



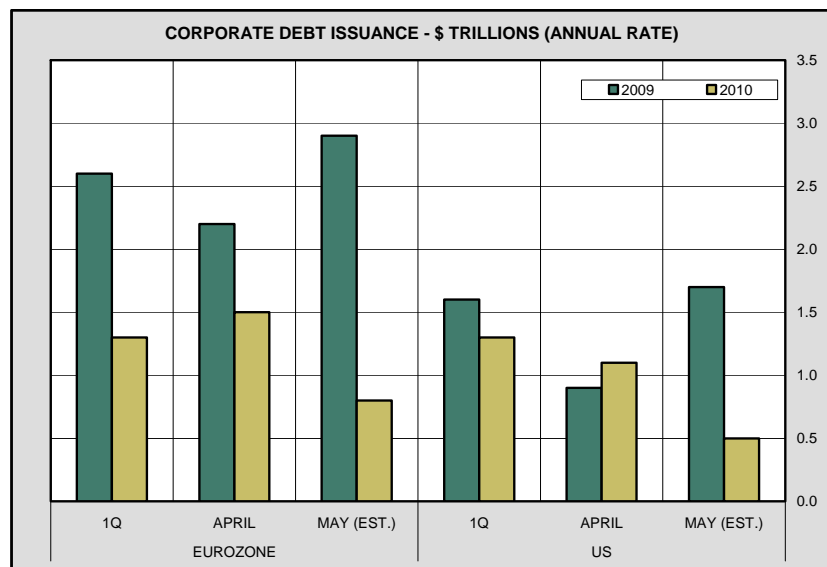
## Insights from Northern Trust

### Commentary from Jim McDonald, Chief Investment Strategist

May 25, 2010

Financial markets have continued to struggle in the wake of the European debt crisis and its ripple effects. Stocks in the United States, as measured by the Standard & Poor's (S&P) 500, have fallen by 14% over the last month (roughly coinciding with the recent cycle high), as compared with a 16% decline in European stocks and an 18% decline in emerging market equities. Corporate credit has also seen some pressure, with spreads on investment grade bonds rising from 130 basis points (bps) to 166 bps, while high-yield spreads have jumped from 525 bps to 625 bps. We have seen market volatility, as measured by the Volatility Index (VIX), reach levels late last week that were seen during prior market disruptions like the Long-Term Capital Management crisis and the attacks of September 11, 2001. Much of the proceeds from the sale of risky assets have gone into the safe haven markets of U.S. Treasuries and German Bunds. To put the magnitude of this flight to safety in perspective, two-year U.S. T-bills have fallen in yield to 71 bps at the time of this report, compared with a rate of 1.03% less than a month ago. Looking forward, what are the key issues that could help stabilize the markets and set the stage for improved risk taking?

The deterioration in the credit markets was central to our more-tempered view of risk assets from early this month, and this continues to be the area of greatest focus.

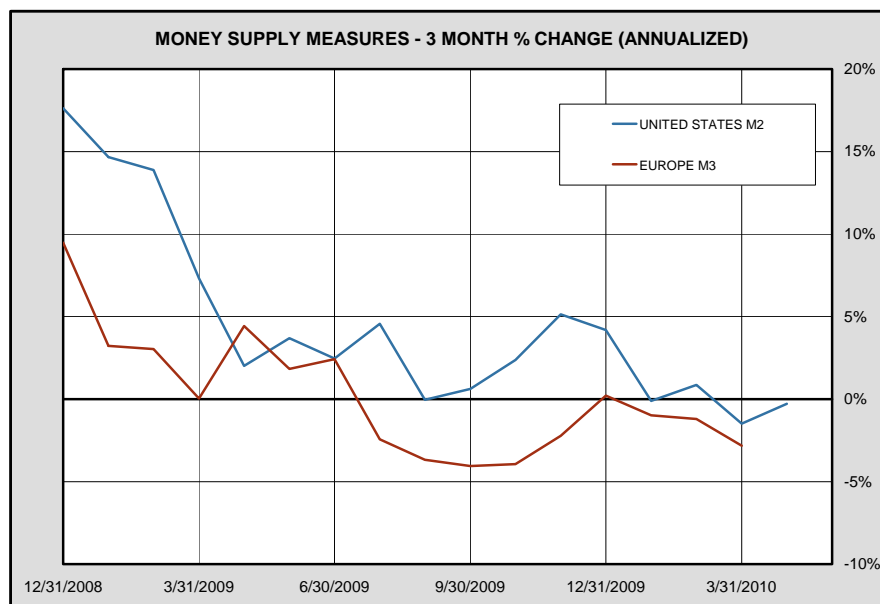


Source: ISI Group

The tremendous improvement realized in credit markets since March 2009 has underpinned the cyclical economic recovery, enabling banks and non-financial companies to shore up their finances and set the stage for economic expansion. The revival of whole asset classes, such as real estate

investment trusts, can be attributed very importantly to this improved financing environment. What is currently transpiring threatens to undermine that improvement. As worries about sovereign credit quality in Europe pressure those issuers – with the negative knock-on effect on the European banks and insurers that hold much of this debt – inter-bank lending rates rise and risk-taking retreats. We saw signs earlier this month that secondary market trading in corporate and government debt was losing liquidity, and this is now spilling over to the primary markets where deal flow in European and U.S. corporate debt has slowed significantly. The higher resulting interest costs to issuers will become a headwind to the economy going forward. We need stability to return to these markets to have confidence in the sustainability of the global recovery.

