



Perspective on the Latest Market Events

Commentary from Bob Browne, Chief Investment Officer

April 13, 2009

The Law of Unintended Consequences

Now that central banks and governments have gone “all-in” to stabilize the global financial system and reverse the sharpest economic contraction since the Great Depression, it might be beneficial to review a few laws of the physical world and capital markets. One is Newton’s second law of motion, which loosely states that an object will change velocity and direction when pushed or pulled, depending on its mass and the force applied.

Right now, the fiscal and monetary policies of the United States and other major governments are geared toward pushing two objects of substantial mass back into motion: the securitization and housing markets. Policymakers realize that these two objects are very much linked to a third object of large mass: the financial industry. Unfortunately, they cannot push the securitization and housing markets without inadvertently also pushing other objects that just happen to be in the way. Thus, they can control neither the direction nor the velocity of *all* the objects they ultimately are pushing.

Some governments, including our own, admittedly are trying to push additional objects – education programs, infrastructure projects, equity prices, aircraft financing, etc., – that were not part of the original problem. Inevitably, all this pushing of different objects of different masses in different directions and at different velocities will lead us back to the law of unintended consequences: *If you don’t know what you’re pushing, you don’t know where it will go or how fast it will get there.*

It is the job of any investor to forecast expected events and manage risks around unexpected events. The market seems once again to be focusing too much on the former and not enough on the latter. While we, at Northern Trust, certainly are monitoring the two objects of substantial mass (securitization and housing markets), it is also necessary to analyze risks and opportunities with regard to the other objects. In particular, we have focused on the unintended beneficiaries of the U.S. government’s largesse. For those portfolios where it is appropriate, we have increased our recommended risk exposures surgically in three areas during the past two months: commodities, high yield fixed income and emerging market equities. We also continue to believe that there are multiple opportunities within the municipal bond sector where across-the-board credit concerns are misplaced. None of these objects were intended recipients of the Federal Reserve’s quantitative easing or the Treasury’s Public-Private Investment Program (PPIP), yet, they will likely be disproportionate beneficiaries.

We have up until now evaluated our risk exposures from a valuation and macroeconomic perspective. But it also is helpful to have a physical perspective of these asset classes, which have



less mass and never were at rest. By contrast, the housing and securitization markets are larger objects that *are* at rest and thus need more force to start moving.

Here are some facts: the value of outstanding U.S. mortgage-backed and asset-based securities at the end of 2008 was \$11.6 trillion¹. The total value of money market instruments – another key object of the Fed’s attention – was another \$3.8 trillion². In order to support these markets and lower the yield levels of their debt securities, the Fed has expanded its balance sheet by more than \$1 trillion³, lowered the Fed funds rate to effectively zero percent and started purchasing U.S. treasuries. While not specifically stating so, the Fed is also keeping an eye on U.S. equities, a \$7.3 trillion⁴ market. Compare this to the size of the U.S. high yield market (\$440 billion)⁵, the municipal bond market (\$2.7 trillion)⁶ and emerging markets (\$1.7 trillion)⁷. The total size of the commodities market is harder to pin down but here is one fact: total net purchase demand of gold in 2008 was only \$115 billion⁸. Compare that to the total value of U.S. homes being purchased at an annualized rate – about \$920 billion⁹. The housing number is just for the United States, while the gold number is the entire global market.

We are dealing with objects of very different mass here, and yet they are receiving the same force: lower risk-free rates, expanded central bank balance sheets and greater market liquidity. The Fed is hoping that it is the two large objects – securitization and housing markets – which will move. So this is where two of its recently applied major forces, PPIP and the expanded Term Asset-Backed Security Lending Facility, are focused. But capital is fungible, and so there is another law of the capital markets which we should remember: excess capital will gravitate toward the object offering the greatest potential reaction.

Data Sources: ^{1,2,6}Securities Industry and Financial Markets Association. ³The Federal Reserve Board. ^{4,7}MSCI Barra. ⁵Barclays Global Investors. ⁸World Gold Council. ⁹National Association of Realtors.

Important Information

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. This material is for information purposes only. The views expressed are those of the author(s) as of the date noted and not necessarily of the Corporation and are subject to change based on market or other conditions without notice. The information should not be construed as investment advice or a recommendation to buy or sell any security or investment product. It does not take into account an investor's particular objectives, risk tolerance, tax status, investment horizon, or other potential limitations. All material has been obtained from sources believed to be reliable, but the accuracy cannot be guaranteed.

