Insights from Northern Trust

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Last week saw global investors preempt that eponymous groundhog of Punxsutawney, Pennsylvania, due within mere days to make his 122nd annual assessment of a forthcoming spring or lengthy continuation of winter. Wary of the long shadows cast by the Great Recession, investors didn't give the poor creature a chance and instead resigned themselves to prospects for a continuing wintry spell of global deleveraging and stimulus hangovers.

This chilly forecast has cooled the 70% rally equity markets have experienced since last March and led to key stock benchmarks declining for the third week in a row. The Dow Jones Industrial Average ended last week down 106 points, or -1%, while the Standard & Poor's (S&P) 500 index fell 18 points, or -1.6%. With its heavy technology focus, the NASDAQ composite fell 2.6%.

The heightened risk aversion played out across all global capital markets as investors demonstrated growing concerns about sovereign debt issues, the longevity of the global economic recovery and Chinese policy tightening. Investors sold commodities, emerging market equities and small cap stocks, while they sought out the relative safety of U.S. Treasury bonds and the dollar. The dollar gained 1% last week, while Treasury Inflation-Protected Securities (TIPS) posted a modest 0.3% rise.

With these declines, January posted negative performance for the third year in a row. The MSCI World Index closed January down 2.6%, while the MSCI Emerging Markets Index declined 3.1% for the month. In our domestic markets, the Dow was down 3.5%, the S&P 500 fell 3.7%, and the NASDAQ was off 5.4% for January. Most indexes have declined sharply below their 50-day moving averages, but with the exception of the Chinese Shanghai Index, most indexes are still above their longer-term, 200-day moving averages.

The index price movements reflect the declines of their constituent components. As an example, in the S&P 500 index the percentage of stocks trading above their 50-day moving average has dropped from more than 80% of all stocks at the start of the year to just fewer than 35% now. This is the lowest level of stocks above their short-term trading averages since mid-year 2009, and an indication of widespread weakness in market breadth. Sectors with the worst short-term breadth include technology (with just 22% of stocks above the 50-day moving average) and materials (only 10% above the 50-day moving average). Exhibiting relative strength is the healthcare sector, with

nearly 50% of its constituent stocks above their 50-day moving averages. In a typical bearish sector rotation, investors are focusing on defensive sectors over cyclical ones.

This risk aversion dynamic is illustrated in last week's performance of the S&P 500 sectors using the appropriate iShare proxy. Since the most recent downturn commenced on January 20, cyclical sectors such as the Materials SPDR (XLB), Technology SPDR (XLI) and Energy SPDR (XLE) have been leading the market lower, as expected. Conversely, traditionally defensive sectors such as Consumer Staples SPDR (XLP), Health Care SPDR (XLV) and Utilities SPDR (XLU) have also declined, but to a far lesser extent than the cyclical sectors or even the S&P 500 index as a whole (the S&P 500 was down 6.6% during the period).

Conventional Wall Street lore suggests that full calendar year returns always follow the precedent set in January. This "January Effect" is promulgated by various market commentators and analysts and gains its most traction in research by market boutique Ned Davis Research, Inc. Their work shows that if January is positive, subsequent full-year equity returns average 10%. If equity returns in January are negative, subsequent full-year returns average just 0.3%. This performance dynamic was even discussed in *Barron's* financial magazine over the weekend, with Michael Santoli's *Streetwise* article pointing out that the Ned Davis work is statistically correct. But like all other rules of thumb, the January Effect can be very wrong in any individual year – one need look no further than 2009's poor January return giving way to a stunning year-long rally. So the month was down, but the jury is out.

Perhaps foremost on global investors' minds this past week was growing concern over the debt of sovereign nations such as Greece. With heavy spending programs having lifted Greece's debt-to-gross domestic product (GDP) ratio to well over 100%, the nation has need to refinance more than €25 billion of debt in 2010 from a European Union whose own rules prohibit it from lending to member nations to plug holes in their budgets or bridge deficits. As such, Greece went to the public markets this week and averted a buyers' strike by paying a significant yield premium on €8 billion of five-year government bonds at 6.2%. The latest chatter over the weekend was of bailouts from European or Asian nations – talk which normally precedes significant events. The costs to insure sovereign debt soared as would be expected, hitting levels usually associated with emerging market economies. CME Group, which tracks credit derivatives, said the implied probability of default for Greece reached 28%, making it the eighth most-likely nation to go bust.

