

In this issue



By Colin Moore
Chief investment officer

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The Doves Are Flying Circles Around The Hawks

Most of the members of the Federal Open Market Committee (FOMC) of the Federal Reserve (the Fed) remain concerned about the level of economic growth and inflation over the next few years. The Committee expects growth to be modest over coming quarters which appears to be a downgrade from moderate. As a consequence, the FOMC pledged to keep rates near zero into 2014 versus 2013, as previously indicated. Some members were slightly more hawkish. Six members thought monetary policy tightening should begin as early as 2012 or 2013. Five participants chose 2014. Six participants thought 2015 or later. Additional asset purchases (Quantitative Easing — Round 3 or QE3) were not ruled out. The FOMC elected to keep the Fed's balance sheet at its current size, but commented that it "is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability." According to ISI Research, "The language of the statement and Bernanke's words in the press conference suggest that the odds of QE3 are increasing, although QE3 remains data dependent."

The FOMC statement said "inflation has been subdued." For the first time, the FOMC appeared to set an explicit inflation target of 2%, using the Personal Consumption Expenditure (PCE) deflator rather than an implied range. PCE deflator is a measure of inflation based on actual changes in personal consumption of a wide range of goods and services

including healthcare. Unlike the Consumer Price Index (CPI), which is based on a fixed basket of goods the "average" family consumes, the PCE deflator finds the average increase in prices for all domestic personal consumption. PCE Deflator has been shown to be a more comprehensive and consistent gauge of inflation in the U.S. The FOMC forecast inflation of less than 2% in 2012, implying there may be renewed concerns about deflation.



Michael Darda of MKM Partners LLC notes "the recent disconnect between the risk-free rate

structure, equity prices and the flow of macro data — long rates have "decoupled" from the flow of macro data and the stock market. In other words, forces that would typically push rates up — rising equity prices and better-than-expected data — are no longer exerting upward pressure on rates." The popular term for this is Financial Repression. According to Strategas Research Partners, "In a Financial Repression environment, two core investment themes should remain 1) the search for yield (because the Fed is not letting you get much in Treasuries) and 2) the search for growth (because growth is scarce, consistent with low real interest rates). Having these two themes at the same time is somewhat strange, but a low real interest rate environment is artificial as well."

The Fed's dovish stance was supported by the subsequent release of weaker than expected fourth quarter economic growth data.

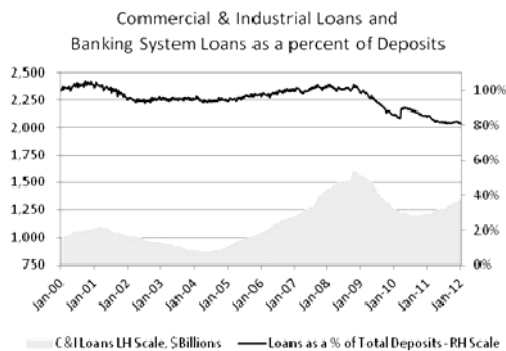


By Tom West
Director of Equity Research

A Tale of Two Indicators

There is an interesting divergence between signals from the capital markets and those from the commercial banking sector. That is, prices and spreads on various financial instruments tell us things are bad, that investors and major institutions are cautious and wary of each other. But in commercial banking, things look better. Banks are showing an increasing capacity and willingness to lend.

But the capital markets indicators seem to say the recovery is considerably more fragile, that things are better than a few months ago, but worse than one year ago. The financial stress index published by the St. Louis Federal Reserve includes metrics such as investment grade and high yield bond spreads, interbank lending rates and volatility indicators from equity and bond markets. By nature these metrics are



"High yield bonds for example are trading at a spread of about 700 basis points, which is not only above normal levels, but also above what would be needed to cover most estimates for estimates losses from defaults."

