



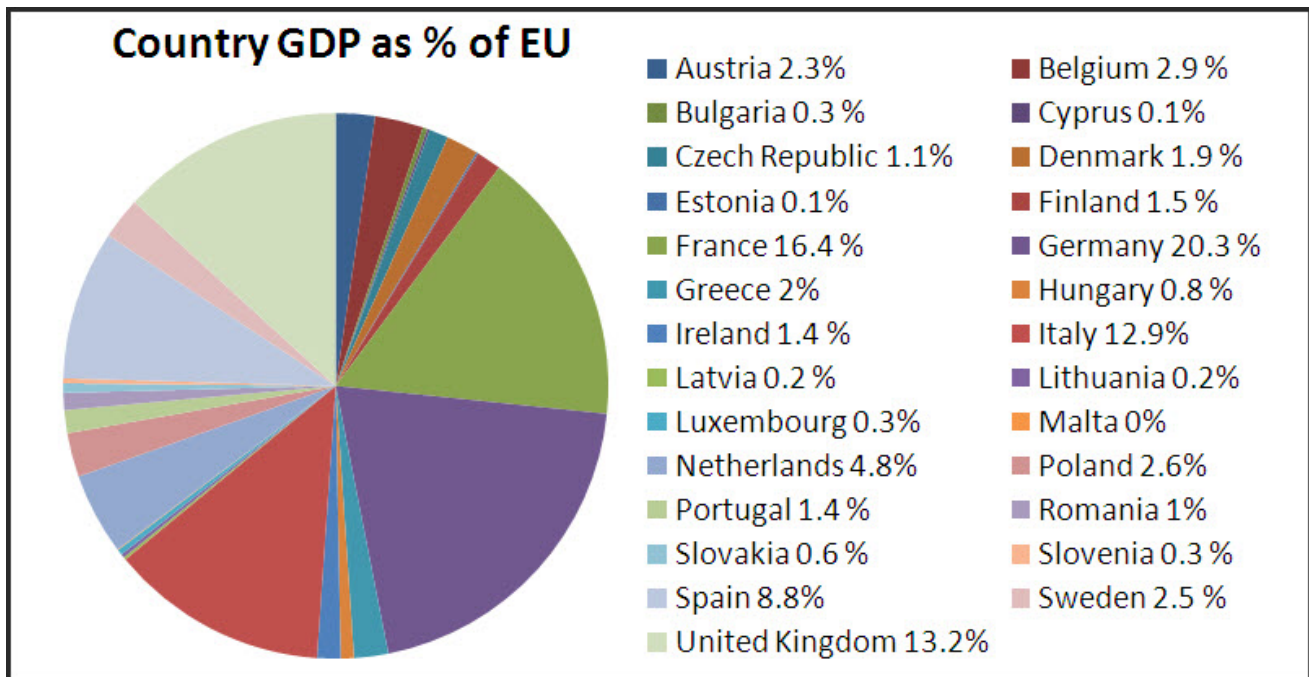
Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Investors proved themselves to be twice shy last week in the market, selling risky assets with abandon and driving global bourses further into the red on a year-to-date basis. Having been burned in 2008 and early 2009 by believing in the decoupling theory, investors are now convinced that growing problems within the Eurozone will jeopardize the fragile global economic recovery, and that asset class correlations will remain very high. Equities around the world lost ground last week, with the Dow Jones Industrial Average breaching the 10,000 mark briefly on Friday. Despite closing above that important psychological level, the Dow lost 0.55% for the week and the Standard & Poor's (S&P) 500 fell 0.72%. Equities across the pond fared even worse, with the pan-European Dow Jones Stoxx 600 losing 2.2%. Emerging markets fared the worst in the unwinding of the risk trade, with Shanghai losing 1.87% and the Hang Seng in Hong Kong losing more than 3% on the week. Commodities followed suit, with crude oil falling 2.33% to \$71.19 per barrel. The asset class of choice last week was the U.S. dollar - thought to be a safe port in this volatility storm. The euro fell to \$1.37, its lowest level against the dollar since May. Whether on a flight to quality or an unwinding of the growing U.S. dollar carry trade, the dollar held its own.

