

A group of people practicing Tai Chi in a city skyline at sunset. The title 'Rebalancing Act' is overlaid on the image in a large, orange, serif font.

Rebalancing Act

The financial crisis ignited a historic shift in the world economy. Here's what it may mean for your investments.

Stand on one leg long enough and you're bound to take a tumble.

For the better part of two decades, U.S. consumers made up that single leg holding up global growth. The world economy looked like a famous yoga pose.

But when fatigue finally set in, economies worldwide hit the mat.

"American consumers no longer have the financial strength to support global growth all by themselves," notes Jim McDonald, chief investment strategist for Northern Trust. "Much of our spending was financed with borrowed money. We think those days are over."

Which is not an altogether bad thing, McDonald asserts.

Americans spent too much and saved too little in recent decades, while large segments of the world did just

the opposite. That caused severe trade imbalances, which eventually proved unsustainable.

"The global economy had gotten badly out of balance," McDonald notes, "and that's not healthy over the long haul."

Another leg to stand on

It may have taken a near-catastrophe to make it happen, but the global credit crunch could be the catalyst for a long overdue rebalancing of economic growth around the world.

"The composition of the global economy must and will change," says McDonald.

As that transitional process evolves, robust growth in developing countries could give rise to expanding middle classes with more money to spend on

the kind of consumer goods that most Americans take for granted, such as cars, televisions, cell phones and computers.

While McDonald foresees slow and roughly similar growth rates in mature economies, he believes emerging markets will turn out to be a much happier story.

By 2050, nations now classified as "emerging" are projected to make up close to 60% of the world's economic output, up from just 20% a few years ago.¹

The near term also looks promising.

Developing countries are projected to grow by around 5% this year, triple the rate of their rich country counterparts.²

The young and the debtless

Such rapid growth won't happen by accident.

"Most developing countries entered the

global recession in better fiscal shape than did the developed world,” McDonald says. “They learned from their own crises in the 1990s and got their financial houses in better order.”

The housing bubble was concentrated in rich countries, which responded to its demise by spending trillions of dollars bailing out financial institutions deemed too important to fail.

By 2014, advanced economies are projected to owe 120% of GDP, compared to less than 40% for emerging markets.³

Those numbers contradict the perception that developing countries play fast and loose with the public purse strings.

“Sovereign debt issues have gotten a lot of attention recently and we’re watching them carefully,” says McDonald. “But with a few exceptions, the biggest problems are in the developed world.”

It’s not only government balance sheets in emerging markets that are relatively pristine. Corporate debt also is on the low side. In the so-called BRIC nations of Brazil, Russia, India and China, most companies have debt-to-equity ratios of barely one-third that of their American competitors.⁴

Most developing nations also enjoy higher household savings rates than does the United States. That leaves plenty of room to boost spending as living standards improve.

The bottom line: consumption may be set to boom in developing countries.

Investment implications

So, how should an investor approach the prospect of this historic shift?

We believe emerging markets could influence investment returns in two ways: as an asset class whose value currently accounts for only 13% of world equity markets,⁵ and as home to potentially billions of upwardly mobile, mostly debt-free consumers.

“It will be critically important to identify companies that sell to this new class of customers,” McDonald says. “And it won’t matter where those businesses are headquartered.”

Looking ahead, McDonald expects returns from the world’s equity markets to be correlated more to sectors than to countries. He thinks it doesn’t make sense to disqualify thousands of fast-growing, highly profitable businesses just because they are based overseas.

Neither does George Maris, portfolio manager of the Northern International Growth Equity Fund.

“I don’t invest on the basis of where a company is headquartered,” Maris says. “Among other things, I invest in a company because of the characteristics of the industry in which it operates, its financial strength and how well it’s positioned to capitalize on secular trends in global growth and consumption.”

