INVESTMENT STRATEGY

U.S. TRUST

Market Currents Illustrated

October 2011

Fearing Fear

The U.S. economy is squeezing thru a tight spot awash with fear that could potentially strangle the expansion, except that underlying momentum remains sturdy. Double-dip fears persist, magnified by frustration with Washington political posturing and mounting fear of a Eurozone debt implosion as recession there threatens (Charts 1-4). Temporary disruptions aside, the U.S. expansion continues to be driven by mutually-reinforcing growth in consumer and capex demand, which should benefit from falling energy/commodity prices and the impact of the Fed's Operation Twist. The main worry is whether persisting uncertainty exacerbates the recent slowing in job growth, triggering outright declines and thus a direr outcome than the deceleration signaled by leading indicators of employment (Charts 34-37). Though consensus expectations for U.S. and global growth have eased further, global growth of 3.5%-4% would still be quite robust (Charts 17-18), getting additional support from lower commodity prices. (The IMF has also lowered global growth projections to a still-strong 4% pace for 2011-2012.) Similarly, consensus expectations for S&P 500 EPS, though falling, still anticipate record-high earnings. Robust profits growth to date and sturdy consensus expectations are not consistent with recession (Charts 25-28), nor are our own below-consensus estimates.

Chart 1: U.S. sentiment: current conditions weak; expectations better

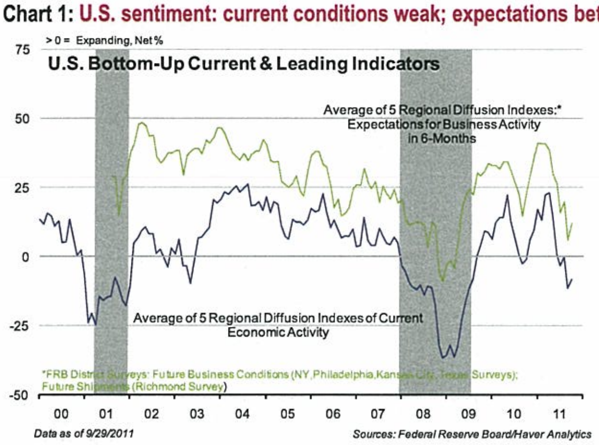

Chart 2: U.S. leading indicators well above recession "thresholds"

Chart 3: Default fears untamed while playing for time...

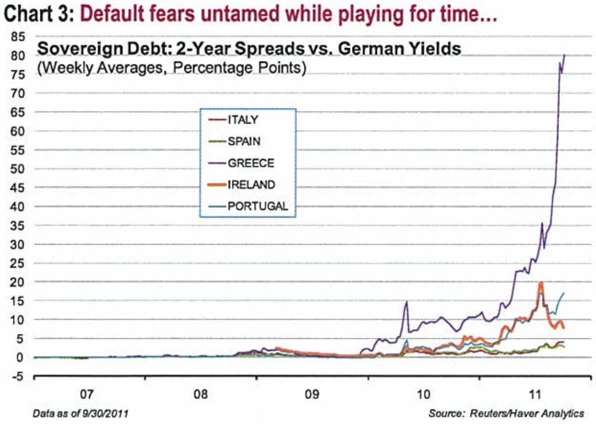

Chart 4: ...which gets harder to do if Eurozone slips into recession

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Chart 5: Housing market in extended bottoming

