



Perspective on the Latest Market Events

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Equity markets rallied sharply last week, delivering a welcome respite from the slide that has pummeled financial markets. After plunging to 12-year lows, global stock markets advanced for four consecutive days last week. In the United States, the cumulative gains approached 10% in major market indexes, while the XLF – an exchange traded fund tracking share performance for a broad group of financial sector stocks – vaulted 33% by week's end.

Encouraging management commentary from America's largest banking institutions largely drove last week's rally. Specifically, the CEOs of Citigroup, Bank of America and J.P. Morgan Chase all asserted positive operating performance during the first two months of 2009 and dismissed speculation about their need for further federal assistance. Last week's other corporate news included Standard & Poor's (S&P) long-anticipated downgrade of General Electric's credit rating to AA+ from AAA, a move that was less severe than many investors had expected and which helped buoy stocks.

Economic news was relatively light but decidedly mixed: first-time unemployment claims continued rising, but February retail sales registered less weakness than the consensus forecast. More important, however, were last week's developments on the policy front. Before last week's rally, the S&P 500 index had lost 27% since the 111th Congress convened January 6 and 15.5% since President Obama's January 20 inauguration. These declines reflected investors' widespread dissatisfaction with the recently passed fiscal stimulus bill and budget appropriation, the combination of which will propel both federal borrowing and operating deficits to post-World War II highs.

Monetary policy has not proved sufficiently stimulative, either. Despite its November 25 pledge to purchase up to \$600 billion of high-grade mortgage and government agency bonds, the Federal Reserve has so far acquired less than \$100 billion of these securities. In addition, the introduction of the Fed's Term Asset-Backed Loan Facility (TALF) has been repeatedly delayed due to concerns over the program's operating complexities. As a result, the Fed's balance sheet has actually contracted by more than \$400 billion since December 2008.

Fortunately, last week witnessed some notable progress on other important policy fronts. Rep. Barney Frank, D-Mass., who chairs the House Financial Services Committee, signaled his support for reinstating the "uptick" rule. This rule, introduced in the Securities and Exchange Act of 1934 but revoked in July 2007, required that short sales in a publicly traded security be executed at a



price *higher* than the immediately preceding trade in that security. Supporters believe the uptick rule can once again prevent short selling from exacerbating downward pressure on securities prices that already are declining. Congressman Frank's comments in favor of reinstatement follow similar remarks from Fed Chairman Ben Bernanke.

Also last week, Rep. Paul Kanjorski, D-Pa., led a hearing on the Financial Accounting Standards Board's (FASB) Rule 157, the now controversial "mark-to-market" accounting practice that forced banks and insurance companies to recognize massive losses in their securities portfolios. Critics of FASB 157 claim that its strict application in the current environment is unduly punitive, since the "marks" used to determine "fair value" are typically disconnected from (i.e., much lower than) true, intrinsic value as a result of today's distressed and illiquid credit market conditions.

Last Monday, legendary investor Warren Buffet told CNBC's audience that applying mark-to-market accounting during a banking crisis was like throwing "some gasoline on the fire." Indeed, the huge non-cash write-offs realized by financial companies have eroded their regulatory capital levels at precisely the same time that raising new equity to meet adequacy requirements is either impossible or prohibitively expensive. During Rep. Kanjorski's hearing, FASB Chairman Robert Herz agreed to provide revised guidance on the application of Rule 157 within three weeks, bolstering hopes that this change may mitigate the rule's onerous effect on bank and insurance company balance sheets.

It remains to be seen, however, whether these deliberations will yield productive policy changes. Moreover, this week's Federal Open Market Committee meeting should provide greater clarity into the Fed's plans for TALF and its progress on other elements of its "quantitative easing" campaign. We are encouraged by last week's equity market rally and the improved corporate and policy news that sparked it. Nonetheless, we wait for better evidence that fiscal, monetary and regulatory policy actions are producing improvements in credit market and banking system conditions before we take a more aggressive posture in portfolio construction.

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