

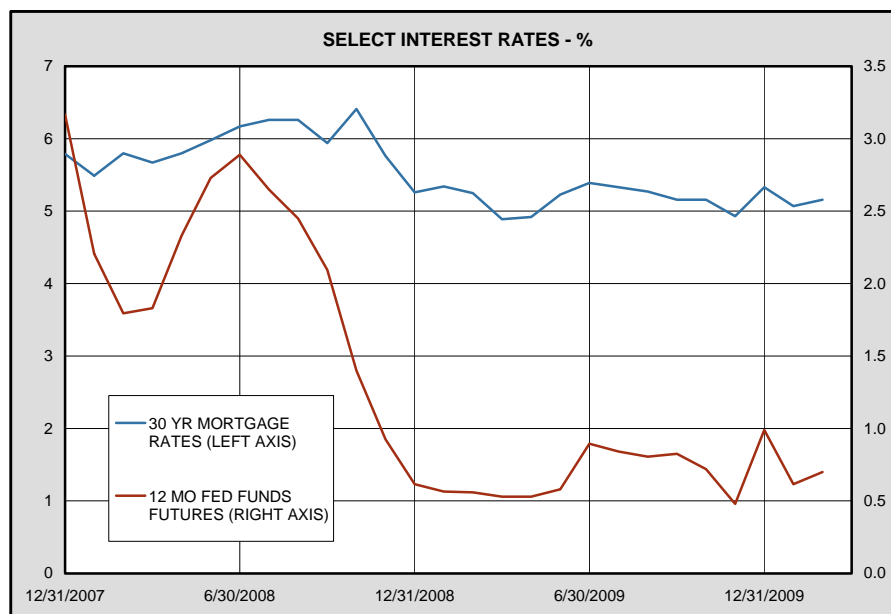


Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

February 22, 2010

Markets briefly fluttered last week when the Federal Reserve announced after the close of trading on Thursday that it was increasing the discount rate from 0.50% to 0.75%. As a reminder, the discount rate is the rate charged banks that borrow directly from the Fed, as opposed to the (unchanged) fed funds rate, which is what banks charge each other for borrowings. Historically, the discount rate has been set at a punitive rate of around 1.00% above the fed funds rate to penalize banks that need to borrow directly from the Fed. Is this a signal that the Fed is gearing up for tightening of monetary policy, or is it just another step in removing emerging liquidity programs established in the wake of the financial crisis? We do not think this is a sign of material monetary tightening to come but view this as a technical move to normalize emergency liquidity programs. But let's discuss the conditions that we think *will* lead to monetary tightening, analyze the Fed's actions in the context of other global central banks and discuss what this all may mean to financial markets.



Source: Bloomberg. Monthly data through 1/31/2010; February data point as of 2/19.

The Fed's dual mandate – to control inflation while also promoting full employment – is typically the framework investors use to assess the outlook for monetary policy. The recent actions taken during the financial crisis, including serving as the lender of last resort to promote stability of the



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banking system, also come into play as we assess the Fed's willingness to tighten monetary policy. The fact that the discount rate still remains below the typical premium to the fed funds rate may be a signal that the Fed thinks the healing of the banking system is only partially complete. The news on the unemployment front remains clear – with the U.S. unemployment rate at 9.7% and going nowhere fast, the Fed must feel political pressure to remain accommodative. Fortunately, we expect the disinflationary pressure of high unemployment and the deleveraging process to allow the Fed to be patient in tightening policy. January's consumer price inflation index, ex-food and energy, showed a drop in prices of 0.1% – the first fall in 28 years. Falling rents (-0.1%) contributed to the decline, and should this continue, the risks of inflation going forward should decline. To that end, the breakeven rate on the 10-year Treasury Inflation-Protected Securities has fallen to under 2.3% over the last two months.

While global central banks loosened policy in a coordinated manner during the financial crisis, differential growth and inflation prospects are leading to widely varied tightening campaigns. China has been leading the way in trying to slow growth of its economy, but with Chinese money supply growing 26% year-over-year in January, more actions should be expected. India's wholesale price index has gone from deflation of 10% at the end of 2008 to a current rate of 20.6% (three-month rate annualized) – central bank actions will result. But the developed economies are still focused on avoiding deflation (Japan) and recession (United States and Europe). These central banks remain firmly in accommodative mode.

The performance of financial markets around the start of a tightening cycle is highly dependent on the conditions leading to the tightening and the subsequent performance of the economy. Currently, we view the actions of the Fed as merely removing some of the remaining emergency liquidity from the financial crisis. We don't see economic conditions forcing rate increases this year, and our economics department has just moved its forecast of the first rate hike to January 2011. Since 1928, there have been 19 tightening cycles and the historical pattern is that after a period of digestion, stocks have generated reasonable gains on average over the ensuing year. According to analysis from Ned Davis Research, the average gain in stock prices three months after the first rate hike is 1.6% but expands to 8.6% after a full year. In two-thirds of these cases, stocks have generated positive returns during this first 12-month period.

S&P 500 RETURNS POST-INITIAL FED RATE HIKE			
MONTHS	AVG. GAIN	# UP	# DOWN
1	0.6%	10	9
3	1.6%	7	12
12	8.6%	13	6

Source: Ned Davis, Northern Trust
 Note: 19 Tightening Cycles Since 1928

So will this tightening cycle also be benign? Like the skilled mountaineer starting to navigate a narrow ridge, we have confidence that the Fed can traverse the early part of this journey successfully. However, the winds could easily whip up, given the unbalanced nature of the global economic recovery and the extraordinary role of government in today's economy and markets. To keep with our mountaineering analogy, we have our harnesses and helmets in place but expect the

Fed's efforts over the next year to be broadly successful. However, we remain on the lookout for storm clouds and are ready to call off the climb if prudent.

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