We also need to have confidence that the capital markets will be open for business and able to support credit creation. Over the last several months, the markets have wobbled in the wake of U.S. financial reform regulation, the fraud allegations against Goldman Sachs and the German ban on certain types of short-selling. Bankers and investors aren't sure what the rules of the game will be going forward. As we were reminded during the financial crisis, when financial players face significant uncertainty, they will sit on their hands. If their new motto becomes, "When in doubt, don't lend it out," the money supply won't start growing again and the economic recovery will be imperiled.

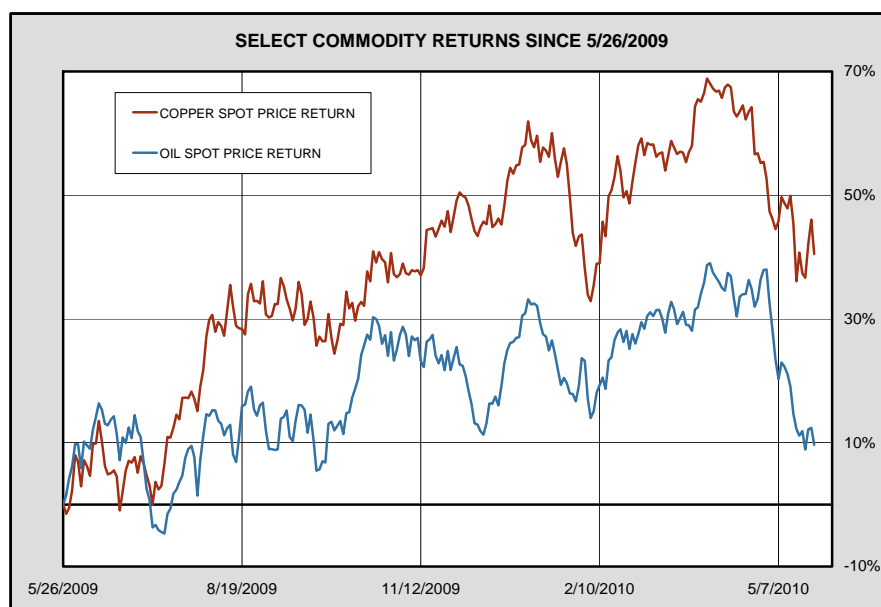


Source: Northern Trust, Bloomberg.

There is reason for some optimism on regulatory reform, as the U.S. financial legislation is currently in the reconciliation process before being sent to President Obama for his signature. Completion of this regulation could significantly reduce investor uncertainty over the outlook for the financial sector and potentially reduce overall risk aversion.

Turning from the financial markets to the global economy, current economic data show a continuing global recovery offset by some recent softer data points. Purchasing manager index (PMI) data remain strong, with the U.S manufacturing PMI most recently at a level of 60.4, new orders at 65.7 and inventories at just 49.4; but this data series has likely peaked. Strong corporate profitability has led to an improving employment picture, with overall job growth of 520,000 over the last two months. But much of the economic data is backward-looking, and the markets tend to discount

changing economic prospects well before the data will demonstrate it. The lore on Wall Street is that the market will discount a change in economic trajectory six months in advance, and this held true in 2009 as the stock market bottomed in March and the economy started growing again in the September quarter. Economically sensitive commodities, like oil and copper, are down 24% and 17%, respectively, from their cycle highs set over the last two months.



Source: Northern Trust, Bloomberg

To us, the significance of these commodity price declines indicates an increased risk of a slower global economy. There is also risk to the U.S. expansion from the turmoil in Europe. The resulting stronger dollar is likely to hurt U.S. exports and multi-national corporate profits; the fall in equity prices could reduce spending and investment; and tightening credit conditions could hinder growth. Conversely, the weaker euro will likely help cushion, somewhat, the economic drag from fiscal consolidation that Europe is currently undertaking.

For the economic recovery to successfully transition to a sustained expansion, improved confidence must be realized, not snuffed out. This will be most evident in the credit markets, as it is a real-time indicator of investor risk appetite and is central to supporting economic growth going forward. We also must see improvement in the coordination of Europe's rescue plan, with evidence that the different countries' citizenry will at least grudgingly go along. Markets will likely benefit from completion of the U.S. financial regulatory reform, as the fear of the process may prove to be more problematical than the final regulation. Finally, the global economic recovery must have enough self-sustainability to weather this current disruption. As we wait for evidence of progress on some of these signs, we do remain tactically overweight gold and cash as a way to protect against the sovereign credit problem and have some funds available to potentially capture future opportunities. Without doubt, the environment for risk taking has changed this month, with the half-full glass suddenly becoming half-empty. We'll need progress on credit markets, financial reform and evidence of continuing global growth for the markets to return to the more optimistic view.

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