Insights from Northern Trust

June 21, 2010

Commentary from Richard K. Barnett, West Region Chief Investment Officer

The new watchword is "austerity." Capital markets rallied for the second week in a row, creating optimism that the recent selloff in equities and commodities driven by fear of eurozone debt contagion is abating. For the week, the Standard & Poor's (S&P) 500 finished up 2.2%, while the NASDAQ was up 2.8%. On Tuesday, the Dow Jones Industrial Average advanced through a widely followed technical barrier and crossed the 200-day moving average to close at 1,115.

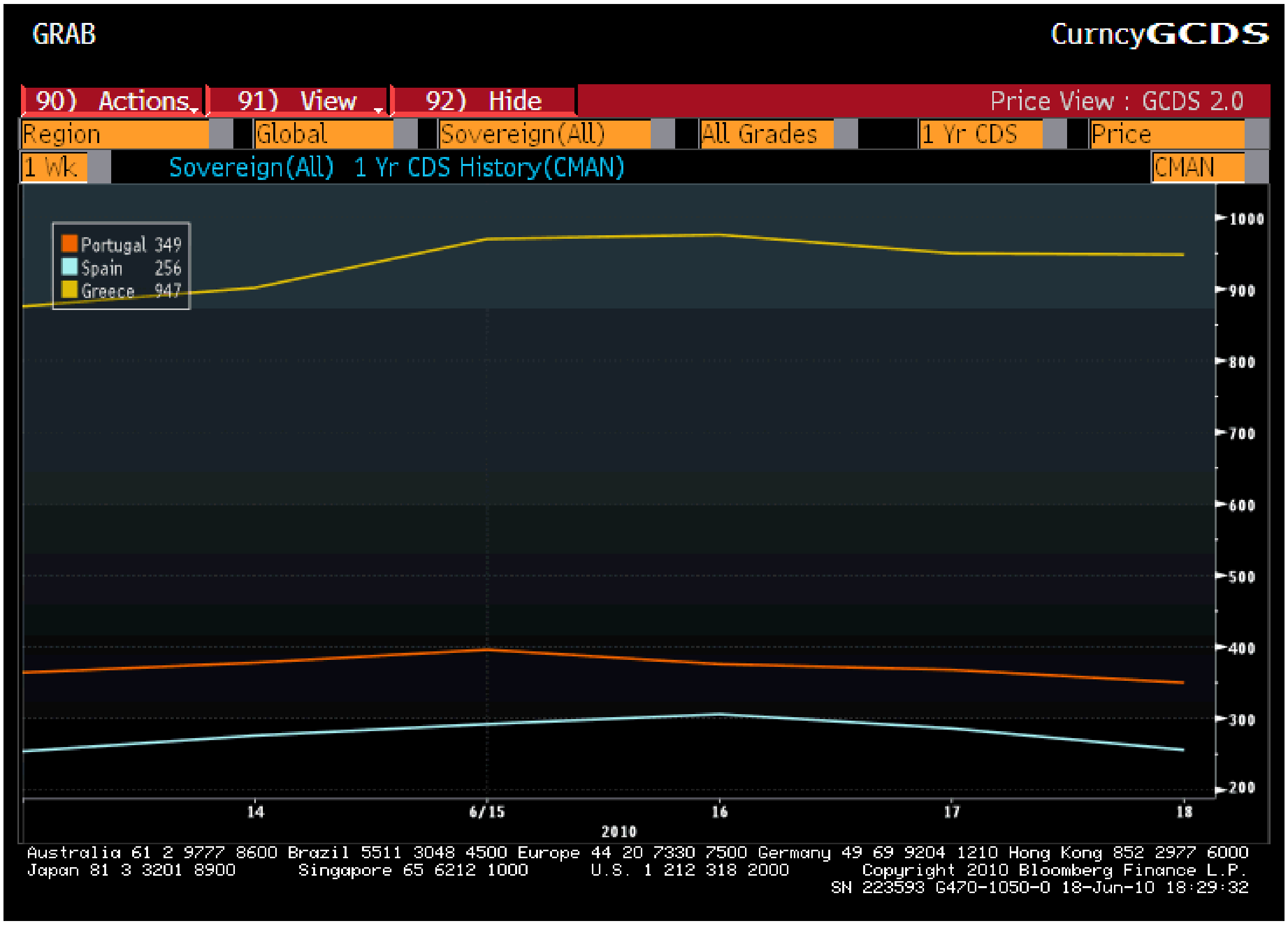
Stock market returns were more upbeat in Europe, which continued to stage a relief rally based on positive announcements of fiscal austerity measures. The French CAC 40 stock index was up 3.7% for the week, the Spanish IBEX stock index rose 4.3%, and the Swedish OMX advanced 3.8%.

