

## A Bumpy Ride, But Not a Tailspin

THE WORD “RECESSION” STRIKES fear into the hearts of most investors, and investors have been hearing the R-word a great deal lately. And the U.S. equities market is likely going to face at least another three months of extreme volatility as the economy flirts with a recession and starts to mend.

Even though the volatility surely will make many investors edgy, the economic fallout won't be harsh, or last as long, as many fear. In fact, this stage in the business cycle could be viewed as an investment opportunity rather than impending Armageddon.

The global economic situation leading up to this recession — if this proves to be a recession — is very different from those leading up to previous recessionary periods in the United States. Before this downturn, the world economy was in the fifth year of a strong business cycle. It was, in fact, witness to the best global output period since the early 1970s. It was marked by significant, above-trend growth driven by global liquidity and accompanied by very strong savings rates in developing markets, which were the primary growth-drivers.

### The Triple Shock: Housing, Credit, Oil

Now, admittedly, the U.S. economy has suffered some shocks. Key among them were the housing and mortgage market crises — both critical components in determining when the economy hits a nadir on which it can begin to rebuild — and oil prices.

Housing currently is in the worst cycle since World War II. The United States normally experiences a 32-month housing cycle, and it's currently in year three. The cycle is nearing the bottom, but not quite there yet. The problem is the huge inventory of homes for sale. Thus, housing starts will need to continue declining and sales will need to begin increasing before the housing sector truly bottoms out. We think the cycle will hit bottom and the numbers start to turn positive again during the second half of this year.

Hand-in-hand with the housing market problems is the credit market, which was torpedoed by well-publicized subprime credit problems that first surfaced over a year ago, and led investors to become increasingly suspicious about all asset-backed securities. In August, yields for asset-backed commercial paper in short-term money markets started to climb, sparking a safe-haven flight to buy U.S. Treasuries. Now money markets generally are viewed as bastions of stability, so these events proved particularly jarring to the entire financial system.

The “freezing up” of markets that is publicized in the press really did occur this time. No one wanted to step out and transact because of asset-backed securities suspicions. In response to the evolving crisis, the Federal Reserve lowered interest rates and injected liquidity by relaxing its discount window borrowing standards, in an effort to un-seize the market. But ultimately, the crisis rattled confidence in the markets and, some would venture, in the Fed itself. U.S. equities hit an all-time high in October, but started unraveling by year-end.

Since October, U.S. interest rates have fallen dramatically and likely will fall even further during the next few months to shore up the economy. The Fed, whose policy curve has fallen behind the market-based curve, likely will cut its Fed funds target rate by another 50 basis points in March 2008 and by another half-point soon thereafter to kick-start the economy.

The third shock that hit the U.S. economy in 2007 was the increase in oil prices. Crude oil broke \$100 a barrel for the first time ever. But because the amount of oil needed to generate \$1 of gross domestic product (GDP) has dropped, the oil price rally hasn't caused the same amount of damage as it might have in the past when it represented a larger portion of GDP.

### Economic Wildcard: Consumer Spending

January's drop in nonfarm payroll numbers scared the Fed. Granted, these monthly figures are notoriously volatile and subject to sometimes-startling revisions, but the overall trend points to a decline in employment. Today's 4.9% jobless rate isn't near the rates typically seen during recessions. Even the possible 5.5% or 6% unemployment rate at the end of this year is lower than what is typical in a recession. But this rate still spooks the Fed because it affects consumer income, which drives spending.

The last decline in consumer spending was in 1991. So the U.S. economy has seen 64 consecutive quarters of growth in consumer spending. Even though liquidity and income have become less volatile during the last 35 years, if unemployment rises dramatically, it will hurt consumer income, thus affecting spending.

### Balancing Stimulus With Inflation Concerns

The Fed's anticipated move to lower the Fed funds rate by another full percentage point in 2008 may help bolster the economy. But at the same time, concerns about recession must be balanced against concerns about inflation.