Recognizing those new patterns might compel Americans to broaden their investment horizons by increasing their international allocations. There’s plenty of

scope for such broadening. For instance, U.S. pension plans remain significantly underweight international stocks compared to the foreign component of the MSCI All Country World Index.⁶

But the home country bias is potentially costly. Putting all or most of your eggs in a single market basket could lower long-term returns while boosting volatility. And while some investors believe they’re getting enough exposure to international economies through U.S. multinational corporations, foreign sales account for only 32% of revenue for American businesses.⁷

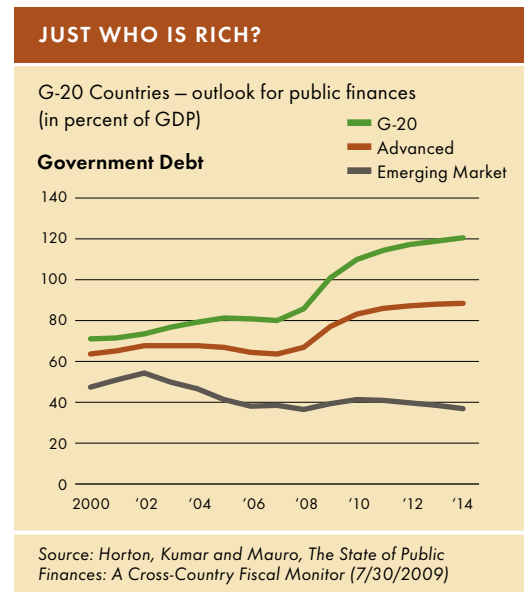
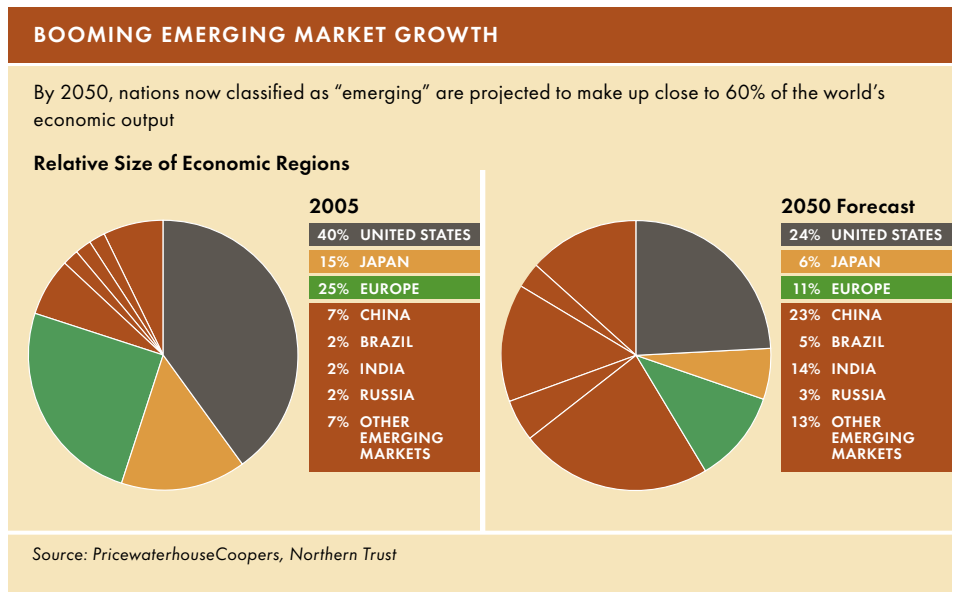
“That’s a very inefficient way of exploiting global growth,” McDonald says.

Is the price still right?

Emerging market stocks soared last year, climbing almost three times more than their developed-world counterparts. After a decade of bubble trouble, you might wonder if things are getting frothy. “We’re always on high alert for excesses,” Maris says, “but, in general, emerging market valuations do not appear unreasonable.”

In fact, the median price-to-earnings ratio of emerging market stocks is about equal to that of U.S. equities,⁸ and while that represents a premium over its historical average, Maris thinks the upgrade is warranted.

“These are not your father’s emerging markets,” he says. “Their finances are in better shape, their currencies appear



strong and their growth rates are attractive. There's a lot to like." Elsewhere, developed market valuations are in line with the long-term average of parity with U.S. equities.⁹

Key drivers

The reconfiguration of the world economy won't happen overnight. Structural issues that have constrained consumer spending in the developing world still remain.

Most countries lack social safety nets that could give their populations confidence to spend. Few provide unemployment insurance or anything close to the American Social Security system.

McDonald forecasts that many countries will make the changes necessary to stimulate domestic consumption in coming years.

But the emergence of consumer-friendly policies won't be the only factor driving a rebalancing of the global economy. The need to develop better infrastructures also will play an important role.

