



Broader, Deeper and More Protracted

MONETARY EASING STIMULATES ECONOMIC activity primarily through four channels:

1. Lowering market interest rates,
2. Boosting asset prices, which in turn produces a wealth effect on spending,
3. Increasing the value of collateral and encouraging lending, and
4. Weakening the dollar.

The Federal Reserve must be exceedingly frustrated by the lack of response to its unprecedented efforts to inject liquidity and lower interest rates. These efforts have included reducing the Fed funds rate by 300 basis points in six months and accepting credit risks onto the bank's balance sheet.

The Fed's aggressive easing has had a predictable effect on the dollar, driving the currency sharply lower against the yen and euro. Dollar depreciation, however, hasn't proven an

unquantified benefit: It has supported strong export growth but it also has contributed to higher oil prices.

Beyond the dollar, Fed easing has yet to produce expected responses. Market interest rates have been essentially flat since last autumn, credit spreads have widened and asset prices have fallen, discouraging lending and producing a negative wealth effect. Financial conditions, in other words, have tightened rather than eased.

The problem isn't the availability and supply of money, but the hoarding of cash. Since the Fed cut the Fed funds rate 75 basis points in January, U.S. money supply has risen 20.4%. This has been accompanied by double-digit money growth outside the United States. These flows are accumulating in pools of liquidity; for example, year-to-date money market inflows have totaled \$390 billion, corporate cash now exceeds \$1.6 trillion and reserves for developing economies have grown more than \$1.2 billion during the past year.

The problem of hoarding cash is particularly pronounced in interbank lending markets. Since the credit crunch

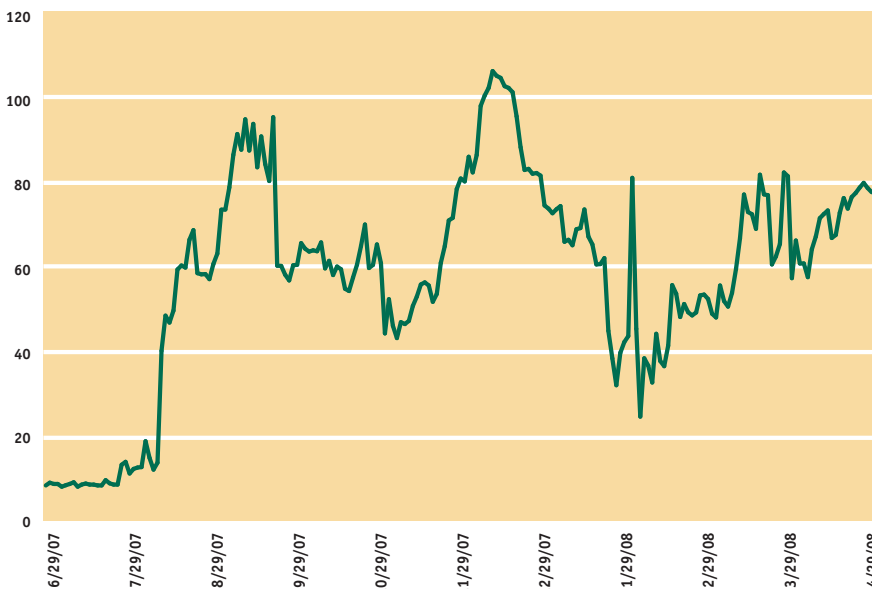
began last August, the leading barometer of stress has been the behavior of the London Interbank Offered Rate (LIBOR). LIBOR is the rate at which banks will purportedly lend to each other.

LIBOR is currently reflecting renewed worries about the health of banks, counterparty risks and a hoarding of cash. This can clearly be seen in swaps that measure the difference between overnight lending rates set by central banks and the three-month LIBOR, known as overnight index swaps (LIBOR-OIS spread). During normal times, such swaps should trade around 12 basis points. They're currently near 80 basis points.

The lack of confidence reflected in these swaps and other credit products was recently highlighted by Federal Reserve Governor Kevin Warsh. He correctly noted credit markets would return to normal only when private institutions were again willing to lend each other money and make markets

LIBOR A BAROMETER OF STRESS CAUSED BY THE CREDIT CRUNCH

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Left Axis: The spread between the London Interbank Offered Rate (LIBOR) and the Overnight Index Swap (OIS) measured in basis points (BPS) and quoted in U.S. dollars.

Source: Bloomberg



in financial securities. He warned the healing process “is unlikely to be swift or smooth.”

Credit problems are increasingly harming the real economy. Unfortunately, these tougher credit conditions are only one of several forces dragging down consumer spending. The others include:

- Falling house prices and declines in home equity values. Home prices could decline another 5% to 10% this year.
- Higher food and fuel costs. The price of crude oil is 17% above its first-quarter average, and agricultural commodities are 5% to 10% higher.
- A deteriorating labor market. Unemployment is rising and wage gains are slowing. Weekly private-sector wages rose 3.6% in the year to March, the slowest pace since mid-2003.

Continued credit problems and slowing consumer spending increase risks that the current economic contraction will be broader, deeper and more protracted. Accordingly, we would use the current rally in stocks to return equity overweights to strategic norms and increase cash reserves.

Orie L. Dudley Jr.
Chief Investment Officer

INVESTMENT STRATEGY

What Has Changed

- Credit markets remain under stress, particularly money markets where fears about the financial strength of banks and counterparty risks persist.
- Equity markets rallied, as several bellwether companies reported solid first quarter results, and record short positions were squeezed.
- The International Monetary Fund (IMF) lowered its 2008 global growth forecast to 3.7% because of the “largest financial shock since the Great Depression.”
- The IMF estimated global financial losses stemming from the credit crisis may approach \$1 trillion.
- Crude oil futures touched \$117 a barrel as supply worries increased.

Rising Unemployment and Private-Sector Job Losses Signal a Contracting U.S. Economy

- Higher energy and food costs, rising unemployment, and falling house prices are slowing consumer spending.
- U.S. home foreclosures rose 57%, and bank repossessions more than doubled in March.

Economy Faces Protracted Period of Deleveraging, Further Dampening Economic Activity

- Many interest rates and spreads have remained stubbornly high despite aggressive easing by Central banks.
- The London Interbank Offered Rate (LIBOR) rose unexpectedly and could increase interest rates for homeowners, companies and other institutions around the world.
- The Federal Reserve is committed to do whatever it takes to avoid a severe and lengthy recession, including effecting a negative real Fed funds rate and creatively using its balance sheet.

Equity Markets Must Brace for Increasing Pressure on Corporate Margins and Possible Earnings Estimate Reductions

- First-quarter earnings, excluding the financial sector, are slightly above expectations — increasing 8% to 10%.
- The S&P 500 is benefiting from non-U.S. profits (40% of total) and a growing commodity sector (18%).

The Dynamism and Resilience of Developing Economies Continues to Drive Global Growth

- China reported a 10.6% increase in first-quarter gross domestic product despite slowing exports.
- The slowdown in euro-zone growth remains gradual, exemplified by unexpected rises in German and French business confidence.
- China’s foreign exchange reserves increased by a record \$154 billion in the first quarter.

Conclusion

- Equity markets rallied despite limited improvement in credit markets and increasing pressures on the real economy. Use this opportunity to tactically reduce portfolio risk and increase liquidity reserves. Stock holding should be trimmed to strategic norms.

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