Despite a somewhat soggy global economic backdrop, I believe that in the next six months or so the trajectory of global equity markets will continue to be up, with Europe and Emerging Markets likely to be the best performing regions. Economic data in the U.S. is stable, albeit at a low level. “core” European countries such as Germany have been on a steadily deteriorating path, while the economic backdrop in peripheral Europe continues to be extremely challenging. Japan remains stuck in the mud.

The graph below plots purchasing manager indexes (PMI’s), a common measure of economic activity, for various economies. My call for the markets in the near term, despite this somewhat bleak economic underpinning, is driven by aggressively supportive monetary policy globally, which should overwhelm the impact of feeble growth. QE3 was recently announced in the U.S., entailing $40 billion of mortgage purchases each month which I expect to be followed by a Federal Reserve (Fed) announcement that Operation Twist, which is the purchase by the Fed of long dated Treasuries funded entirely by the sale of short dated Treasuries (sterilized intervention), will be replaced by QE4 where the Fed will be conducting outright purchases of Treasuries without any sales to offset the balance sheet impact (unsterilized intervention). As noted in a recent Perspectives article by Daisuke Nomoto, our Senior Pac-Asia portfolio manager, upcoming elections in Japan are putting immense pressure on the Bank of Japan to radically expand monetary operations to stimulate their flagging economy. China has also been stepping up their stimulus program, adding to the powerful flood of liquidity that should fuel equity markets higher. I believe the biggest swing factor however will be Europe. European Central Bank (ECB) President Mario Draghi recently announced the Outright Monetary Transactions program (OMT), the potentially large scale purchase of the short dated sovereign debt of any Euro Area country entering into a formal bailout agreement. Spain is widely expected to be the first recipient of this aid. Unfortunately, though not surprisingly, Spanish Prime Minister Ra-

(Continued on page 2)
joy has been reluctant to commit to a program due to the austerity and monitoring that are a prerequisite of the funding. The evidence so far on austerity programs is mixed at best, with Portugal, Ireland and Greece suffering massive economic down drafts at least partly as a result of the enforced austerity. Further, no political leader initially submitting to a program has been re-elected, yet another powerful deterrent. Spain’s reluctance puts the ECB in a bit of bind. The OMT was their vehicle to engage in quantitative easing, but in the absence of a country such as Spain entering a program, their ability to provide monetary stimulus to the flagging Euro Area economy is limited. The pressure is mounting as the need for stimulus builds. It is fairly clear that Spain will ultimately need bailout assistance, likely early next year when they face record gross bond issuance, and there is certainly pressure on PM Rajoy to accept the aid so the ECB can begin its monetary action through the OMT. My guess is that when the logjam finally breaks and Spain formally requests assistance, the ECB will be very aggressive in buying debt, providing a major boost to global equity markets. It’s also possible that even in the absence of a Spanish application, Mr. Draghi will continue his string of creative monetary tactics and announce an alternative means of stimulating the Euro Area, such as through the direct purchase of corporate debt.

Despite this benign near-term outlook however, I believe an existential crisis in global equity markets resulting in massive wealth loss is a significant possibility over the next few years. This is premised on my belief that the developed world simply has far more debt than it can reliably support. At some point a major write-down of the value of this debt (like the subprime crisis in 2008 only with government debt) will be unavoidable, resulting in immense capital market losses around the world. The trajectory of these debt burdens is accelerating due to economic weakness and the reluctance of politicians to address entitlement spending that is no longer supportable.

The irony of the situation is that as long as the global economy remains weak, everything should be fine. Weak economic growth keeps inflation at low or negative rates, allowing the current zero interest rate policy (and variants thereof) to be maintained. With borrowing costs around zero, almost any debt burden is sustainable. Japan is a great example of this, with 10-year interest rates below 2% for the past decade having permitted the support of a massive and growing debt burden. The problem will arise when the global economy starts to strengthen, which will put upward pressure on inflation and ultimately interest rates. Given huge debt burdens across the developed world, higher debt servicing costs will quickly begin to consume progressively greater percentages of tax revenues, making the debt burdens facing most developed economies eventually unsupportable. Japan is in