Countries need roads, bridges, rail and telecommunications systems, as well as legal frameworks that safeguard foreign and domestic capital, to reach their economic potential.

"The modern industrialized U.S. economy only started to develop after the rail system was in place in the late 19th century," Maris recalls. "That was essential to the acceleration of consumer spending. Consumption growth is a natural consequence of possessing a healthy economic infrastructure."

China is especially well-positioned to meet its massive infrastructure needs because of its command-style economy.

"What the Chinese government wants the Chinese government gets — and quickly," Maris says. "Command economies have many shortcomings, but there is certainly a lot less political wrangling."

Bean soup

Understandably, some investors still harbor concerns about the reliability of earnings reports from companies overseas. But while such worries were once justified, in recent years various global accounting methodologies have converged.

The creation of the International Accounting Standards Board in 2001 made overseas bean counting similar to that of America's Financial Accounting Standards Board. More than 100

countries, including most emerging markets, now are required or permitted to operate under the International Financial Reporting Standards that were issued in 2003. Those standards are similar to generally accepted accounting principles, or GAAP, which are used by U.S. corporations.

"Political leaders know that investors require transparency now more than ever," says McDonald, "and it's in their best interest to provide it through an accounting system that is trustworthy." Keep in mind that the supposedly iron-clad accounting system used in the U.S. didn't prevent the massive frauds at Enron or WorldCom.

"Good research improves the odds of spotting fraud early on, but the best defense is diversification," he says. The inescapable reality of heightened political risk overseas also could be mitigated through professional management and broad geographic diversification.

Moving on

It's important to note that diversifying internationally doesn't necessarily reduce losses when most economies are infected with the kind of severe financial virus that struck in late 2007.



"We think the best returns in coming years will be a result of having a broad exposure to international markets."

JIM McDONALD,
CHIEF INVESTMENT STRATEGIST,
NORTHERN TRUST

How to Gain Exposure to International Markets

But such global financial pandemics are mercifully rare.

“Geographic diversification can be a big help during the more common periods of localized economic trauma,” says Scott Ayres, senior product manager for Northern Trust.

Though correlations between the U.S. and international markets have crept higher in recent years, they remain below 1.0, indicating that stocks don’t move in lockstep around the world. The tendency of one market to zig as another zags dampens volatility, and thus minimizes the temptation to bail out of stocks at the wrong time.

“That’s why it’s important that investors not concentrate on fighting the last war,” says McDonald of betting only on U.S. companies that sell mostly to over-indebted American households. “We think the best returns in coming years will be a result of having a broad exposure to international markets.”

Time to put that other foot down. **N**

*Diversification does not guarantee a profit nor protect against a loss.

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Finally, if you’re looking for broad exposure to international stock markets through an index product, the Northern International Equity Index Fund and the Northern Emerging Markets Equity Fund seek to replicate returns from the MSCI EAFE and MSCI Emerging Markets Indices, respectively. Funds that mimic broad-based market benchmarks also offer potential advantages for investors. “Indexing can help to maximize diversification while lowering costs,” says Stefanie Hest, investment strategist at Northern Trust.

For more information on how Northern Funds’ international mutual funds can work for you, please contact your financial advisor or visit northernfunds.com.



Equity Risk: Equity securities (stocks) are more volatile and carry more risk than other forms of investments, including investments in high-grade fixed income securities. The net asset value per share of this Fund will fluctuate as the value of the securities in the portfolio changes.

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Managers and allocations are subject to change at any time.

¹ PricewaterhouseCoopers, Northern Trust.

² IMF.

³ Horton, Kumar and Mauro, *The State of Public Finances: A Cross-Country Fiscal Monitor* (7/30/2009).

⁴ JP Morgan. Data updated through 2009.

⁵ FactSet, MSCI. Annual data through 2008.

⁶ *Pensions & Investments*, MSCI Barra (October 2009); FactSet, MSCI. Annual data through 2008.

⁷ MSCI Barra (October 2009).

⁸ Sanford Bernstein. Monthly data through 10/30/2009.

⁹ Sanford Bernstein. Monthly data through 10/30/2009.

Before investing, you should carefully read the prospectus and consider the investment objectives, risks, charges and expenses of Northern Funds. A prospectus with this and other information may be obtained at **800-595-9111** or northernfunds.com.

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