



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

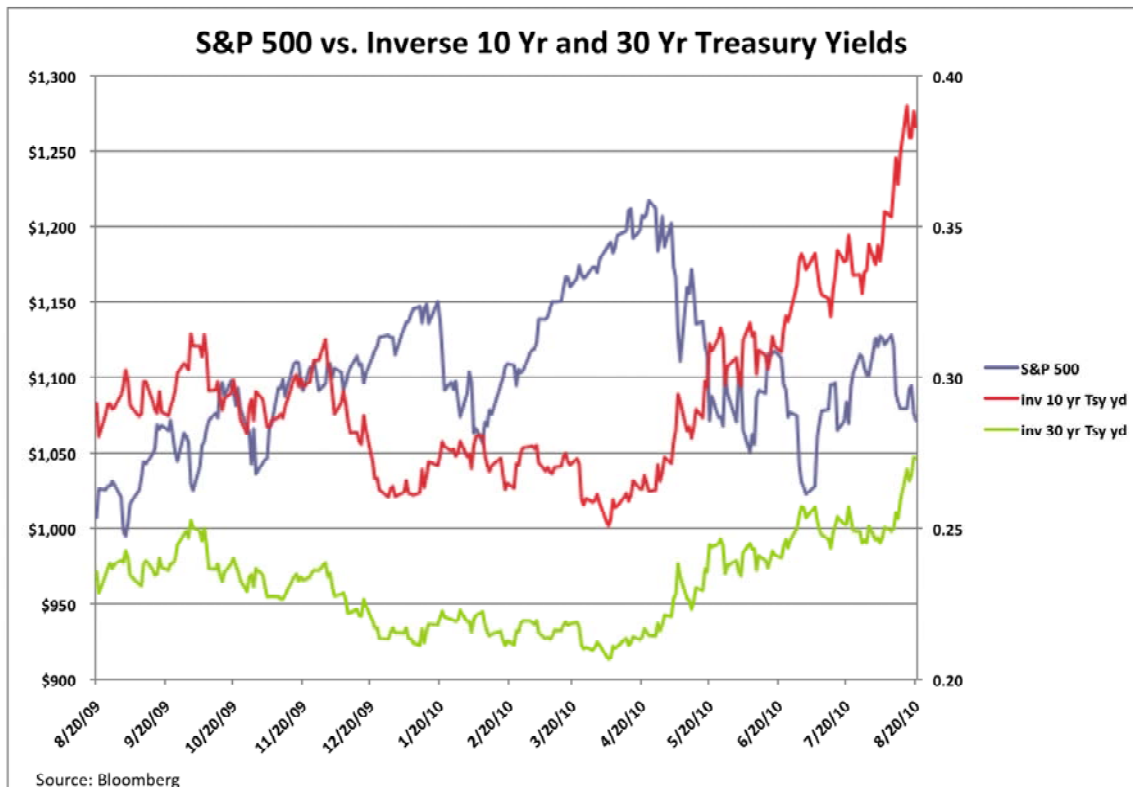
August 23, 2010

Continued worries about the pace and durability of the global economic recovery weighed heavily on most equity markets last week. Both the Dow Jones Industrial Average and the Standard & Poor's (S&P) 500 posted losses on the week; abroad, European indexes followed suit as did the Japanese Nikkei 225 index, ending the week in the red. Even the Hang Seng index posted a marginal loss, as investors attempted to forecast the direction of markets that appear to be more and more dominated by negative macroeconomic news.

A bright spot this week continued to be the sovereign debt market. Across the central Euro zone, bonds rallied and the 10-year UK gilt fell to below 3%. On the heels of a four-week rally, the U.S. Treasury market – the “flight to safety and quality” trade – also saw yields down significantly across the yield curve, most substantially in the 30-year U.S. Treasury, which ended the week at a yield of 3.661%. In contrast to negative year-to-date equity returns, the 30-year U.S. Treasury has returned a whopping 21.15%. Who would have thought it? Many strategists and money managers are issuing *mea culpa* missives for not foreseeing this rally, as predicting movements in the global capital markets has proved too big a challenge for even the most experienced managers. The announcement that Stanley Druckenmiller will retire is a stark example of the challenges many investment experts face.

The continued rally in bonds has spurred a vigorous debate on Wall Street – is the bond market in bubble territory? We don't believe so and, in fact, think that the bond rally is a relatively rational response both to the weak economic data and the professed and reiterated Federal Reserve policy. It also is evidence of the continued risk aversion by investors who have lived through a lost decade in equity returns. That credit spreads have remained relatively narrow in both the investment grade and high-yield markets provides evidence that investors are not pricing in a recession scenario to bond prices. That being said, looking at bond yields and equity returns side-by-side illustrates the “risk off” trade we have seen take hold over the past several weeks. In fact, investors continue to vote with their feet, with significant equity mutual fund outflows – estimated at more than \$3 billion withdrawn this year through July – continuing unabated while, in contrast, \$185 billion has flowed into fixed income, according to the Investment Company Institute.





Negative news on the housing and employment fronts in the United States met head on with an extremely negative Philly Fed survey (-7.7%) and combined to create tremendous uncertainty around gross domestic product (GDP) advances. This gave credence to those economists (including our Chief Economist Paul Kasriel) who have been reducing their expectations for the second half 2010 and into 2011. We will get the revised second-quarter GDP numbers this week, and the unfortunate expectation is that the revision will be down significantly from the 2.4% annualized pace previously reported. The macro data out of housing and employment is critical here, as improvements in both are widely considered to be main ingredients in a sustainable economic recovery. Housing activity has resumed its downward track as the expiration of the first time buyers tax credit has taken a toll on demand despite a record low 4.42% 30-year mortgage rate. In related news, stubbornly high unemployment resulted in new claims breaching once again that all-important 500,000 mark and validated concerns about a more profound slowdown: a double-dip.