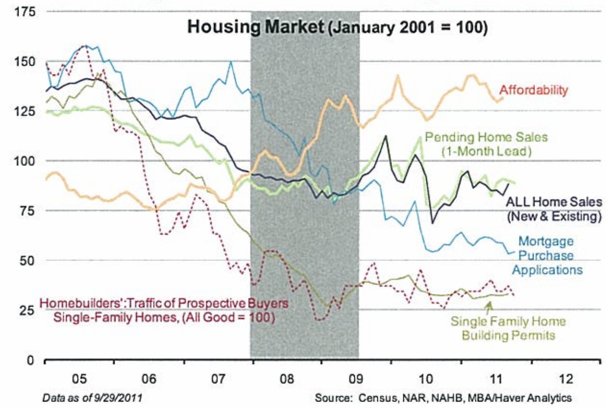


Chart 6: Multifamily housing recovery getting traction

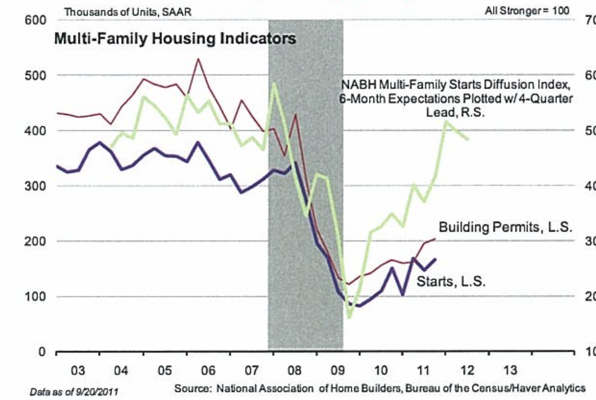


Chart 7: Property prices holding despite weak job growth

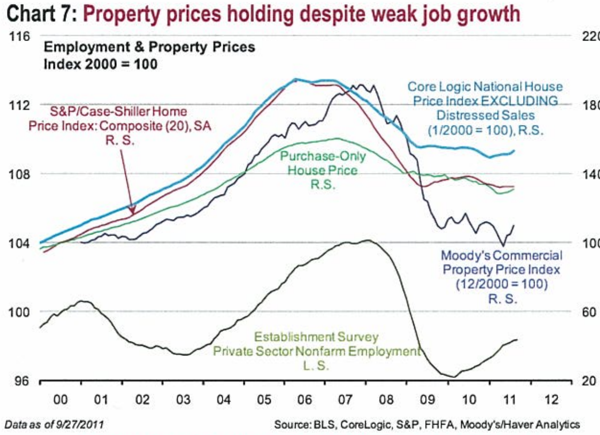


Chart 8: Commercial real estate: interrupted stabilization

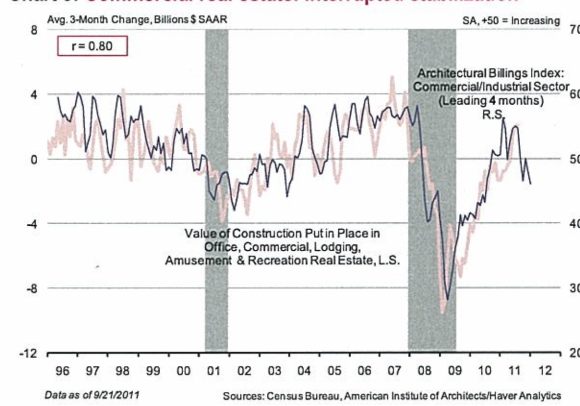
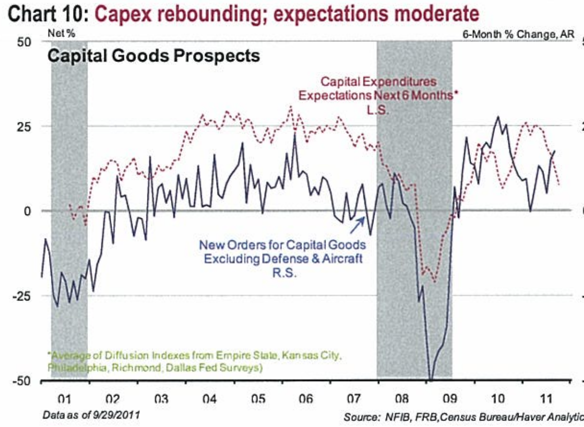


Chart 9: Volatility aside, yr/yr real spending growth steady

Chart 10: Capex rebounding; expectations moderate



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As the economy emerges from transitory disruptions in H1, weak business and consumer confidence may be tempering the unfolding rebound but not sufficiently to suffocate the mutually-reinforcing dynamic between consumer and capex (C&C) activity. In housing, weakness persists in the single-family market, where construction is hobbled by the excess supply of existing homes for sale (inventories of unsold new homes are at historic lows). Existing sales rose in August but sustained faster growth is critical for absorbing excess inventory, which is being fed by a still-high foreclosure rate. Yet, multi-family construction is showing traction and home prices remain on a stabilization path (Charts 5-7). Some downward pressure on property prices, including commercial real estate, cannot be ruled out given market jitters, which continue to press down the leading indicator for nonresidential business construction (Chart 8). With governments also retrenching, C&C activity, which accounts for nearly 80% of GDP, is doing the heavy lifting. Despite monthly volatility (as seen in retail sales), Q3 real consumer spending should show 1%-2% growth vs. 0.7% in Q2—consistent with solid underlying 2% yr/yr growth (Chart 9). In the meantime, capital goods/software investment remains on a sturdy growth path though expectations have moderated (Chart 10). There is upside from pent-up demand and a paradigm shift underway in information technology which bodes well for this cycle, especially given robust corporate profitability. See our September Focus, *The Cloud: IT Paradigm Shift*. In the near term, the economic rebound underway may not get much support from net exports or business inventories.

Chart 11: Headline inflation about to turn?