U.S. Treasuries gained for the week on signs of low inflation and anticipation of continued forbearance from the Federal Reserve. The 10-year U.S. T-note yield fell by two basis points for the week to finish at 3.22%. Interest rate expectations, implied from federal funds futures pricing on the Chicago Mercantile Exchange, showed a 75% chance that the Fed will maintain or cut interest rates by its December meeting, up from 62% one month ago.

The week ended well for the stock market after a rocky start, as Moody's cut Greece's credit rating to Ba1, or high-yield (aka "junk") status on Monday. This move paradoxically had little effect on the market, where Greek debt was already trading as high-yield bonds.

Fiscal and monetary responses to the debt crisis in Europe continued, as France introduced a proposal to raise the retirement age in France to 62 from 60. This compares to the retirement age of 67 in Germany. The proposal will cut state pension costs as retirement phases in over time. In debt-burdened Italy, the government of Prime Minister Berlusconi approved a €24 billion austerity package that freezes public sector wages for three years and cuts ministers' salaries by 10%. It also plans to shrink the government body by replacing only one for every five public sector employees who leave their jobs. These austerity measures are unpopular in Europe, and we may see a powerful political backlash played out over the next election cycle.

European short-term credit default swaps, which are a reliable market measure of the riskiness of debt instruments, actually ended only mildly higher for Greece and flat for Spain and Portugal, reflecting a slight stabilization in the overall economic and credit environment.



On the economic front, inflation continues to be benign, as the U.S. consumer price index (CPI) fell 0.2% in May after a 0.1% drop in April. Core CPI, which excludes energy and food, edged up slightly by 0.1% in May after holding steady in April. The wholesale measure of inflation, the producer price index, was actually deflationary for the month, falling 0.3% in May after a 0.1% drop in April. With inflation at bay, the Federal Reserve is free to pursue growth-oriented policies to encourage the tepid economic recovery. Housing starts in May were disappointing at 593,000, which was 55,000 lower than expected and 79,000 below the prior month.

Initial jobless claims stood at 472,000, which was 12,000 higher than the prior week and 22,000 higher than analysts' forecasts, in an uncomfortably consistent pattern of the jobless recovery. Continuing claims also rose by 88,000 to 4.6 million. On a positive note, the index of leading economic indicators (LEI), which is widely followed at Northern Trust and the industry, increased by 0.4% in May after holding steady in April. The year-to-year change in the index reflects a smaller gain in the second quarter (+9.6%) compared with the first quarter (+10.4%). Industrial production rose 1.2% in May following a 0.7% increase in April. The 4.8% jump in the nation's utilities helped to raise overall production.

On Thursday, BP agreed, under pressure from the Obama administration, to place $20 billion in an escrow account against pending and future claims for damages related to the worst oil spill in U.S. history. BP stock recovered from a recent low and fueled the U.S. equity market upward as Wall

Street finally had some, if still limited, clarity on the magnitude of the potential damages. This relief was realized despite President Obama's comment that $20 billion was not a cap on damages. BP also announced that it would cut its dividend and sell $10 billion in assets to help cover costs from the spill.

The euro hit a three-week high above $1.24, off a recent low of $1.20, due to increased confidence from the successful Spanish bond auctions and austerity measures.

In a move of some historical significance, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, known by their colloquialisms Fannie and Freddie, are set to be delisted from the New York Stock Exchange, formalizing the fact that these are government-owned and controlled entities after a massive bailout by the U.S. government during the credit crisis of 2008 - 2009. The eventual financial reform of these institutions likely will take many more billions of dollars, and is being postponed until at least 2011 by the Obama administration.

Over the weekend, the Chinese confounded the world with their currency controls. Saturday evening, perhaps because of innumerable not-so-subtle requests from the United States and others, China announced that it would finally allow its currency, the renminbi, to fluctuate to a "managed floating exchange rate." The announcement was not received well at home, and 24 hours later, the Chinese central bank said that any appreciation would be minimal and gradual. On Monday, to reinforce the aforementioned, the People's Bank of China kept the yuan's exchange rate unchanged from Friday's 6.8275 to the dollar. Nevertheless, Asian stock and commodities markets reacted favorably to the news as prices rallied in trading on Monday morning.

This week, we look ahead to the G-20 summit on European debt management in Toronto. In advance of the summit, President Obama sent a letter to G-20 leaders urging them to focus on policies to stimulate economic growth. This is in sharp contrast to the prevailing view of European politicians, led by German Chancellor Angela Merkel, to focus on fiscal austerity.

Richard K. Barnett holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.