There was similar negative news reflecting slowing economic activity out of Japan and, to add insult to injury, it was widely reported that China has surpassed Japan as the world's second-largest economy. The Japanese yen has been incredibly strong recently, creating a challenge for exports in an environment of continued deflation. With few weapons left to use, and with currency intervention an extreme last resort, we look for additional quantitative easing but we do worry about the efficacy of such a program in the absence of credit demand.

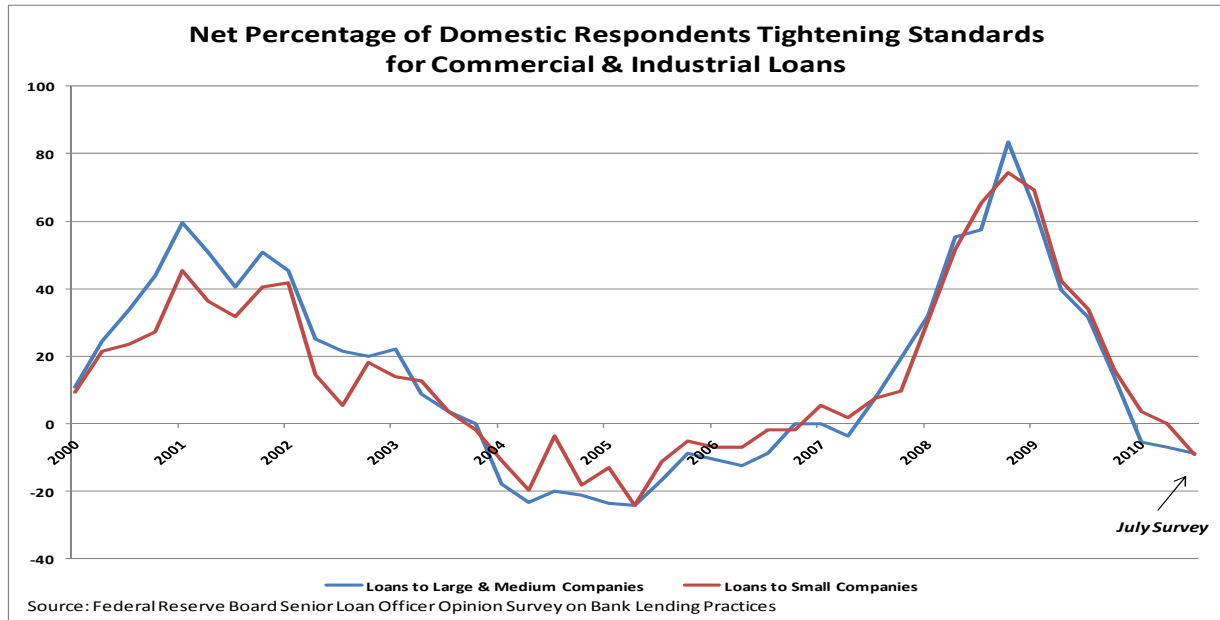
News out of the European Union (EU) reflects economic caution as well, with Deutsche Bundesbank's President Axel Weber confirming fears of the durability of the economic recovery for the region, pushing off the heavily anticipated "exit strategy" into 2011. With strong data out of Germany contrasting with some anticipated slowing in France and Spain along with the expected



mild recessions in the peripheral EU, it is increasingly a challenging environment with regard to broad monetary policy.

So, the macro picture across the globe appears murky, and investors are increasingly focused on this macro view. In contrast, however, the micro view is much more positive, and it is this microeconomic view that enables us to maintain our equity exposure at current levels. At this stage we are all well aware of the results of the second-quarter earnings season, and the fact that almost across the board we had companies beat expectations on both the top and bottom lines. In fact, some say we have seen the best four-quarter run of positive earnings surprises in 20 years. We also see valuations well within reasonable ranges, and the majority of the stocks in the Dow have dividend yields that exceed the 10-year U.S. Treasury yield.

We are also seeing some green shoots in terms of the potential revival in lending activity, with the recent Fed's Senior Loan Officer Opinion Survey reflecting that loans are at least marginally easier to obtain. Recall that the effects of the current Fed zero interest rate policy have been extremely effective in enabling banks to recapitalize, and now the expectation is that they will use their now-healthy balance sheets to support lending activity.



Finally, the combination of low interest rates, corporate cash coffers overflowing with liquidity, an insatiable corporate bond market and low valuations – along with the rational expectation of challenged growth – has created a fertile environment for strategic merger-and-acquisition activity. Nowhere is the battle of the macro versus the micro more apparent than in burgeoning acquisition activity, with BHP Billiton going hostile in its \$39 billion bid for Potash Corp., and with two technology deals announced just last week – Intel Corp. to acquire McAfee Inc., and Dell Inc. to acquire 3PAR Inc. in a now-contested deal with a competing bid by Hewlett Packard Co. Those who analyze specific companies are seeing value at these levels, particularly in an environment that will be, at the least, growth-challenged.

In the current battle of the macro versus the micro, we acknowledge that the global macroeconomic environment is challenged in terms of growth as well as effective policy initiatives, and we similarly acknowledge that risky asset markets likely fully reflect these challenges with current valuations. We are heartened by the recent spate of strategic acquisition activity, believing that this may unlock some of the long-term equity value in current stock prices.

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

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