Columbia Management bank analyst Ted Paluszek points out that the recovery in "bankland" follows a process of repair, positioning, and growth. Banks must deal with bad assets on their balance sheets, "fill the holes" with retained earnings or equity issuance, position their balance sheets and operations for the new environment and grow from there. Some banks still have a lot of repairing to do, while others are further along and are showing growth. Many banks are more constrained by the lack of demand for loans, than by their capacity to lend. Even with some banks still in repair mode, the fourth quarter 2011 showed total loan growth up 1.6% versus 2010 in the U.S. banking system and commercial and industrial loans up 9.8%. These were fueled by growth in core deposits of 12.7% versus fourth quarter 2010. In addition, the system-wide loan to deposit ratio sits at 81%, the lowest level in the last decade, which indicates that banks have plenty of capacity to lend. The strength in commercial and industrial loans is especially encouraging because of its implications for business investment and job growth.

more sensitive to global macroeconomic conditions, budget imbalances, liquidity crises and the health of major capital market institutions themselves. High yield bonds for example are trading at a spread of about 700 basis points, which is not only above normal levels, but also above what would be needed to cover most estimates for losses from defaults. With investment banks reticent about keeping inventory to trade, the market seems to demand more compensation to hold these less liquid securities.

Let's hope that loan growth is the more important indicator, that loan growth drives hiring and investment in small and medium businesses and that the "real" economy will triumph. But we cannot dismiss the capital markets indicators, because in a broad sense, they remind us of the budget and trade deficits in the United States, the European debt crisis, regulatory uncertainty and other structural issues. The good news is that we don't need to fix these issues. Stabilizing them ought to be good enough.

By Marie Schofield
Chief economist

U.S. GDP Growth — Little Cushion

The advance estimate of fourth quarter Real Gross Domestic Product (GDP) came in at 2.8%, a little light of consensus. However, this was still the best quarter in 2011, helping Real GDP (economic growth after inflation) to grow at 1.6% for the year. That said, the mix of growth was a little disappointing. The inventory contribution was large, contributing about 1.9% of the overall gain and was the biggest jump in almost two years. It was suspected that businesses would replenish inventories last quarter, since data reflected these had been

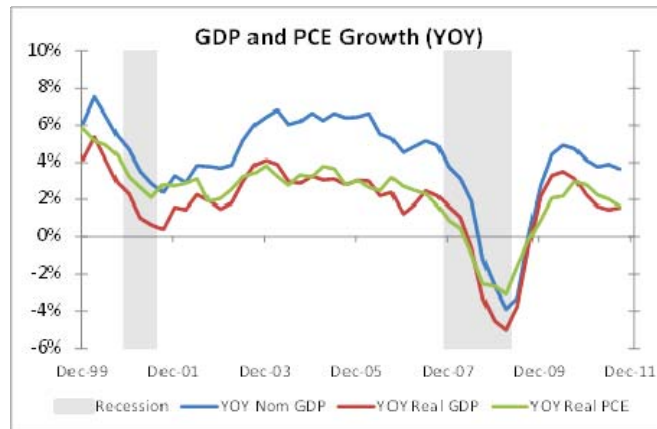
drawn down most of the year. But the concern is that the added stockpiling this quarter may be at the expense of coming quarters. If we exclude the effect of inventory stockpiling, the picture looks soft. Final demand (GDP growth less the inventory contribution) is a key indicator of underlying trend growth, and this came in at a paltry 0.8% and 1.4% for the year as a whole.

Consumption (personal consumption expenditures or PCE) rose 2%, held back by service spending which has been very soft this cycle. Durable and non-durable spending has held up well, as consumers continue to spend money on cars, electronic gadgets, food, gas and clothes — but spending on services taking a back seat. While consumer spending in the quarter began strong, it steadily weakened into year end. Remember that incomes aren't growing and consumers had to dip into savings and credit to advance their spending last quarter — trends that are unlikely to continue. PCE still accounts for 70% of all economic growth. The year over year growth rate is only 1.6%, the weakest reading since the recession ended, after peaking about a year ago. Spending will continue to be anchored to weak income growth.