When you want to stimulate the economy, you ease monetary policy — as the Fed is doing aggressively now — implement fiscal stimulus — as the White House is doing with the tax rebate checks — and depreciate currency.

The most obvious risk of the U.S. dollar's lack of strength is that it will contribute to inflation. The dollar's deflated value increases the cost of foreign goods and services, which can contribute to a higher cost of living for consumers (inflation), which could lead to an increase in interest rates to quell inflation and protect the currency.

The Fed is focused on expectations. And one way to gauge the market's inflation expectations is to take the 10-year nominal Treasury note and subtract the Treasury Inflation-Protected Securities — this shows what the market is pricing in for the consumer price index during the next 10 years. So, even though the market expects that inflation will rise during the next 10 years, it's only pricing in a level of inflation of about 2.2% — which isn't that high.

Because inflation expectations aren't high, the Fed feels it has a window of opportunity to let the currency erode, which would stimulate exports and benefit multinational companies that have business outside the country.

### Credit Access Has Not Dried Up

Fed policy doesn't directly affect consumers; it affects banks. Bank behavior, however, does affect consumers. People, including the all-important consumer, are worried about entering a true bear market because they think bank lending will dry up, taking access to credit with it.

Right now, the government lenders' survey shows that bankers are tightening lending standards. Yet, 90% of businesses say they aren't having problems with financing. The much-ballyhooed bank lending slowdown is evident only in surveys, not yet in actual numbers.

In the capital markets, the price of the 10-year bond, at 3.6% currently, is a stimulant. Even BBB-rated borrowers still can get money at 2.5% over 10-year bonds, which certainly isn't restrictive. But credit spreads are rising as concern about less creditworthy entities has grown. However, even the high-yield market isn't seeing a spread where it was in the early 1990s; nor have there been defaults in this market.

### Is a Recession Inevitable?

Consumer net worth is based primarily on three pieces: housing prices, equity prices and bond prices. Housing prices in the 20 largest metropolitan areas are down 10%, and equity prices appear to be headed lower. But with the equity markets near the bottom,

housing prices will have to be watched to determine whether a bear market is coming.

Equity markets are nearing the bottom because entering this period corporations are in excellent condition. Profit margins as a percent of GDP are holding. Free cash flow is strong and has produced ongoing dividend increases. We expect dividends this year to grow about 10% despite slower economic growth because of operating strength.

Share repurchases continue to fly off the charts, and mergers and acquisitions are again starting to increase, driven by strategic acquisitions. This trend likely will continue unless there's a collapse in earnings.

Aggregate earnings in the fourth quarter were down 20%; yet after excluding financial companies, overall earnings were up 14%. So, outside of the financial industry, corporate performance and earnings are still high. There will be further write-offs in the financial sector, and estimates are probably still too high.

A normal recession would see corporate earnings decline 30%. In such a scenario, the Standard & Poor's 500 index could fall another 5% from where it stands today.

### Sovereign Wealth Funds a Factor

Sovereign wealth funds have become large investors in the global markets. At an estimated \$2.5 trillion, their size dwarfs even the combined \$1.5 trillion invested in hedge funds and private equity. And they're often major players in capital markets.

For example, eight major U.S. and European banks that wrote off more than \$100 billion of subprime-related assets were able to raise \$85 billion in capital from sovereign wealth funds within three weeks. Sovereign wealth funds, led by China, have begun investing more intelligently and actively.

### Follow the Funds, Not the Herd

Because the sovereign wealth funds aren't interested in short-term trading horizons of less than five years, they're not following the herd like many other investors. And neither should you. While I wouldn't advise anyone to run out and take a lot of risk tomorrow, you don't want to compromise your five-year plan by selling into this market.

Globalization is bolstering the economy, the Fed's policy response is stimulative and companies are in good shape going into this period. Even though the market will be much more volatile as it tries to build a base during the next several months, it also likely will overshoot. And that provides opportunity.

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