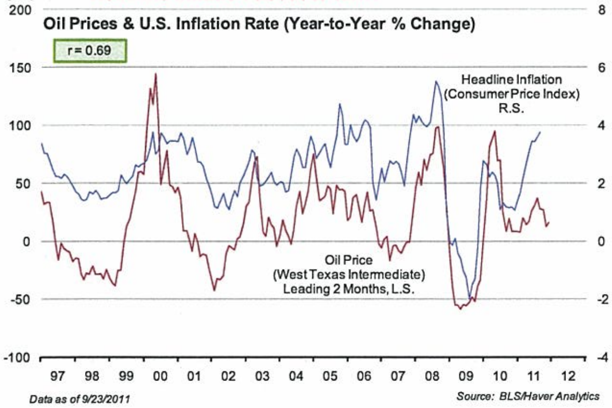

Chart 12: Oil trading at low end of our $80-$105/barrel estimate

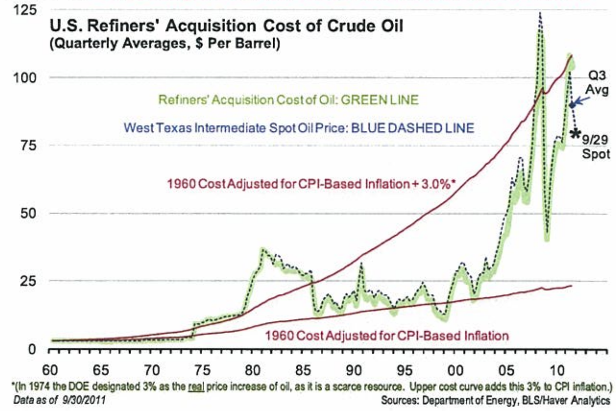

Chart 13: Near-term rise in food CPI unlikely to persist

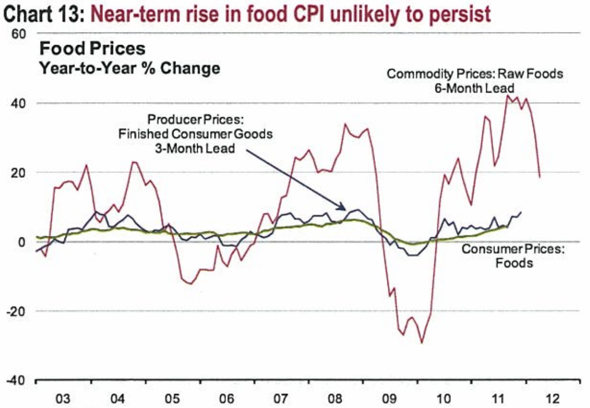

Chart 14: Core inflation running in 1.5% - 2% range

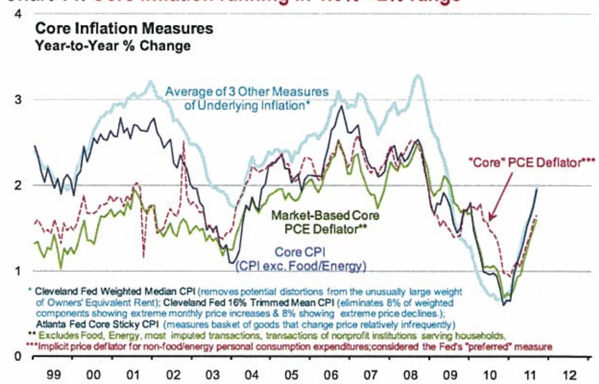

Chart 15: Pricing power conditions & expectations stay subdued

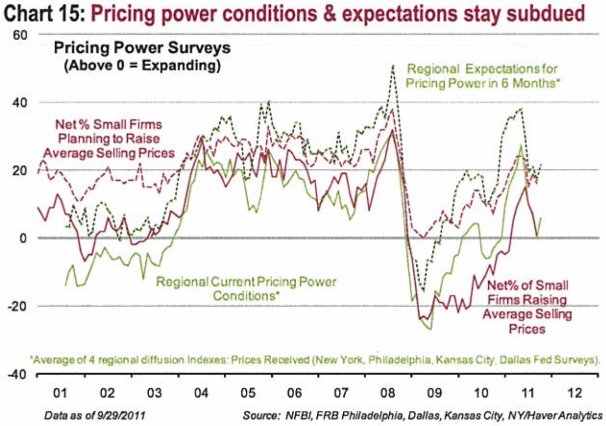

Chart 16: Market-based expectations rolling down

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The tricky spot the expansion is currently moving thru in a context of weak business/consumer confidence and political dysfunction has created enough uncertainty/downside risk for the Federal Reserve to announce (following the 9/20-21 FOMC meeting) plans to drive long-term Treasury yields lower. The Fed's "balance sheet neutral" Operation Twist (OT) aims to lengthen the maturity/duration of its Treasury security portfolio by about two years. In contrast, the second round of quantitative easing (QE2 expired in June) had virtually no impact on the portfolios' maturity/duration and, as Stone McCarthy Research notes, "in terms of the fact that OT will *remove more duration from the market* than QE2, it packs more punch…" Also, the Fed will switch from reinvesting principal payments from agency debt and agency mortgage backed securities (MBS) in long-term Treasuries to reinvesting in Agency MBS to support the mortgage market. With oil and other commodity prices declining on fears of a global slowdown and leading indicators signaling moderating "core" inflation (Charts 11-15), OT looks timely and broad-based enough to help stem the downside. As Stone McCarthy adds, *extending the duration of Fed holdings* aims beyond a flattening of the yield curve; it is "more importantly…designed to lower private sector borrowing costs, boost stocks, etc." Operation Twist is thus consistent with allowing the economy to squeeze thru current pressures while keeping longer-term, market-based inflation expectations well anchored and Fed credibility intact (Chart 16).

Chart 17: Slight downward revisions but still-strong global outlook

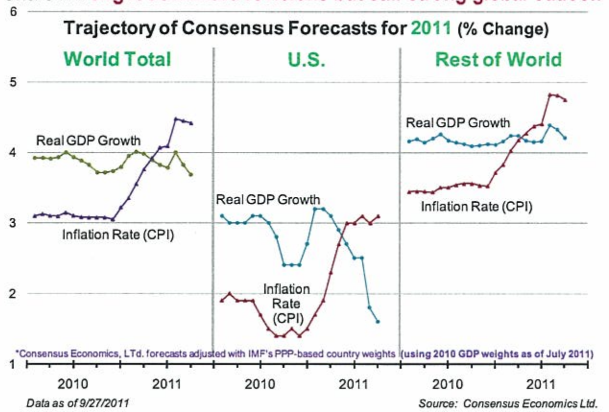


Chart 18: Eurozone, Japan, US drive down 2012 expectations

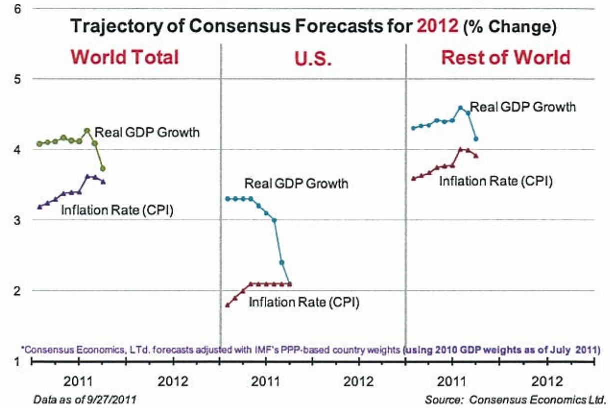


Chart 19: Global trade & output rebounding

Chart 20: US leading indicators: higher momentum vs. globals

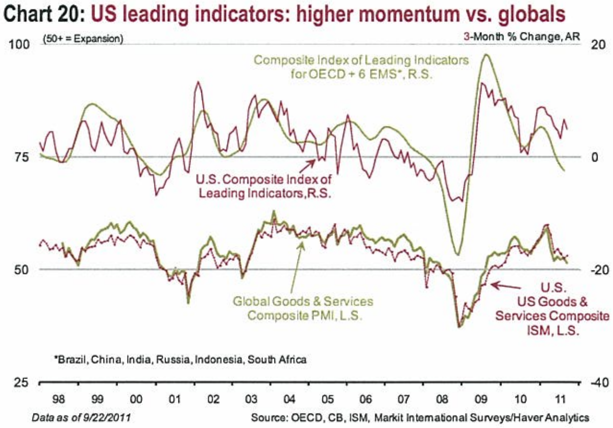
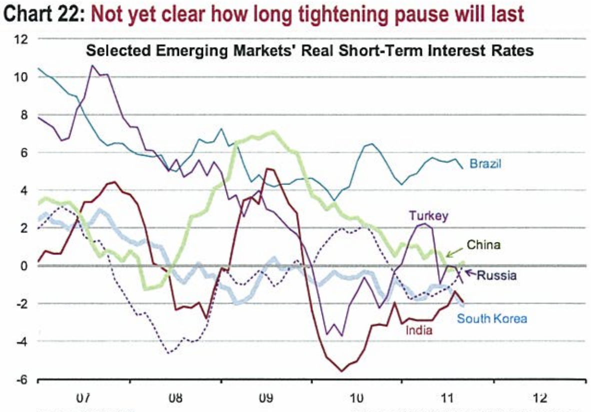


