Economic Vista
Renuka Kumar, *Portfolio Manager*

In the U.S. the tone was more upbeat this month with many economists raising their growth projections for the fourth quarter from around 2.5 percent to 3.0 percent. The second reading of third quarter GDP came in at 2 percent, down from the preliminary reading of 2.5 percent but above first and second quarter growth numbers of 0.4 percent and 1.3 percent, respectively. The revision reflected a drop in inventories, although consumer spending held up at a 2.3 percent annual growth rate.

Much of the growth in consumer spending has been at the expense of savings. Savings rates declined in the third quarter while consumer borrowing rose by $7.4 billion in September. A sustained recovery of the consumer seems unlikely at this time with stagnant wage growth and an unemployment rate of 9.0 percent. The economy created only 80,000 jobs in October, less than the 200,000 number needed to bring the unemployment rate down, and average hourly earnings was unchanged month over month and down slightly from the prior year. On a positive note, initial jobless claims fell to the lowest level in seven months, signaling we may begin to see some improvement on the jobs front.

Earlier in the month, Federal Reserve officials reiterated their language about keeping borrowing costs low and supporting the housing market. Record low mortgage rates and affordable home prices seemed to provide some reprieve to the housing market as existing home sales rose 1.4 percent in October, much stronger than the 3.0 percent decline last month.

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 2011, the aggregate net profit was $35.3 billion for all institutions, an increase of 48.6 percent recorded for the third quarter 2010. This is the highest level for industry profits since second quarter of 2007.

As revenues remained soft, lower loan loss provisions were the primary driver to the enhanced earnings. Provisions for loan losses for the third quarter 2011 were $18.6 billion down 47 percent compared to a year ago, the lowest level since the third quarter of 2007. Loss provisions have declined for the eighth consecutive quarter. Banks were able to reduce provisions considerably as the asset quality of their portfolios exhibited improving delinquency and default performance during 2011. Net charge-offs for nearly all loan categories also declined 39.2 percent to $26.7 billion in the third quarter. Although overall loan growth remained muted, the largest loan growth remained in Commercial and Industrial Loans which increased by $44.8 billion (3.6 percent), the fifth consecutive quarter of rising balances. Total assets increased by 1.5 percent mostly in securities portfolios with mortgage-backed securities holdings increased by $54.4 billion while U.S. Treasury securities rose by $10.4 billion.

Also noteworthy was the decline in the number of "problem" institutions in the quarter from 865 to 844; 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 in Europe 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 a tremendous amount of negative news coming out of Europe in October, we saw the Eurodollar Synthetic Forward Rates (EDSF) — the curve used to price short-end bonds — spike in yield. The one-year yield rose dramatically from 50 basis points to the high 70's, until the last day of the month, when major global Central banks cut the cost on U.S. dollar swaps to help provide liquidity to European banks. However, U.S. corporate issuers continued to be well-bid as short-term bond supply is low and many traders are not seeing the EDSF curve as a reflection of credit risk for non-European bonds. One-year maturing U.S. industrial bonds were yielding 0.35 to 0.50 percent, while U.S. financials were at 0.60 to 0.70 percent levels. Commercial paper rates did climb with EDSF, even non-European issuers, as many money funds are staying on the sidelines making short-term funding tougher to access. Three-month maturities are now being offered in the 0.35 percent area.

The indecisiveness of the congressional super-committee in reducing the national deficit had little effect on the demand for Treasuries. The two-year note has been locked in a range of 25 to 30 basis points for the last few months and Treasury bills are still yielding almost zero. Even with the uncertainty of the U.S. economy, Europe is in worse shape and U.S. debt is still the global flight-to-quality.

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