



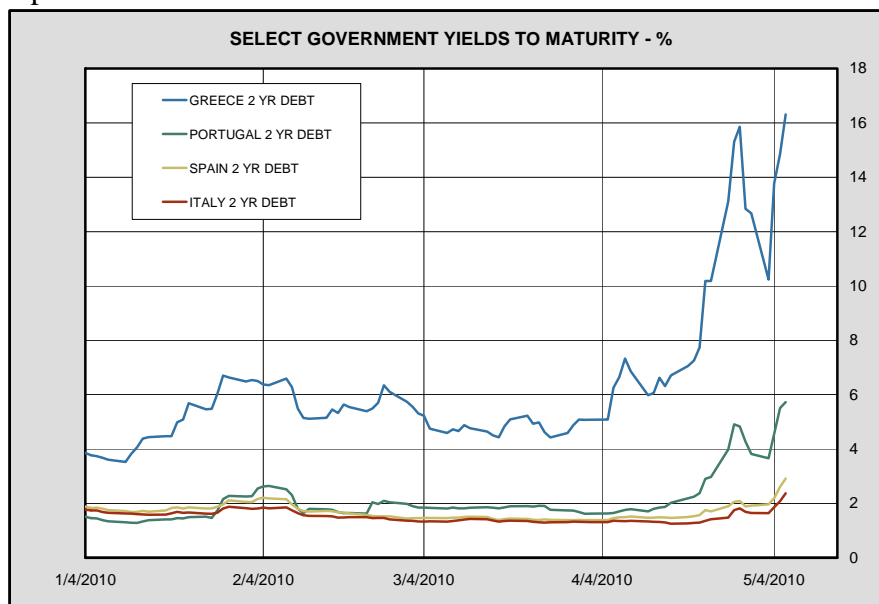
Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

May 7, 2010

This week has seen a significant sell-off in global equity markets, primarily due to concerns over the building sovereign debt crisis in Europe. The pressure on stock markets was exaggerated on Thursday by a trading problem in the U.S. markets, leading to a near 1,000-point intraday drop in the Dow Jones Industrial Average (DJIA). At this point, it isn't known if this was a trading error, accelerated trend trading by computer-driven models, or something else altogether. But the DJIA was already down by more than 400 points before the plunge and recovered to close down nearly 350 points, or 3.2%. So the plunge was a bit of a sideshow to an already deteriorating market, but it could clearly increase risk aversion among some investors.

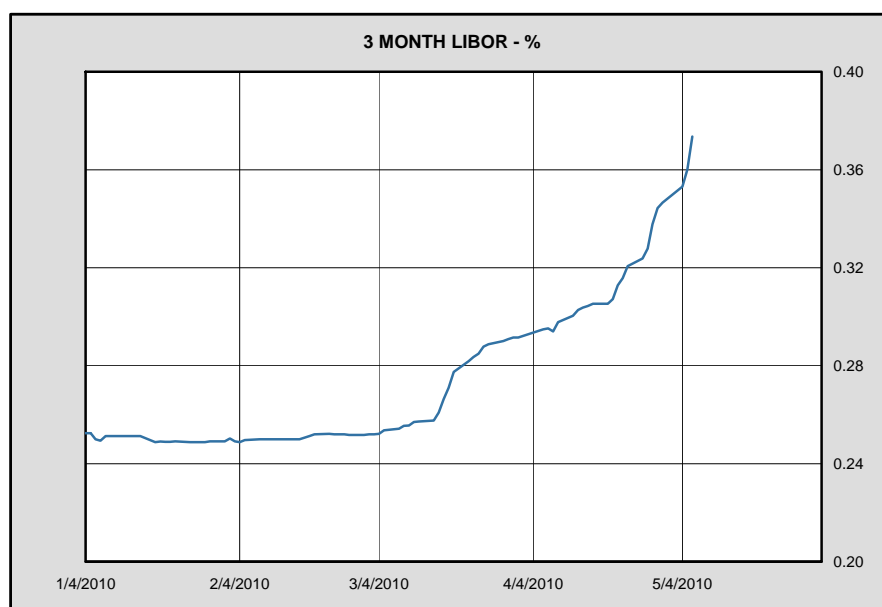
We have been constructive on risk assets such as emerging market and U.S. equities and commodities over the last year, predicated on the improving economic fundamentals and easing credit conditions. Also, the steady and benign inflation outlook was expected to allow for a continuation of accommodative monetary policy. However, the situation in Greece has deteriorated beyond our expectations as market participants have become increasingly frustrated with the lack of eurozone leadership in dealing with this mounting problem. We had identified Greece's debt problem as one of the key risks to the outlook for risk assets, but our confidence in a positive resolution to this problem has diminished over the last several weeks.



Source: Bloomberg. Daily data as of 5/7/2010.

We do think that Greece and Portugal could be at risk of needing to restructure their debt levels, while we think that Spain and Italy should be able to handle their debt loads. While the possibility of Greece or Portugal failing is not so worrisome, given their relatively small size and importance to both the global economy and the health of banks' balance sheets, the prospect of contagion could have much farther-reaching negative implications magnified by the uncertainty of government involvement. The repeated attempts to put the Greek debt situation to rest have been rebuffed by the markets, and it doesn't appear that European authorities understand what it will take to satisfy the credit markets. And at yesterday's meeting of the European Central Bank, leaders did little to change that perception. An additional handicap in fighting a financial crisis today is that little fiscal ammunition remains after the efforts over the past two years, so monetary policy must take center stage.

Most worryingly, contagion could potentially result in a frozen credit market (similar to the aftermath of the collapse of Lehman Brothers), which would be damaging to a still-recovering global economy. European banks and insurers are significant investors in the troubled Southern European economies, and to the extent they worry about the value of those related investments, their willingness to extend credit to support financial markets or the economic recovery will fall. Our fixed income team notes that measures of credit conditions, including the London Interbank Offered Rate (LIBOR) and liquidity in eurozone government bonds, are showing signs of strain and could deteriorate further from current levels. This is also happening in an environment where money market funds are moving to increase their liquidity, reducing their willingness to extend maturities and alleviate credit market pressures.



Source: Bloomberg. Daily data as of 5/7/2010.

Given the current environment, and the lack of clarity about how European leaders will address the situation, we think the attractiveness of risk assets has diminished and that it makes sense to raise cash levels until the risk of the investment landscape becomes clearer. Specifically, we think that equities (developed ex-U.S. and emerging markets) and commodities will not perform as well during this period of market uncertainty, and that cash reserves and gold are appropriate substitutes.

Making moves like this reduces the pro-cyclical tilt of a portfolio, creating some breathing room to assess the markets' likely direction going forward. For example, will the European authorities become more assertive, allowing risk-taking to return and the global economic recovery to retake center stage? Or will they fumble along, leading to growing credit market worries and increased investor risk aversion? Finally, increasing concerns are emerging about the health of the Chinese economy. One of our equity research analysts is currently in China and is raising concerns about an infrastructure overbuild and resulting slowdown in the demand for commodities and overall economic activity. As we gain additional insights into these issues, we will decide whether it makes sense to take risk levels back up again or to become more defensive.

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