Chart 21: China: longer-term leading indicator pick-up continues

Chart 22: Not yet clear how long tightening pause will last



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As we had anticipated, global growth consensus expectations for 2011-2012 were driven down further by lower U.S. and Eurozone estimates—but still show a robust overall pace (3.5%-4%), with inflation expectations easing a bit (Charts 17-18). Reduced 2011/2012 Eurozone growth estimates from 1.9%/1.5% to 1.7%/1% are not consistent with the negative momentum there (Chart 4), as they assume a modest acceleration in H2. There is thus more downside to Eurozone/global growth estimates. Japanese expectations for 2012 also dropped notably (Chart 42). Though global trade and production are rebounding from H1 disruptions, global leading indicators have lost more momentum (Charts 19-20)—Eurozone-led—and the hope prevails that emerging market economic growth will hold up. Fortunately, Chinese growth looks likely to remain strong, even as it eases into an 8%-9% range. The likelihood that near-term pressure in manufacturing will be short-lived is supported by accelerating momentum in medium-term leading indicators (Chart 21). The big question for emerging markets is for how long the tightening pause afforded by falling commodity prices will hold. Real interest rates are mostly low/negative, domestic demand is strong but currencies are now falling, putting upward pressure on inflation. EM central bank foreign exchange intervention may not suffice; eroding credibility in Brazil and Turkey, for example, may force an about-face from their recent easing. As for China, further yuan appreciation may be in its interest given inflation pressures, but there is some speculation that it may stall absent faster export growth. Exports grew in July and August but are only 0.8% above March levels in yuan terms.

Chart 23: Growth trajectory slower but still upward bound

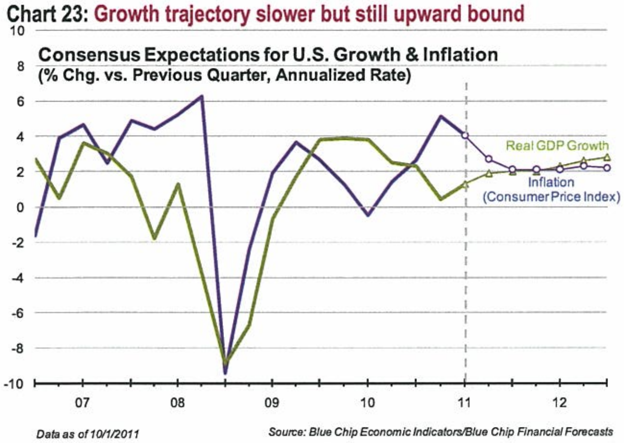


Chart 24: Fed on hold thru mid-2013; dollar flat

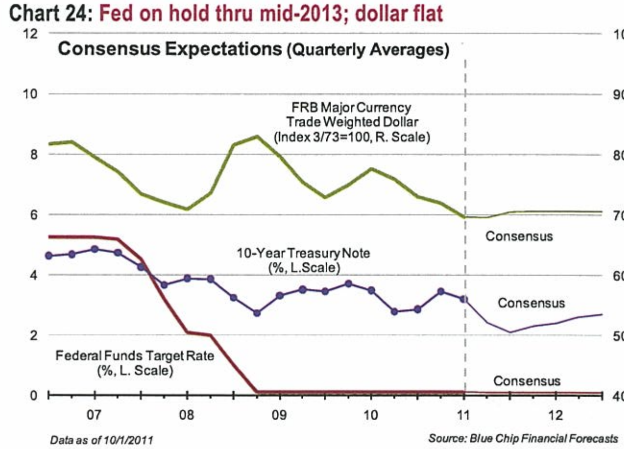


Chart 25: Q2 profits revised up; no profits recession in sight

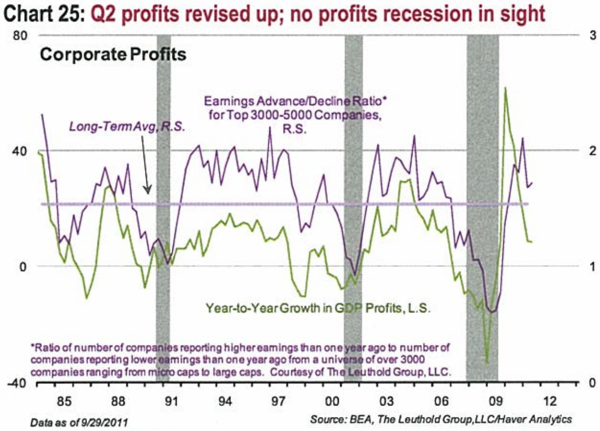


Chart 26: Earnings revision factor turns negative

Chart 27: 2011 GDP profit growth upwardly revised; S&P downwardly

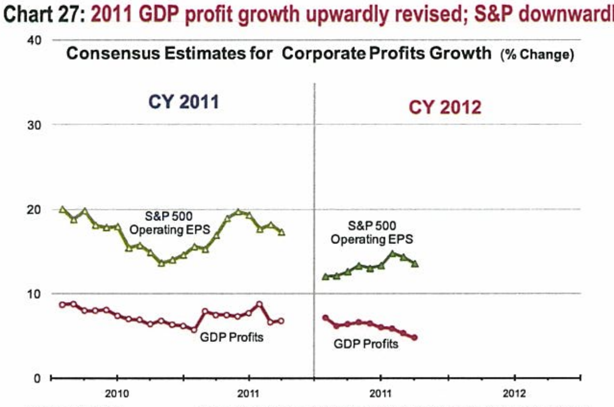
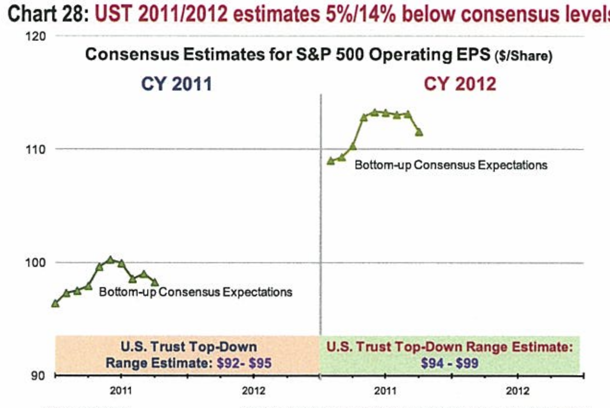