Despite a plethora of U.S. economic data, all eyes were on the Eurozone as concern grew over the growing fiscal problems of some of the peripheral countries in the European Union (EU), specifically Greece, Spain and Portugal. Now, how is it possible that a fiscal crisis in Greece, which is responsible for around 2% or approximately €240 billion (\$327 billion) of the EU's gross domestic product (GDP), is undermining global capital markets? (Greece has a smaller economy than Massachusetts - \$351 billion - and a contribution the size of Maryland's - 1.9% of U.S. GDP.) Unfortunately, we have seen the downside of the domino effect that can take hold when default risk rises and investor confidence falls. While Greece may not represent significance in terms of relative size, when joined by Spain and Portugal - and potentially by Italy - you are suddenly talking about something quite impactful, with a combined 25% of EU GDP represented by those member states.



Data Source: Eurostat

Greece is the most immediate problem, with a budget deficit of close to 13% of its GDP and an economy that is still contracting. Coupled with the difficulty in addressing the profligate spending – we have seen demonstrations and a pending strike as Greek citizens react to austerity measures – Greece may have little choice other than to ask for EU support. We believe that the potential default risk is remote; however, any debt restructuring could take weeks, so it is likely that this will be an issue creating market unease for a while. The end game is quite possibly overt member state support – an interfamily loan of sorts – if Greece can't raise the funds for the April/May refunding at a reasonable interest rate. The premium, or spread, that Greece has to pay above the benchmark German bund had already widened to 400 basis points during the last week, closing at 370 basis points - significantly higher than the 130 basis points the market demanded in October 2009. Further, the reduction in the Portugal debt offering last week from €500 billion down to €300 billion reflects a growing difficulty in issuing peripheral sovereign debt in this environment. In short, any solution will be expensive and will be only a short-term solution to what appears to be a structural fiscal challenge not only in Greece, but in many other peripheral member states.

For the European Central Bank, these issues likely put formal tightening measures on hold. Despite the fact that peripheral corporate debt only represents 14.2% of the EU corporate bond market, much of the credit exposure to these areas is held on local and regional bank balance sheets. Hence, the slower growth that will be a natural outcome of any austerity measures imposed by the EU will likely constrain bank lending and will represent a *de facto* tightening. With economic data out of Germany – by far the strongest contributor to the EU economy at 20% of regional GDP – showing a loss in momentum, it is apparent that the recovery is frail.

Signs in the United States point to a relatively rosier picture, and Friday's jobs report showed that employment is moving in the right direction, albeit slowly. The unemployment rate fell 0.3 percentage point to 9.7%, importantly beneath the psychologically important 10% level, and the manufacturing employment (+11,000) turned positive for the first time since January 2007. The January non-farm payrolls were reported at -20,000, so the economy continues to shed jobs; however, data on hours worked and labor income show improvement. Temporary employment is up 52,000,

which represents a 55% seasonally adjusted annual rate increase over the past three months and the strongest growth in the history of the series (since 1990). While we continue to expect job growth this quarter, the labor market is going to take time to absorb the near 15 million unemployed Americans. Our forecast for a “jobless recovery” *a la* 1991 and 2001 remains a major theme for 2010.

The release of the 2011 budget by Obama was replete with tax hikes and spending freezes but still projects a \$1.3 trillion deficit and a cumulative deficit of \$8.5 trillion over the next decade. This clearly illustrates that the various policies put into place during the global financial crisis, coupled with the significant decline in economic activity, have created a significant headwind against the goal of reducing our government debt - currently 64% of GDP.

We are in the midst of an important transition in the global economy, anticipating the hand-off of the stimulus baton from the public sector to the private sector as we await the normalization of monetary policies and a refocus on organic growth. The increasing concern over sovereign debt in the face of the degradation of sovereign balance sheets; uncertainty around the pace of the policy unwind; the specter of financial regulatory reform; and the longer term impact of the policy measures put into place are weighing heavily on the capital markets at this juncture.

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

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