



## Insights from Northern Trust

### Commentary from John D. Skjervem, CFA, Chief Investment Officer, Personal Financial Services

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Financial markets' recent bullish streak ended last Friday when investors dumped stocks on the news that the U.S. Securities and Exchange Commission (SEC) filed civil fraud charges against Wall Street citadel Goldman Sachs Group in connection with some of that firm's 2007 mortgage bond underwriting activities. These charges abruptly interrupted what had otherwise been a week dominated by more evidence of building economic momentum and strong corporate profit performance. However, by close of trading Friday, equity markets around the world were decidedly lower, with shares of financial services companies bearing the brunt of investors' selling angst. Friday's retreat in Standard & Poor's (S&P) 500 shares was broad enough to bring that index's run of six consecutive weekly advances to a close, but appreciating stock prices earlier in the week proved sufficient to push both the Dow Jones Industrial Average and NASDAQ higher for a seventh consecutive week.

Economic statistics released last week largely corroborate the growing consensus that the U.S. economy is steadily gathering strength. Retail sales for March vaulted 1.6%, triple the increase recorded in February and well ahead of the 1.2% improvement analysts had expected. The mid-month Empire State Manufacturing Survey shot up 9 points this month signaling strong month-to-month growth in New York state. The survey's findings included higher readings across the board in new orders, shipments, inventories and input prices. At the national level, industrial production in March fell short of analysts' estimates, but after a utilities-related adjustment, the report's manufacturing component was revealed to have registered a notable 0.9% advance.

But the week's most impressive economic headline came from Asia where China announced that its economic juggernaut produced yet another quarter of stunning growth, an 11.9% expansion relative to 2009's first quarter. Chinese authorities also reported that first quarter inflation had actually come in below official expectations, but these almost magical growth and inflation dynamics were not enough to quell speculation that another round of monetary policy tightening would soon be required in the world's third largest economy. Then on Friday, Chinese President Hu Jintao caught currency markets off guard when he suggested that China may adopt what he called a "floating" exchange rate. This announcement was of course received favorably by U.S. officials, who have long argued that an artificially cheap currency gives China an unfair trade advantage, but the Chinese president's primary motivation is undoubtedly a signal that his country will use all tools necessary to keep domestic inflation from undermining the durability of its robust expansion.



Last week also featured the initial wave of corporate profit reports for the first calendar quarter of 2010. Analysts' earnings projections had been rising in anticipation of upside profit surprises, and so far corporate America has delivered on these optimistic expectations. While the first quarter earnings season is just a week old, last week's results bode well. Better-than-expected quarterly earnings were announced by a wide range of blue chip companies including semi-conductor king Intel, banking powerhouse JPMorgan Chase & Co. and transportation bellwether UPS. At week's end, industrial giant General Electric reported that even its long struggling GE Capital subsidiary had recorded a pre-tax profit, the first positive contribution from that unit in 18 months.

These good bottom-line results were in most cases matched by improving top-line trends too. For example, toy-maker Mattel reported a 12% jump in sales, another sign that consumers' discretionary spending is indeed rebounding from last year's recessionary levels. Meanwhile, the improving pace of the economic recovery was reflected in railroad operator CSX Corp.'s first quarter results, which included a 22% earnings pop and an 11% revenue boost attributable to rising freight volumes and firmer pricing. These impressive top- and bottom-line trends also appear to be gaining traction abroad: LVMH Moët Hennessy Louis Vuitton, the French luxury-goods conglomerate, said its first quarter sales climbed 11% compared to results a year ago.

Despite nearly universal good news on economic growth and earnings, last week's financial headlines also included a deluge of corporate scandal, beginning with revelations that high-ranking Avon Products executives were suspended by the global beauty products leader pending the outcome of investigations into bribery at the firm's China unit. Two days later, technology titan Hewlett-Packard (HP) was accused of paying almost \$11 million in bribes in connection with the sale of an HP computer system to the Russian Federation's office of the prosecutor general. U.S. officials have joined authorities in Germany and Russia to determine whether or not this now decade-old HP transaction violated the Foreign Corrupt Practices Act.

At Goldman Sachs, last week included not only the aforementioned fraud allegations, but also news that the SEC is investigating Goldman director Rajat Gupta on suspicions that he provided inside information about Goldman to Raj Rajaratnam, founder of hedge fund management firm Galleon Group who was indicted last October on insider trading charges. But it was Friday's fraud announcement that sent Goldman's shares plummeting 13% on the day. In structuring and marketing a particular sub-prime collateralized debt obligation (CDO), Goldman appears to have favored one client (hedge fund manager John Paulson) over the investors who purchased these CDO securities. Specifically, the SEC now alleges that Goldman traders misled investors regarding the Paulson firm's role in designing this particular CDO - a role that ultimately enabled the Paulson firm to earn a \$1 billion profit at the expense of these other investors.

Despite confidence-damaging stories of bribery, insider trading and fraud, we remain encouraged by the accelerating pace of global economic growth and the corresponding positive impact that growth is having on corporations' sales and profits. Accordingly, we continue to recommend that investors overweight those asset classes most leveraged to economic growth, namely U.S. large cap stocks, emerging market equities and commodities. Conversely, we are cautious in our near-term outlook for bonds, noting that even modest increases in long-term interest rates can significantly erode investors' total return at today's low nominal yield levels.



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