Chart 28: UST 2011/2012 estimates 5%/14% below consensus levels



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Despite untamed fears of recession, consensus expectations still show a pickup in H2, albeit subdued. The latest *Blue Chip* survey shows H2 growth expectations averaging 2% vs. the 0.8% H1 average. Importantly, the trajectory of expectations remains upward throughout 2012, with inflation around 2% and the dollar steady (Charts 23-24). Survey participants put the odds of recession by the end of 2012 at 34.6% vs. 34.7% one month ago; 72.7% of participants consider potential spillover effects from Eurozone problems "the biggest threat" to continued U.S. growth over the next year. At this point, profits growth and expectations remain robust, with no profits recession in sight even though consensus expectations for S&P 500 EPS are coming down, given Eurozone/Euro fears. Calculations based on 2010 data by our U.S. Trust Market Strategy Team underscore the importance of Europe overall for corporate America. The European exposure of S&P 500 companies, as measured by the share of total revenues coming from U.S. affiliates in Europe, averages nearly 20%. The sector drill-down shows a 20%-25% range for consumer staples/energy/consumer discretionary/IT/health care/materials and an 8%-18% range for utilities/financials/industrials. Bureau of Economic Analysis data show U.S. corporate affiliates' sales in the European Union (EU) in 2008 of $1.8 trillion were 6.7 times larger than exports to the EU. See our October Focus, *Europe's Troubles Will Impact Wall Street and Main Street*, which concludes that "corporate America will hardly be spared the pain" of recession in Europe. Despite downward revisions, S&P 500 consensus estimates are still set to reach record highs (Chart 28).

Chart 29: Expansion under pressure: 40% of states down; 60% up

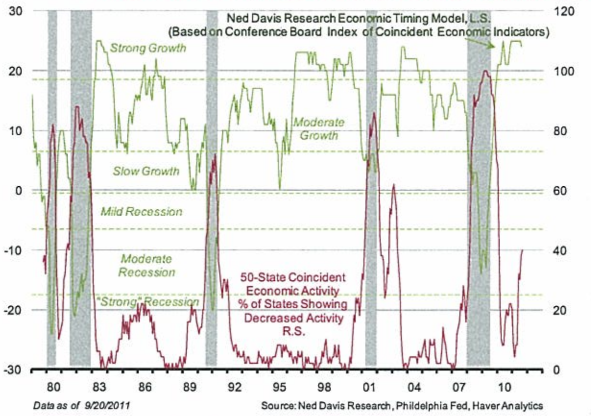


Chart 30: Recession odds <20%; Chicago gauge above threshold

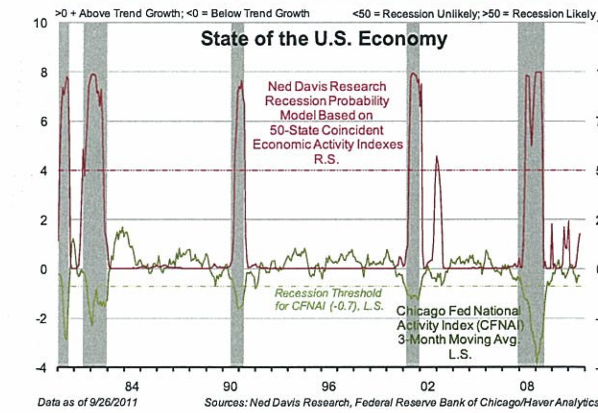


Chart 31: Rebound underway despite weak confidence

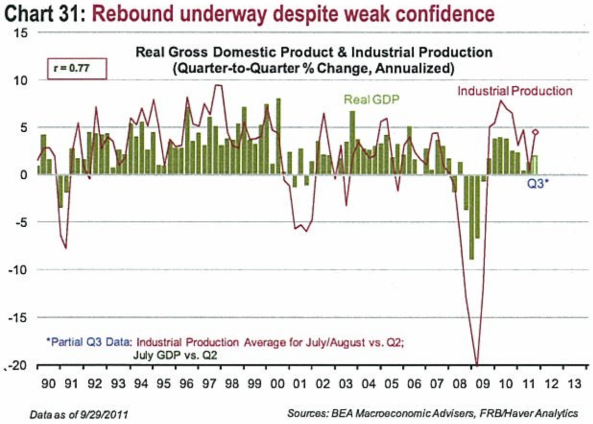


Chart 32: Inventory investment may temporarily become a drag

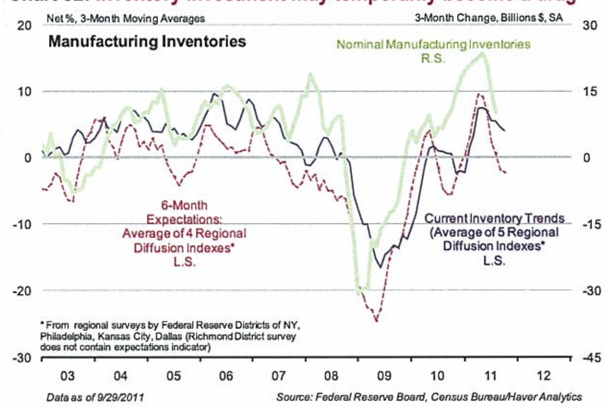


Chart 33: Worrisome private job growth deceleration: short-lived?

