



Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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The strength of the rally in global financial markets rests on the foundation of the successful policy actions and economic recovery realized to date. The monetary policy measures — massive in the United States, smaller but still measurable in Europe and Asia — have led to a significant improvement in financial conditions, such as credit spreads and availability. These improved financial conditions, in turn, are facilitating an economic recovery that is currently being driven by a global inventory cycle. But the improved financial conditions and the current economic recovery are still somewhat fragile due to their dependence on government involvement and their vulnerability to an untimely unwinding of this artificial support. So what will the financial and economic landscape look like as we transition to the second phase of this recovery, where governmental support is withdrawn and end demand needs to become self-sustaining? To slightly torture a baseball analogy, when the team stops taking steroids, will they still hit .300?

It would be hard to overstate the restorative effects of the massive monetary policy actions implemented over the last year since the failure of Lehman Brothers in September 2008. Central banks have kept short-rates extraordinarily low, and with a term structure that helps boost bank profitability as they “borrow short and lend long,” the yield curve has been very stimulative. Interbank lending, as measured by the London Interbank Offer Rate (LIBOR), has improved from a peak in the three-month spread of 3.64% in early October 2008 to a current low of 0.125%. The commercial paper market, so important to short-term financing for major corporations, has improved significantly due to the Fed’s implementation of the Commercial Paper Funding Facility (CPFF) last year. Longer-term corporate finance markets, as represented by investment grade and high-yield credit, have also measurably improved in both price and liquidity over the last year.

As this success has been realized in recent months, the focus of policymakers and investors has moved toward the strategies to exit these extraordinary support programs. Probably the most visible of these programs, the Troubled Asset Relief Program (TARP), has seen current commitments shrink to just \$292 billion (as of July 31, 2009) out of a potential of \$699 billion as banks have rushed to repay the government to demonstrate their financial health and escape extraordinary oversight. U.S. financial institutions are also likely to shortly face the conclusion of the Temporary Liquidity Guarantee Program (TLGP), under which they have issued \$339 billion of new debt against a potential total of \$1 trillion. The TLGP was established to allow financial firms, which were facing frozen credit markets last fall, to issue debt guaranteed by the FDIC when investors were balking at buying their non-guaranteed debt. These programs are two of the most visible being



wound down, and we are optimistic that the banks and markets are ready for this transition. To be sure, though, financial companies likely will face a higher cost of capital for the foreseeable future as their days of over-reliance on wholesale funding markets are over.

As the Fed and Treasury focus on winding down individual liquidity programs, focus will increasingly turn toward traditional monetary policy. In a more typical business cycle, the Fed would be biased toward raising rates sooner rather than later to minimize the risk of inflation. This time around, they are acutely aware of the risk of removing the stimulus too early and fortunately, we foresee a benign inflationary environment facilitating this approach. They will be especially attuned to the excess reserves banks currently hold at the Fed and making sure that any activation of those reserves into loan creation and therefore money supply growth remains measured. The current rate of growth in the money supply, which has fallen from 12% last fall to around 4% today, is not a cause for concern at the Fed.

So while we expect the Fed to remain accommodative for an extended period, other central banks are likely to be less patient. Israel, whose central bank recently raised interest rates, was dismissed by analysts as being too peripheral to the global economy. But attention is now turning to South Korea as the next possible “tightener,” which would be noteworthy as a reflection of resurgent economic activity in Asia. As economies less hurt by the global financial crisis start to tighten financial conditions, their higher interest rates will likely support their currencies and pressure the currencies of those countries still being accommodative (e.g. the U.S.).

So will the global economy and financial markets “team” remain a .300 hitter in a post-steroids era? The initial signs of financial market repair are encouraging, but in the U.S. there is still considerable dependence on the government (think Fannie Mae, Freddie Mac, General Motors, AIG, etc.). Economic growth is enjoying a strong bounce as improvement in new orders is leading to increased production plans, with the strongest growth in Asia and surprisingly better growth in Western Europe. So the global recovery will likely show some players returning to their old batting averages more quickly than others, with the ones who juiced the most (think the U.S.) having a longer rehabilitation period. In the wake of this likely path of repair and in our opinion, participation in global markets for growth and currency reasons looks increasingly attractive.

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