The biggest detractor from GDP was government spending which cut 1% out of growth. Much came from a big slide in federal defense spending and could be related to planned troop withdrawals from Iraq. State and local governments are also continuing to pare budgets and spending. The government will remain a significant drag with fiscal austerity, a secular theme building in coming quarters. Business investment was a little soft, with capital spending rising only 5% in the quarter and 9% year over year — a modest deceleration from prior trends. Residential

investment rose 10% which only contributed about 0.3% to growth, but it is encouraging to see it is no longer a drag. Trade was not a factor for growth, and was largely unchanged.

The report reflected less momentum from the key consumer sector moving into 2012 and suggests underlying Real GDP growth trends remain about 1% to 2% (similar to 2011). Nominal measures of growth softened too, with nominal GDP rising 3.1% in the quarter and only 3.7% year over year. The trends here continue to soften and this certainly begs questions on how fast business revenues and profits can grow going forward. Downside risks persist due to the ongoing financial crisis in the eurozone and the wildcard on congressional action to extend stimulus measures beyond February. This leaves only a modest cushion for growth should these headwinds persist or grow. Lastly, inflation slowed with the GDP deflator up 0.4% and the PCE deflator up 0.7% (both annualized) last quarter. Hence, this data will encourage those on the FOMC who are pushing for more accommodation and QE to support growth.



Source: Bureau of Economic Analysis, December 2011

Deleveraging — It's Only Just Begun



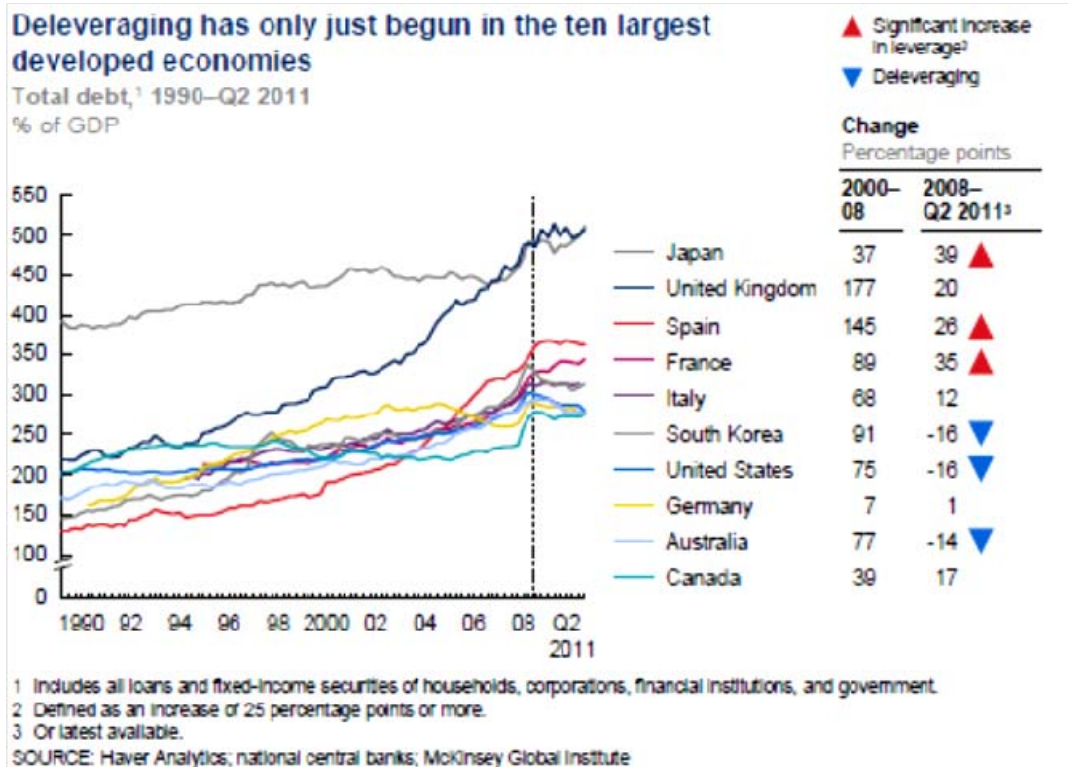
By Marie Schofield
Chief economist

Overall, U.S. household debt burdens (debt costs to incomes) are now a third lower than they are in the U.K. despite the fact that almost all U.K. mortgages are floating rate and U.K. base rates are near zero. They feel U.S. households are about halfway through the deleveraging process. — However, McKinsey believes the U.S. consumer engine will never be as powerful an engine of global growth as it was before the debt bubble burst.