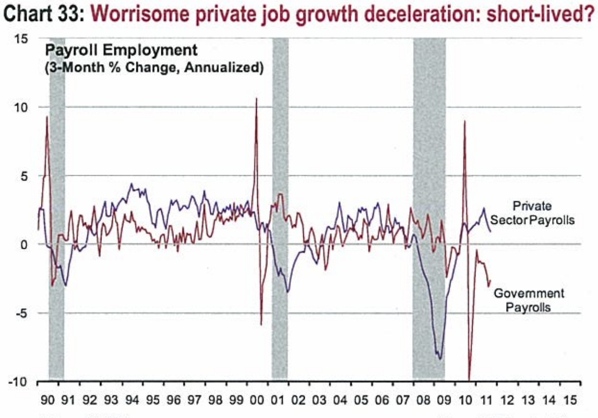
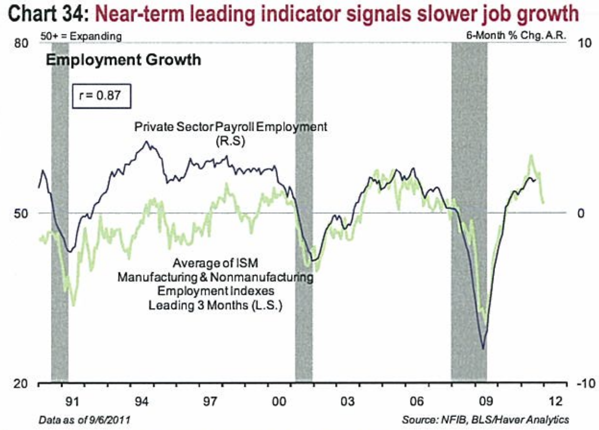


Chart 34: Near-term leading indicator signals slower job growth



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The U.S. expansion remains under pressure, but the odds of recession remain low. The flip side of 40% of states showing decreased activity in August is that 60% are still showing increased activity (Chart 29), which is why the broadest monthly measure of economic activity (the Chicago Fed National Activity Index) is holding above recession territory (Chart 30). Indeed, partial Q3 data show there is a rebound underway (Chart 31) which, though tempered somewhat, is still being driven by consumer and capex demand—and August data on capex shipments and new orders add support. (This is on the back of an upward revision to Q2 GDP growth from 1% to 1.3% driven by consumer spending). The uncertainty behind recent market turmoil/weak confidence is causing businesses to be visibly more cautious on inventory investment and hiring (Charts 32-38). Regional surveys show slowing inventory investment currently and in coming months, suggesting inventories could be neutral to negative for GDP growth in Q3 and possibly Q4, despite the fact that inventories/sales ratios are ultra low. For small independent firms, the biggest source of job creation, weak sales remain their "most important problem" even though there has been some improvement year-to-date. The latest National Federation of Independent Business (NFIB) survey shows small business confidence in August was at the lowest level since July 2010, partly on sharply lower sales volume expectations for coming months. This is pushing their inventory investment plans into deeper negative territory. Nonetheless, their hiring plans

Chart 35: Current employment uptick; expectations moderate

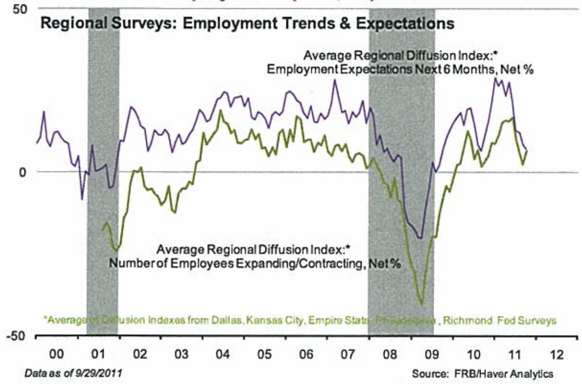


Chart 36: Less deceleration in other leading indicators

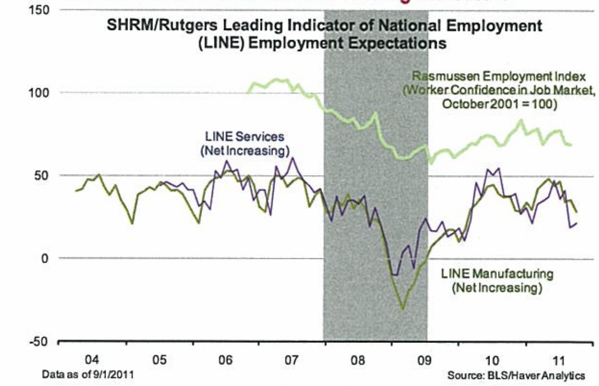


Chart 37: Small firms: firmer job plans despite lower optimism in Aug.