(Continued on page 3)
the most precarious position, and is therefore a likely catalyst for a market meltdown. However, I don’t believe we will reach the tipping point gradually. The cost of some major shock to the system, such as a natural disaster, war in the Middle East, a SARS type epidemic, etc., will be what pushes us over the edge. There is just no slack in the system to absorb a big budgetary hit like this, and as interest rates ultimately rise, our ability to withstand such a shock will be even further diminished. Where the shock originates and who is most impacted is impossible to forecast, so the source of the instability could be almost any of the major developed markets. Given the pervasiveness of over-indebtedness and the interconnection of global markets however, the location is almost irrelevant as the shockwaves will likely be transmitted around the world and the resulting collapse in wealth and activity will be felt everywhere.

This type of negative outcome is certainly not a foregone conclusion. The resilience of human ingenuity in a crisis is always impressive, and there is even some hope that sufficient entitlement reform will occur once the pressure to do so becomes politically compelling. But the fact remains that there is too much debt across most of the developed world, and growth is likely to be subpar for an extended period of time, leaving us extremely vulnerable to shocks, political and monetary mistakes, and even the irrational mood swings of markets.

As long as growth is weak, allowing us to prolong our zero interest rate policies, our debt burdens are supportable and everything is likely to be fine. Once an economic recovery takes hold, putting upward pressure on inflation and then interest rates, we will be at serious risk. Good news may turn out to be very bad news.

(Continued from page 2)

In September the Federal Reserve announced a new open-ended security purchase program, which it said will continue until the central bank sees substantial improvement in the labor market. Fed officials will likely review this policy at their December 11-12 meeting. Here we outline our views in Q&A format.

Q: What will the FOMC announce regarding quantitative easing (QE) at its next meeting?

A: We see high odds that the committee will announce a continuation of QE at the current pace. The Fed is now buying a total of $85 billion bonds per month, which includes $40 billion of mortgage-backed securities (MBS) and $45 billion of Treasuries. When it initiated the latest round of QE in September, the FOMC stated that “if the outlook for the labor market does not improve substantially”, it would continue and/or increase the amount of purchases. Although the last few labor market reports have been marginally better, the gains likely fall very well short of Fed officials’ definition of “substantial improvement”. Indeed, most committee members that have recently commented on QE have signaled that the purchases will continue deep into 2013. We therefore see high odds that the FOMC will stay the course at next week’s meeting.

QE Q&A

By: Zach Pandl
Senior Rates Strategist
Q: Will the Fed continue to purchase Treasuries in the same manner as under “operation twist”?
A: No. Some technical details about the Fed’s Treasury purchases will need to change. The Treasury portion of the current QE program was actually announced at the June FOMC meeting and is a second phase of the Fed’s “operation twist”. Under this easing strategy, the Fed sold its short-term Treasuries and used the proceeds to buy long-term Treasuries. The idea was to remove the riskier bonds from private sector hands and thereby drive interest rates lower. Operation twist has now run its course: after more than a year of sales the Fed has few short-term Treasuries remaining on its balance sheet. Therefore, if it wants to continue buying it will need to actually expand the face value of its portfolio this time around. As during previous rounds of QE, look for the Fed to finance its purchases with overnight deposits from commercial banks (in other words, printed money). The FOMC could tweak a few other aspects of the Treasury purchases as well. First, it might raise or lower the face value of $45 billion. There is nothing magical about this number, and the FOMC could change it next week or anytime thereafter. That being said, the $85 billion monthly purchase amount appeared in the Fed’s regular questionnaire to primary dealers, suggesting it may view this total as a natural baseline. Our best guess is that the face value of Treasury purchases remains unchanged. Second, the FOMC could change the weighted average maturity of its Treasury buying, with fewer purchases at the 30-year maturity and more at 5- to 10-year maturities. This is a close call, and the decision will depend on the Fed’s views about market functioning and other technical considerations.

Q: What does this mean for interest rates?
A: Not much. As far as we can tell, more QE is universally expected by Treasury investors. For example, the median economist at the Fed’s primary dealers expects Fed purchases to continue until Q1 2014 and to total more than $1 trillion (including MBS). The level of rates already reflects the expected impact of Fed purchases, and therefore should not change when the buying actually begins. In contrast, bond investors would likely be very surprised if the Fed does not announce more QE next week. Any technical changes to the Treasury purchases could impact rates at particular maturities. The end of short-term Treasury sales, for instance, should be a modest positive for rates out to three years. Separately, very long-term rates could rise if the Fed decides to scale back purchases of 30-year bonds.