Speaking of emerging economies, China was also front and center in investor focus as authorities there continued steps to temper its red-hot economic engine. China's stimulus programs, led by a government order to banks in late 2008 to flood the economy with cash, helped to carry China through recent global financial turmoil. The Chinese economy has rebounded strongly, posting economic growth nearing 10%. Property prices are sizzling in the major cities, and a recovery in exports and internal investment is underway. All told, the Chinese economy is now poised to surge past Japan this year as the world's second-largest economy, after the United States.

Eyeing potential inflation, Chinese authorities have taken several actions. On January 12, the government raised commercial bank deposit requirements to 16%, which was noteworthy but barely caused a ripple in the Shanghai index. Then on January 20, Chinese authorities ordered banks to temporarily stop making loans in order to slow the advance in the country's M2 money supply. This move spooked investors and was followed by a 3% drop in the benchmark Shanghai index. Lately,

Chinese authorities have raised the yield their government pays on one-year bills to siphon off excess market cash. These developments all represent stage one of China's exit from the emergency stimulus programs of the last 18 months, although Chinese stock prices suffered as a result and the Shanghai index is now the only global equity benchmark to have pierced its 200-day moving averages on the downside. Northern Trust believes these measured policy moves are necessary to foster sustainable economic growth in the Asia-Pacific region and will allow for a continued period of economic expansion. Having initiated their policy exit strategy, Chinese authorities have helped remove some uncertainty from their financial markets, uncertainty that developed nations still face.

Despite concerns over some global market dynamics, investors were presented with a bevy of good corporate and economic reports throughout the week. Most significant was the announcement that U.S. economic growth hit a six-year high as fourth-quarter 2009 GDP registered an unexpectedly strong 5.7% gain (expectations had been for a 4.6% gain). Although much of the strength in the fourth-quarter GDP report came from a slower pace of business inventory reductions, the headline figure was the highest level of GDP growth since 2003 as exports surged and consumers spent more. Surprisingly, according to the Bureau of Economic Analysis (BEA), one area that did not contribute to the 5.7% gain was the government. Government consumption expenditures and gross investments were actually down 0.2% as the marginal contribution from the federal government was offset by a decline in state and local government expenditures.

The big question is whether this growth will continue into 2010's first quarter. Based upon robust earnings reports and improved corporate earnings guidance, companies do, indeed, project a positive outlook. At this stage of earnings season, nearly 75% of S&P 500 companies have exceeded their earnings estimates. Forward revenue and earnings guidance have been equally positive. Examples of strong earnings came from Apple, Microsoft, Boeing and biotech Gilead Pharmaceutical, which all gained from cost-cutting measures that bolstered their bottom lines and future product introductions that enabled them to raise revenue projections.

On the political front, after a brief bout of doubt, Ben Bernanke was reconfirmed midweek for a second stint as Federal Reserve chairman. The Fed's Federal Open Market Committee (FOMC) also announced the continuation of its current policy directive last week – specifically, that economic conditions are likely to warrant exceptionally low levels of interest rates for an extended period of time. The FOMC vote was not unanimous, however, as Kansas City Fed President Thomas Hoenig dissented, believing instead that economic and financial conditions had improved sufficiently for the Fed to begin to unwind its "low-for-long" rate directive.

That same night, President Obama gave his maiden State of the Union address and focused primarily on job creation rather than financial sector or healthcare reform. The President also called for a three-year spending freeze in areas covering one sixth of the federal budget. These pronouncements gave further credence to the notion that Scott Brown's victory in the Massachusetts special Senate election was a call for moderation of the administration's ambitious agenda – with a move toward more centrist policies being potentially beneficial for domestic markets.

For the week, markets failed to respond to the good news of Fed Chairman Bernanke's reappointment, strong earnings, solid economic growth or even the long-awaited Apple iPad announcement. Instead, investors were concerned that current market values, some 60% above last

year's crisis levels, are perhaps the best that government and monetary stimulus can get us. Analysts are now busy forecasting the potential market impact of withdrawing some or all of this stimulus, and to what extent the economic recovery now underway can become self-reinforcing. On that note, our Investment Policy Committee and chief economist do believe we are moving along a clear but somewhat bumpy road to a sustainable recovery. For specifics on our outlook we invite you view our most recent Market Perspective piece found at northerntrust.com/perspective.

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