McKinsey published a comprehensive study on debt and deleveraging in 2010, examining the historical record of deleveraging cycles.

The periods are part of a long and painful process, lasting about 6-7 years on average once begun, beginning with deleveraging in the private sector and ending with deleveraging in the public sector. They recently published an update and the reading is highly recommended. According to the study, only three countries have made progress in their total Debt/GDP

They see two distinct deleveraging phases: private sector debt reduction dragging down economic growth over many years amid growing government debt burdens; followed by years of better growth amid slowly reduced government debt. Overall, U.S. household debt burdens (debt costs to incomes) are now a third lower than they are in the U.K. despite the fact that almost all U.K. mortgages are floating rate and U.K. base rates are near zero. They feel U.S. households are about halfway through the deleveraging process. U.S. households and



ratios in this post-bubble period: the U.S., Australia and South Korea. They examine three countries in depth: the U.S., the U.K. and Spain. McKinsey feels the U.S. is much farther ahead in the deleveraging process than others and highlights the 15% reduction in U.S. household debt/income ratios. While this reflects mainly the write-offs banks have taken and that U.S. homeowners can walk away from homes in many cases without recourse, unlike other countries, i.e. the U.K. and Spain, it is progress nonetheless.

banks have already made much progress in balance sheet repair which could support growth or act as a buffer when the fiscal austerity hits next year. However, McKinsey believes the U.S. consumer engine will never be as powerful an engine of global growth as it was before the debt bubble burst.

Bits & Pieces

Source: *Financial Times*: Equities can outperform bonds in a liquidity trap

Since a liquidity trap is such a distinctive economic condition, we might expect that relative asset market returns might also be very clear cut. For government bonds, that should indeed be the case. Bond yields should drop to the lower limit implied by Keynes, and then remain there. This may need some help from central bank bond purchases, or it might happen because expectations of low inflation and permanently low short rates become deeply embedded in the yield curve. That is exactly what happened in Japan in the 1990s, and it now seems to be happening elsewhere. In the Japanese case, the sustainable downside limit on bond yields turned out to be around 1.3%, with occasional spikes below that level not proving durable. If that proves to be the case in other developed economies, then the risk/return in bond markets already looks unattractive. Even if we make the extreme assumption that yields decline from current levels all the way to the 1.3% lower limit in the next 12 months, then total bond returns would be limited to a maximum of 7% to 8% in the U.S., Germany and the U.K. On the other hand, if economies escape from the liquidity trap and yields begin to rise to a more normal historic level, capital losses could be

very large. Although the most likely case is that bonds continue to provide low positive returns, the risk/return trade off does not seem attractive from here. What about equities? A natural assumption would be that in the disinflationary environment of a liquidity trap, equity returns should also be very low. That may be true in nominal terms but, in inflation adjusted terms, there may still be a good case for holding equities. Investors who suffered through two decades of negative real equity returns in Japan may be skeptical about this, but the valuation of equities relative to bonds in the U.S. and Europe is currently much more attractive than it ever reached in Japan's lost decades.

Source: *Financial Times*: Call for EU to control Greek budget

The German government wants Greece to cede sovereignty over tax and spending decisions to a eurozone "budget commissioner" to secure a second €130bn bail-out, according to a copy of the proposal obtained by the *Financial Times*. In what would amount to an extraordinary extension of European Union (EU) control over a member state, the new commissioner would have the power to veto budget decisions taken by the Greek government if they were not in line with targets set by international lenders.