Q: What else should we expect from the Fed next week?
A: Changes to official communication about the funds rate will be on the table, but action might be delayed until early next year. Public comments last week offered more clues that the FOMC is leaning towards a change in its official guidance about policy. The specific proposal would replace the calendar-based funds rate guidance (no rate hikes until “mid-2015”) with something based on thresholds for economic indicators (e.g. no rate hikes until the unemployment rate reaches 6.5%). This shift could have major implications for the policy outlook and the rates market (for background see “You’ll Never Know if You Don’t Try”, Columbia Management Perspectives, November 19, 2012). A change in official communication looks likely, but it is hard to say whether it will come next week or sometime in Q1 2013.
The Argentine tango is danced to certain “rules”:
1. The dance is conducted in an embrace that can vary from very open, in which leader and follower connect at arms length, to very close.
2. Dancing appropriately to the emotion and speed of a tango is extremely important to dancing tango. A good dancer is one who transmits a feeling of the music to the partner.
3. Argentine tango dancing relies heavily on improvisation.
4. The dancer rarely has his or her weight on both feet at the same time so they can quickly change position.

Both sides in the fiscal cliff negotiations are playing familiar roles in a largely choreographed dance/negotiation. It is hard to argue that the negotiating parties at this "dance' were close so soon after their election war just ended but the headlines suggest the fiscal cliff talks in Washington are “stalled,” “stuck” and “stalemated.” Republicans have rejected President Obama's initial offer as not serious. The President returned to the "campaign trail" as discussions/negotiations that should be conducted quietly moved to hour by hour revelations of essentially nothing. The use of the public spotlight leads to interpretations that these moves are posturing to minimize the impact on voter perceptions ahead of failed talks may be premature but cannot be ignored. Politicians tend to remain light on their feet allowing them to change position quickly so investors should be wary of reacting to the emotion and speed of announcements during this overly public process. However, the President has backed the Republicans into a difficult corner and deft footwork will be required to elegantly get out of it. It is considered rude to bump into or stand on the toes of other dancers during the tango — many republicans may have no choice. Notably they will have to bump aside the no-tax-increase pledge designed by Americans for Tax Reform’s Grover Norquist. Norquist is reported to have said “No Republican has voted for a tax increase. We’ve got some people discussing impure thoughts on national television,” It wouldn’t be the first time those watching a passionate Tango have had impure thoughts and it will not be the last. Politico summarized the current position as follows “The White House notes that it has now put its wish list on the table, rallied Democrats to its side and pushed Republicans into the position of having to counter with painful spending cut proposals. The White House is also very pleased that it presented these very same plans to a parade of CEOs who left the West Wing this week mostly praising Obama’s proposals as reasonable and begging for some kind of compromise. Republican aides also say they will eventually have to swallow at least some of what the president wants. — Still, there may be more bellowing, even a failed vote or two could send markets swooning. But a deal will get done, most people close to the matter say.”

Investors should be prepared for a sizable tax hike in excess of $1 trillion. The Republican position on taxes is untenable. I can find little evidence that a tax yield of approximately 18%/19% harms the economy. I am in the camp of lower tax rates and fewer deductions especially for incomes above $500,000. However spending is at a level not seen since World War 2. I assume (“hope!”) spending cuts will be identified but largely deferred. I am supportive of the deferral assuming the cuts are specifically identified and the deferral period is explicit. However the ratio of cuts to tax increases needs to be approximately 2 to 1.
The third quarter real gross domestic product (GDP) growth was revised up to 2.7% annual rate from 2.0%. This is only the third time since the great recession when the quarterly growth rate in GDP has exceeded the Fed’s longer run 2.3%-2.5% central tendency projection for economic growth. However, the details of the revision leave much to be desired. The key components of U.S. economic growth — consumer spending and business investment — which together represent more than 80% of GDP, slowed down in the third quarter. Real consumer spending was revised down from 2.0% to 1.4%, compared with 2.0% in the first quarter and 1.9% in the second quarter. Business spending, which was already weak, got worse. Capital expenditure by businesses was revised down from flat to a decline of 2.7%. Business investment has not been this weak since the recession ended.