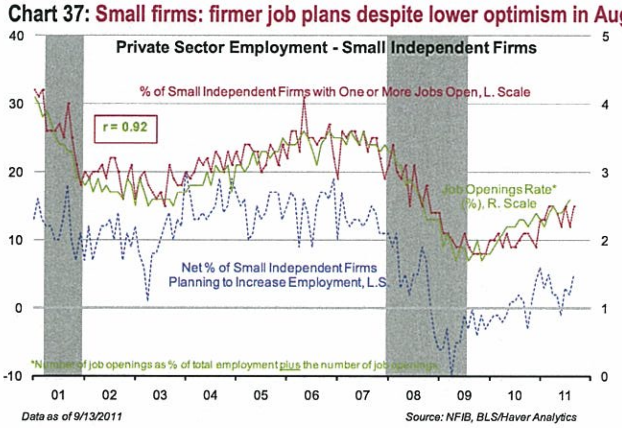


Chart 38: Claims downtrend re-entering "sticky" period

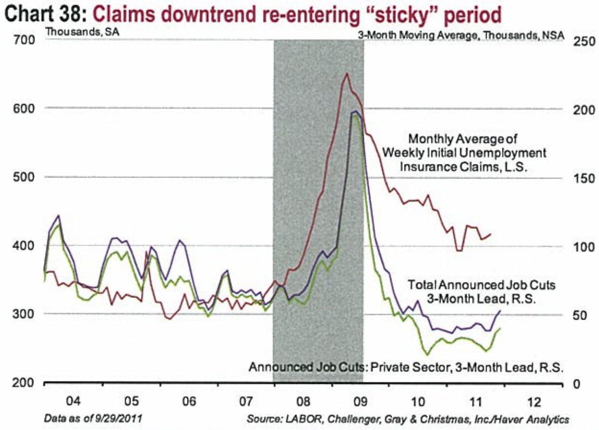


Chart 39: Flight-to-safety/Operation Twist benign for deficit financing

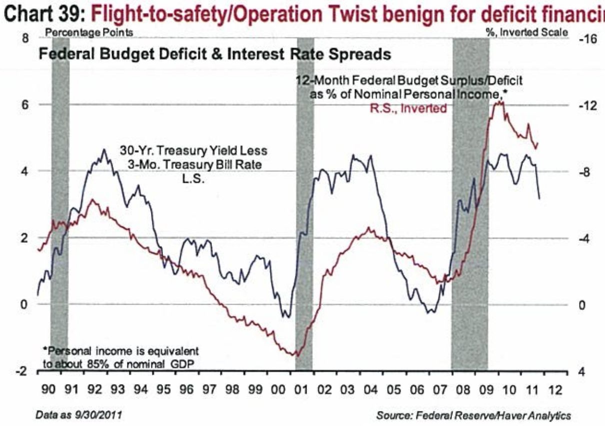
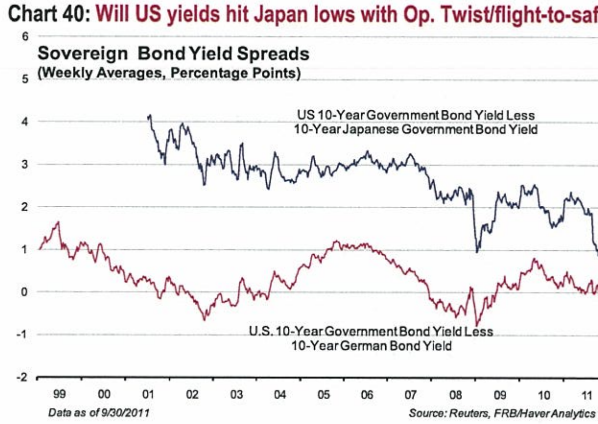


Chart 40: Will US yields hit Japan lows with Op. Twist/flight-to-safety?



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indicator improved in August (Chart 37), though their capex plans remain subdued. Among other things, small firms are worried about the National Labor Relations Board pushing the union agenda and mandating owners to post right-to-unionize notices and about pressure by supporters of the Administration for another minimum wage hike. The uncertainty facing small businesses illustrates the detrimental impact of political dysfunction/election posturing on the expansion. In general, despite the recent stalling in job growth, leading indicators have moderated but remain in expansion territory (Charts 33-36). The latest *Blue Chip* survey shows participants expect an average monthly increase in nonfarm payrolls of 79.6 thousand for the last four months of 2011 and a 131.1 thousand average monthly increase during 2012. This is down from expected monthly increases one month ago averaging 109.2 thousand in the last 5 months of 2011 and 149.9 thousand during 2012. Sustained job growth is the critical element for a sustained expansion; these expectations suggest a still-positive but more tentative path for this expansion over the next year-plus. They also suggest less cyclical support for the gradually improving budget deficit (Chart 39) which in the meantime should benefit from lower borrowing costs emanating from global flight-to-safety and the implementation of Operation Twist. Lastly, one wonders if in the current environment—especially if European leaders fail to come up with a once-and-for-all, convincing resolution to the debt crisis—a combination of frenzied flight-to-safety and Operation Twist could bring U.S. Treasury yields down to Japanese government bond yield lows. At a time when many "unthinkables" are taking shape, the prospect of 1% U.S. Treasury yields is not far-fetched.

Chart 41: Japan mfg. PMI softens but upside in medium term intact

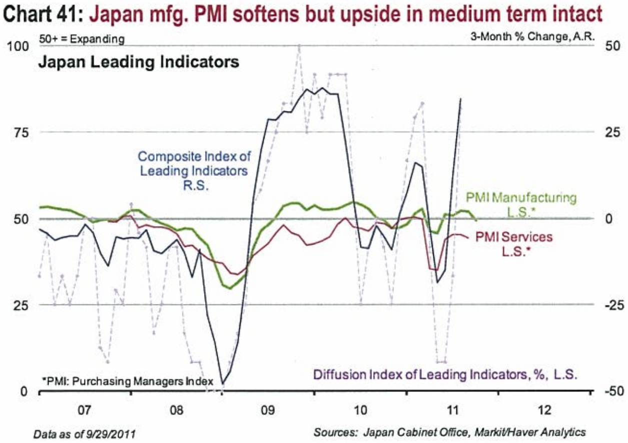


Chart 42: 2011 growth expectations upgraded; 2012 downgraded

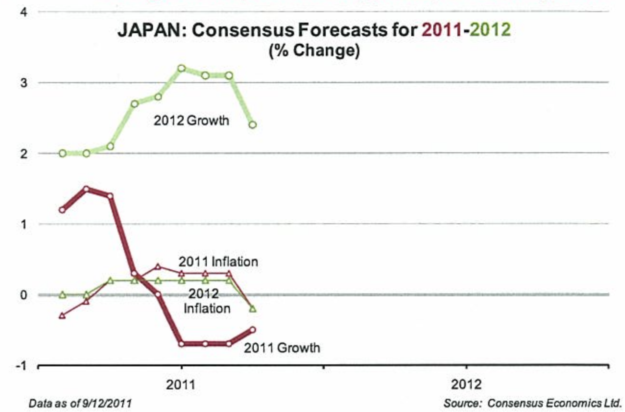


Chart 43: Q3 growth likely up; sales & IP higher vs. Q2 (IP +21.4% a.r.)

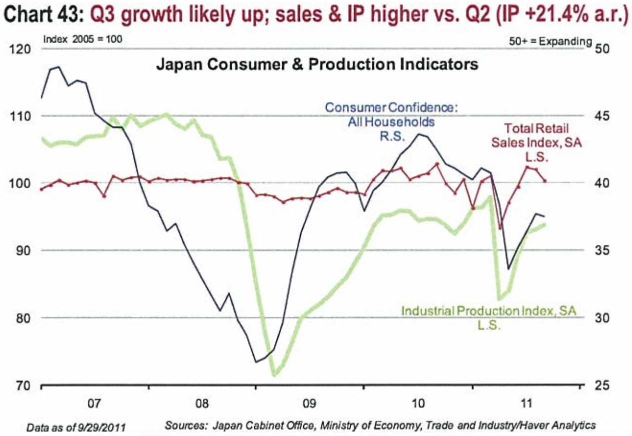


Chart 44: Automotive activity: touching pre-disaster levels?