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There are risks associated with fixed income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is more pronounced for longer-term securities.

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Weekly Market Summary as of 1/27/12

	Last		Week Ago		Month Ago		YTD		Year Ago	
Bonds	Yield	Yield	Chg	Yield	Chg	Yield	Chg	Yield	Chg	
U.S. 2-year	0.21	0.24	-0.03	0.29	-0.08	0.24	-0.03	0.58	-0.37	
U.S. 10-year	1.89	2.02	-0.13	2.01	-0.11	1.88	0.01	3.39	-1.50	
Barclays Capital U.S. Aggregate	2.10	2.23	-0.13	2.35	-0.25	2.24	-0.14	2.98	-0.88	
Barclays Capital U.S. Agg Corporate	3.46	3.66	-0.20	3.86	-0.40	3.74	-0.28	3.99	-0.53	
BofAML High Yield Index	7.96	8.19	-0.23	8.72	-0.77	8.54	-0.59	7.47	0.49	
AAA Muni 10-year	2.17	2.20	-0.03	2.33	-0.16	2.28	-0.11	3.43	-1.26	
Equity Indices	Price	Price	TR Chg	Price	TR Chg	Price	TR Chg	Price	TR Chg	
S&P 500 Index	1,316.3	1,315.4	0.1%	1,265.4	4.2%	1,257.6	4.8%	1,299.5	3.4%	
Russell 1000 Growth Index	616.0	609.1	1.1%	584.6	5.4%	580.9	6.1%	596.0	5.0%	
Russell 1000 Value Index	652.1	655.9	-0.5%	630.1	3.7%	626.1	4.3%	658.5	1.5%	
Russell 2000 Growth Index	460.4	451.0	2.1%	430.8	6.9%	425.0	8.4%	444.9	4.2%	
Russell 2000 Value Index	1,050.8	1,035.0	1.6%	993.4	6.0%	979.3	7.4%	1,079.6	-0.6%	
MSCI EAFE Index	1,495.6	1,472.1	1.6%	1,405.4	6.5%	1,412.6	6.0%	1,715.7	-9.8%	
MSCI EM Index	1,016.6	995.1	2.2%	924.3	10.0%	916.4	11.0%	1,141.8	-8.8%	
Commodities	Price	Price	% Chg	Price	% Chg	Price	% Chg	Price	% Chg	
Gold	1,739.1	1,666.7	4.3%	1,593.2	9.2%	1,563.7	11.2%	1,313.9	32.4%	
Crude Oil	99.6	98.5	1.1%	101.3	-1.8%	98.8	0.7%	85.6	16.3%	
USD Index	78.9	80.2	-1.6%	79.8	-1.1%	80.2	-1.6%	77.7	1.5%	

Source: Columbia Management Investment Advisers, LLC

Past performance is no guarantee of future results.

DESCRIPTION OF INDICES

The Barclays Capital Aggregate Bond Index is a market value-weighted index that tracks the daily price, coupon, pay-downs, and total return performance of fixed-rate, publicly placed, dollar-denominated, and non-convertible investment grade debt issues with at least \$250 million par amount outstanding and with at least one year to final maturity.

The Barclays Capital Corporate Investment Grade Index is an unmanaged index consisting of publicly issued U.S. Corporate and specified foreign debentures and secured notes that are rated investment grade (Baa3/BBB- or higher) by at least two ratings agencies, have at least one year to final maturity and have at least \$250 million par amount outstanding. To qualify, bonds must be SEC-registered.

The BofA Merrill Lynch High-Yield Bond Master II Index is an unmanaged index that tracks the performance of below investment grade U.S. dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The Russell 2000 Growth Index measures the performance of those Russell 2000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 2000 Value Index tracks the performance of those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The Morgan Stanley Capital International Europe, Australia, Far East (MSCI EAFE) Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australia and the Far East.

The Morgan Stanley Capital International Emerging Markets Index (MSCI EMI) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of June 2006, the MSCI Emerging Markets Index consisted of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

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