Housing and net exports were two areas of the economy adding to growth but represent a small component of total GDP. Housing has gone from being a drag to a net contributor to growth, 0.3% in the third quarter. And, Fed’s accommodative policies have kept the U.S. dollar weak relative to its trading partners benefiting U.S. exports which added a small amount (0.1%) to growth.

Almost all of the upward revision can be attributed to inventory additions (0.7%). Sharp inventory buildups in one quarter are generally reversed in the subsequent quarters. Federal government spending added 0.7% to growth mainly driven by a 13% increase in defense spending. Taken together, inventories and government spending added 1.4% to growth, but will not likely add again with this strength in the future. Real private sector demand — consumer spending and business investment — slowed to a mere 1.3% annual rate in Q3. Overall, the U.S. economy is still tracking a sluggish 1%-2% growth rate and faces significant risks in the months ahead if the fiscal cliff issues are not resolved.

GDP Revision — Not What They Appear

By: Anwiti Bahuguna
Senior Portfolio Manager
Asset Allocation

Source: Haver Analytics and Columbia Management Research
Presentations and company meetings at basic materials conferences held over the last several weeks suggest, at best, only modest demand improvement. “Choppy” and “risk averse” were oft-used words. Key industry-specific themes are discussed below.

**Agriculture:** High corn prices and low grain inventories continue to drive the farm economy, although the drought introduced considerable noise and uncertainty. While fall fertilizer applications were generally good in North and South America, exports into India and China remain problematic. In India, changes to government subsidies have driven retail fertilizer prices higher, which has negatively impacted import volumes. In China, import volumes have been stable, but weak global volumes left supply looking for markets and Russia used its rail access to China to displace tonnage from North America. Most fertilizer managements expect a much stronger volume year in 2013, as fertilizer is inexpensive relative to current grain prices, and high grain prices incentivize farmers to chase yield. From a cost perspective, low natural gas prices continue to favor domestic nitrogen producers. The drought and large number of acres expected to be planted in 2013 has led to concerns about seed availability. Most managements suggested ample availability overall, although choice may be somewhat constrained.

**Chemicals:** The cost advantage bestowed on U.S. producers by low cost shale gas dominated most presentations and conversations in chemicals. Margins for U.S. ethylene producers are at record levels, and increased supply of Natural Gas Liquids is expected to keep pressure on input costs and support margins for the foreseeable future. Significant new investment in pipelines, ethylene plants, nitrogen plants and other related projects is expected over the next 5-10 years. On top of the favorable cost situation, some producers see upside from rising global utilization rates given improvement in demand. In contrast to the positive situation in the ethylene chain, the titanium dioxide (an opacifier in paint) market remains under significant pressure on destocking and substitution. The electronics area has also proven challenging for most chemical companies, but most are looking for mid single digit growth in 2013.

**Paper, Packaging and Forest Products:** Demand trends remain relatively flat, although input costs (e.g., resin prices) have proven more stable. Containerboard producers, an industry that has benefitted from significant consolidation in recent years, are benefitting from a recent price increase, although there was much discussion of a potential supply response, primarily from machine conversions. Managements at most wood products companies expect a continued demand benefit from the housing market, and see supply as more constrained, in large part due to reduced supply from Canada.

**Metals and Mining:** Production challenges and cost pressures are key issues, and most managements are being forced to focus on capital discipline and allocation. For many, a rethink is not a choice but a necessity, with free cash flow challenged as inflated capital budgets run into the reality of lower sales revenues. Most managements continue to see China industrialization and urbanization as favorable in the long term, but most also had little positive to say about near term demand trends.
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### Weekly Market Summary as of 11/30/12

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Source: Columbia Management Investment Advisers, LLC

**Past performance does not guarantee future results.** It is not possible to invest directly in an index.

### DESCRIPTION OF INDICES

The Barclays U.S. 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 U.S. 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-capitization 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 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 MSCI EM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

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