



Insights from Northern Trust

Commentary from Bob Browne, Chief Investment Officer

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The employment data released last Friday was welcome news to anyone looking for signs of a meaningful turnaround in the real economy. After losing 469,000 jobs on average each month through the first nine months of the year, the United States has lost “only” 61,000 jobs on average the past two months. It seems likely that job growth once again will be a net positive sometime in the first quarter of 2010 and that is, indeed, a much-needed turnaround for the economy.

The financial markets, of course, have been fabulously turned around for several months now, but the response of the U.S. equity market was indecisive for once, settling up only 22 points on the Dow Jones Index on Friday after having been up over 150 points at one time. The source of this indecisiveness was the interest rate market, where bond prices sold off on fears that the Federal Reserve is now that much closer to its tightening cycle if the positive trend in employment continues. The Fed funds futures market is, in fact, now discounting a hike of 50 basis points in the official short rate by June 2010. That’s only about six months away. A lot can happen in six months – believe me, I know – but the beginning of a protracted hike in rates by the Federal Reserve is not one of them.

Over 7 million jobs have been lost in the past two years while new entrants continue to join the work force. Even if the recent positive momentum is maintained, we likely will be well into 2011 before even 2 million of those lost jobs are replaced. All the while, we need to create about 125,000 - 150,000 jobs every month just to break even because that is the growth of the work force. Is the Federal Reserve really going to risk a sustainable recovery and put those jobs at risk with a premature tightening? More importantly, is the Fed willing and able to put at risk all its hard work so far? Did it really bring interest rates to zero, balloon its balance sheet, help orchestrate the bail out of AIG and the takeover of Merrill Lynch, allow Morgan Stanley and Goldman Sachs to become bank holding companies in their hour of need and finally, did they commit the cardinal sin of central banking – the monetization of government debt – just to blow it all away by creating the uncertainty and volatility that inevitably comes with a change in interest rate policy? No way. They know there is no second act. This is it. We need a sustainable, demonstrable recovery in the real economy, and that will not happen until there is quarter after quarter after quarter of job growth and home price stability. That is not happening by June 2010.

Balance sheets remain large and collateral values remain fragile despite their impressive rally since the lows of the crisis. The good news is that the housing market is on the verge of bottoming out – maybe – and risk capital is gathering steadily to fund the required commercial real estate refinancing, which is anything but small over the next two years. The Fed cannot afford to risk this, especially in an election year. The surest way for the Fed to jeopardize a recovery is by extrapolating a trend. The president of the Federal Reserve Bank of Philadelphia, Charles Plosser, recently said the Fed needs to be forward-looking when determining policy. He used one of my own favorite quotes from hockey great Wayne Gretzky, who famously said he



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skates “to where the puck is going to be, not to where it has been.” The Fed must move to where the puck is going to be, says Plosser.

So where will the puck be a year from now? That is, indeed, the question and quite simply, the answer is: no one has a clue. All I know is that things are much better than they were a year ago and I much prefer today’s environment to the one we had in September 2008. I think I am in a comfortable majority on that one. But let’s look forward a year from now and separate the “what we really know” from what is simply a forecast. A year from now, it is reasonable to expect that credit spreads will be low, capital will be accessible for large companies and positive job formation will have taken hold. Exports will gain momentum on the back of a weak dollar and stronger growth overseas. These are not certainties, but I am willing to bet on them. They are all “good guys” which lend support to Plosser’s argument that the puck is moving to a place requiring interest rate tightening. Before you skate over to that part of the rink, however, remember that all of the above are merely forecasts. Now let’s focus on what we know for sure. A year from now, the current fiscal stimulus in place will have all but been spent while higher taxes will be in place. That is a massive fiscal reversal. In addition, we will be in the middle of implementing and dealing with a major healthcare reform in one form or another. We also will just have completed the mid-term elections, and who knows what that might bring. Finally, the banking and commercial real estate sectors will have just begun a massive rollover of debt coming due over the next three years. Do you still know where the puck is going to be a year from now?

If the Fed gets this wrong, the consequences will be severe. Investors have learned to shoot first and ask questions later. Somebody is always caught on the wrong side of an unexpected change in interest rate policy. Many major financial institutions are assuming “extended period” means just that. It is important to note that neither the Fed nor the market thus far have made any distinction between rates being kept low for emergency measures versus being kept low to support the real economy. While the Fed possibly may make a token hike to remove the legacy of emergency zero percent interest rates, rates nonetheless will remain “low” for a long time and the market no doubt is positioned accordingly. As we have stated before, the Fed cannot afford to surprise the market.

We continue to believe that commodities and emerging markets remain the unintended beneficiaries of this liquidity support. More importantly, their long term fundamentals appear attractive. Gold sold off sharply on Friday, but it was long overdue for a correction. The story for tangible assets remains in place. Do we worry that the Federal Reserve might catch us and the market off guard? Absolutely. Interest rates actually have had a nasty seasonal bias of rising sharply from March through June over the past several years, and signs of life in the job market might give birth to this trend once again. We are constantly thinking about our potential downside and what can go wrong with our assumptions. We hope the Fed is going through the same process.

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