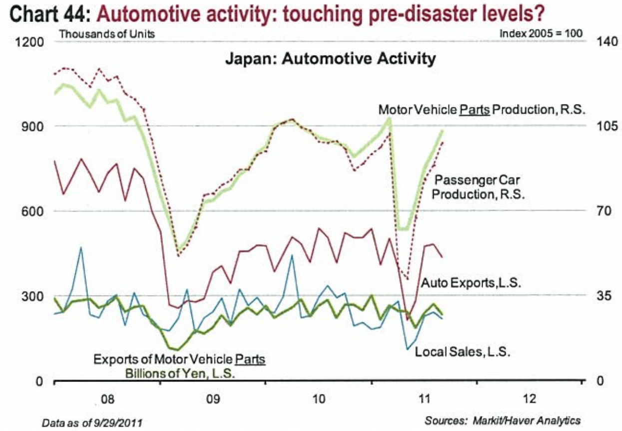


Chart 45: Normalizing foreign trade; tourism lagging

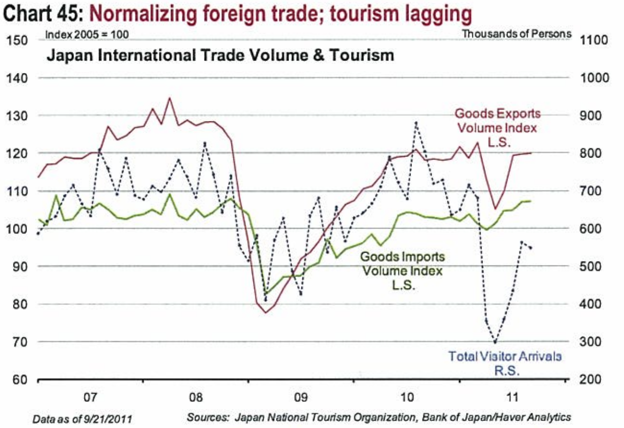
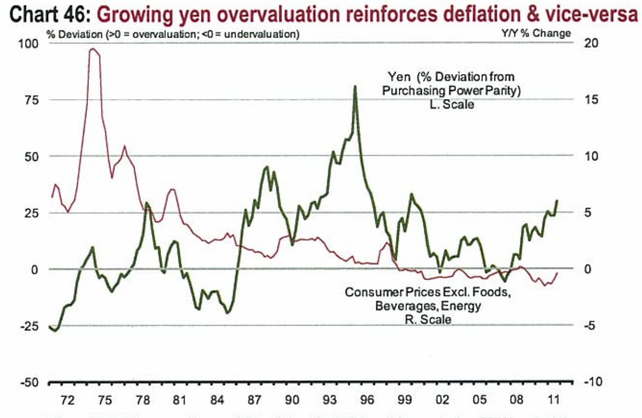


Chart 46: Growing yen overvaluation reinforces deflation & vice-versa



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Japan's rebound from the March natural disasters continues. 2011 growth expectations have been upgraded, but 2012 expectations have been downgraded (Charts 41-45) partly on global growth concerns and partly due to slow progress on reconstruction, despite the recent change in prime ministers. A just-proposed third supplementary budget of ¥11.2 trillion aimed at reconstruction includes a temporary income tax hike lasting 10 years from January 2013, along with a ¥2 price hike *per cigarette from October 2012, a* ¥500 increase in the residency tax and a smaller-than-scheduled corporate tax cut. Consensus on the tax hikes is necessary by early October before submitting to the Diet, and the proposed sale of all gov't-owned shares of Japan Tobacco, Inc. requires changing laws prohibiting selloffs. In the meantime, a fourth supplementary budget covering ¥1-¥2 trillion in economic stimulus is being considered in light of the global economic slowdown. The overvalued yen is reinforcing deflation, which looks likely to persist throughout 2012 (Charts 42, 46), especially if taxes rise.

Nora C. Mirshafii
Senior Vice President & Senior Research Analyst
U.S. Trust, Bank of America Private Wealth Management
October 1, 2011

CONCEPTS/DEFINITIONS

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index.

Conference Board's Coincident Index: composite of nonfarm payrolls, real personal income less transfer payments, industrial production, real manufacturing trade sales.

COLA is a Cost of Living Adjustment

CPI is the Consumer Price Index

The Dow Jones Global Indexes (DJGI) real time international equity indexes (world, regional, country, economic sector, market sector, industry-group, subgroups.

EMs refers to Emerging Markets

FOMC: Federal Open Market Committee - makes decisions on official interest rates.

FRB Chicago National Activity Index: This proxy for U.S. GDP is the broadest monthly index of national economic activity containing 85 indicators. Above 0=Above Trend Growth; 0=Trend Growth, Below 0=Sub-trend Growth.

IMF: International Monetary Fund

PMIs: Purchasing Managers Indexes based on World Bank's GDP country weights. Manufacturing PMI covers 26 countries (83% of factory output); Services PM covers 11 countries (60% of services activity). Advanced economies & EMs represented.

Leading Indexes signal activity 3-6 months ahead (factory orders, average weekly hours, vendor performance, initial unemployment claims, building permits, money supply (M2), consumer expectations, stock market prices, interest rate spreads).

LIBOR: Dollar based London Interbank Offered Rate

L.S.: Left scale.

National Federation of Independent Business Small Business Optimism Index: Reflects sentiment on key aspects of business conditions.

OECD Index of Leading Indicators is a composite of data for 30 member countries providing advance signals of changes in economic activity

Philadelphia Fed Diffusion Index nets out monthly changes in activity among 50 states. Based on nonfarm payrolls, unemployment rate, average hours worked in manufacturing and wages and salaries.

Pps refers to Percentage Points

Refiners Acquisition Cost of Oil: Weighted composite of domestic and imported oil prices, includes transportation costs + other fees. Effective price of oil in U.S.

R.S.: Right scale.

S&P/Case-Shiller Home Price Index tracks housing prices for 10 or 20 key markets

Standard & Poor's 500 Index tracks stock prices for 500 US companies

TIPS definition: Bloomberg's real yield benchmark for Treasury Inflation-Protected Securities (TIPS) is an unmanaged index calculated from the yield of the current on-the-run TIPS bond of a selected, stated maturity.

Trade-Weighted Dollar Index: Reflects the dollar's international value against a basket of currencies, weighted according to bilateral exports/import flows.

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Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties, such as rental defaults.

An investment in a hedge fund involves a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage, and short sales which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund. Hedge funds are speculative and involve a high degree of risk.