Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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As we turn the calendar to 2010, and bid farewell to a truly Dickensian year in the capital markets, it is only fitting to spend a few moments reflecting on the year that was, and on the end of the "aughts."

2009 was truly a vicious and egalitarian bear market as well as a powerful and broad bull market across asset classes and geographies. Equities posted strong returns, having staged a comeback worthy of the 2004 Boston Red Sox. Both the Dow Jones Industrial Average and the S&P 500 posted their best performances since 2003, with gains of 18% and 23% respectively. More notable, however, is the rally from the March nadir that had brought the averages to 12-year lows. The Dow and the S&P have surged by 59% and 65% respectively since those dark days when fear of global economic depression and financial sector nationalization dominated the headlines. Investors embraced small cap stocks as well, and the Russell 2000 Index gained over 25% — again, the best performance since 2003. The equity rally of 2009 was a global party, with bourses in the developed world advancing strongly with the German market gaining 24% and even the U.K. FTSE 100 Index posting a 22% gain. However, these stellar returns pale in comparison to the seemingly parabolic rise in emerging market equities in 2009: The BRIC markets (Brazil, Russia, India and China) soared to advances of between 80% and 128%!

Gains were to be found across fixed income as well, with sharply lower rates (read zero interest rate policy) coupled with increased risk appetite pushing credit markets ahead to strong annual returns. The Barclays Capital U.S. Credit Index was up over 16% for the year, the best return in 14 years, while the high yield benchmark, the Merrill Lynch U.S. High Yield Master II Index, advanced over 57%, which set a record. Records were set in issuance as well, with investment grade companies issuing over $1 trillion in U.S. dollar denominated bonds, and non-investment grades successfully issuing over $145 billion, according to Dealogic. Globally, bond issuance surged over 35% in 2009 as companies took full advantage of both the investor's appetite for yield as well as the historically low absolute interest rates.

Commodities joined the party as well, with broad-based commodity funds gaining, crude gaining over 77% and copper posting a 138% gain on the year — the largest in history. Almost counterintuitively, gold also gained for the year. Oftentimes seen as a "risk aversion" asset, the 25% gain in gold seems counter to the renewed investor risk appetite we experienced in 2009. The gain in this particular commodity was likely due to the unprecedented global fiscal and monetary stimulus that was undertaken to address the financial crisis of 2008, and the fear that the aftermath of this stimulus would be damaging to fiat currencies across the developed world. Further, gold has benefited from investors becoming unfortunately familiar with "tail risk" — the low probability, high impact event that can wreak havoc on portfolios. Gold, as a safe haven asset, can adequately hedge against the improbable but not impossible.

Among the few asset classes that lost ground in 2009, we find the U.S. Treasury market, which posted a loss of -3.30 %, and the U.S. dollar, which lost ground against the Euro and fell 2.4% for the year. Well, that's not so bad…investors must be feeling pretty good, right?

Well, as we step back from the frenzy of 2009 to look at the broader (and longer) picture, things don't appear as rosy. Despite the meteoric rise in risky assets in 2009, the decade of the aughts was not entirely kind to equity investors. Developed market equities are still well in the red for the decade, with the S&P 500 off over 24% and the FTSE off over 22%. The Nikkei has fallen over 44% over the past 10 years. To add a bit of insult to injury, most investors missed out on the incredible returns of the decade of 1990-2000, getting into the equity market late in 1999 and near the peak of the market. Similarly, most investors did not fully participate in the rally of 2009 as cash of $3.3 trillion sits on the sidelines as investors prefer to dip their collective toes in the fixed income market (investors added $380 billion to bond funds last year) and have continued to be net sellers of equities. With two bear markets in one decade, the average investor is more than twice shy.

Looking into 2010 it is clear that many of the tailwinds that converged to create the favorable environment for risky assets in 2009 may dissipate, or even turn into headwinds. Specifically, focus remains on exit strategies and on the timing and sequence of removal of the historic stimulus that has characterized global monetary policy. This may be a "be careful what you wish for" year as signs of economic stability embedded in the most recent unemployment claims report, which declined unexpectedly last week to the lowest level since July 2008, join signs of potential improvement — Northern Trust's own Paul Kasriel recently increased his estimate for 2010 economic growth. Such economic progress may be met with a change in the Federal Reserve stance away from the "low and long" mantra and may be aimed at normalizing policy. The bond market is certainly signaling that rates will rise, and the 10-year treasury closed Thursday at 3.84% — up substantially from the 3.20% seen in late November and the 2.21% yield of December 31, 2008. A policy misstep — the Fed removing stimulus too soon — would be detrimental to both economic stability and equity prices.

We focus on the health of the emerging markets, where the overwhelming political agenda is economic growth and the potential for asset class bubbles to form is very real. China has most recently announced measures aimed at curbing property price advances, and other emerging markets (India and Russia) have enacted policies aimed at reducing speculation as well. With emerging markets expected to be the key driver for global economic growth well into the future, it is critical to understand where the risks as well as the opportunities reside. We also focus on the degradation of public finances around the world, with debt to GDP (gross domestic product) levels across the G-20 (The Group of Twenty Finance Ministers and Central Bank Governors) reaching unsustainably high levels. The situation in Greece should serve as a wake-up call to investors who have become complacent regarding such risk. Finally, we recognize that the strong correlations between and within risky asset classes that characterized returns in 2009 likely will not recur in 2010, and that the markets may become more discerning. As always, Northern Trust is reviewing our investment policy and stands ready to make appropriate changes in risk levels if warranted.

Katherine Ellis Nixon holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.

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