INVESTMENT STRATEGY COMMENTARY

THE DEBT CEILING DEAL: HOLD THE APPLAUSE

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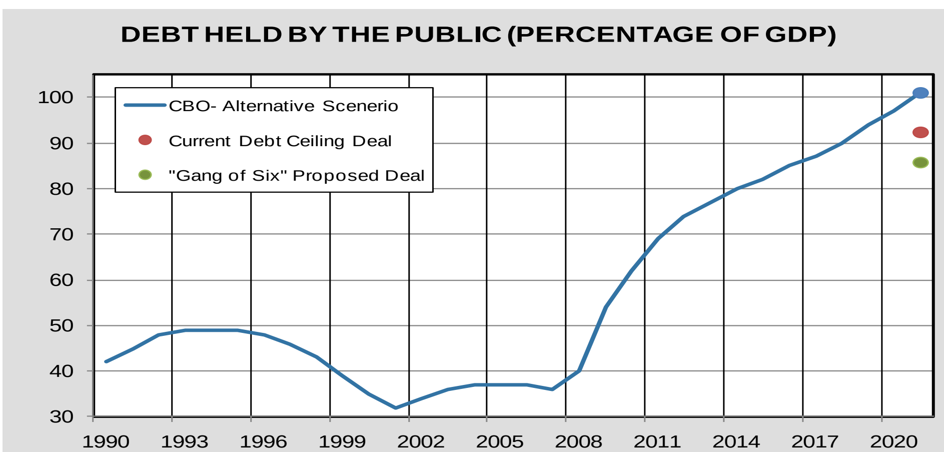
The agreement to raise the debt ceiling reached this week between Congress and the Obama administration has avoided the worst outcome – a default by the U.S. government through the delayed payment of interest or principal on outstanding debt. But the package didn't sufficiently reduce the longer-term deficit issues, didn't address tax reform and relies on Congressional committee work through the rest of 2011. As shown in Chart 1, the Congressional Budget Office estimates the national debt at 100% of gross domestic product (GDP) in 10 years. We estimate this plan could reduce it to 92%, while the "grand bargain" of $3.7 trillion in deficit reduction could bring that level down to 86%. But at least the political dialogue has moved in the direction of budgetary restraint, a positive development.

It has long been our view that the longer-term fiscal debate wouldn't be determined around this debt ceiling discussion. That debate will be the focus of the 2012 Presidential election. This agreement should take the question of default off the table through the election, deferring the big questions on spending and taxes until 2013. In this report, we will analyze the deal that was struck, discuss why it is so important, address the relative standing of the United States and the U.S. dollar, review the outlook for interest rates, and discuss potential industry winners and losers.

CHART 1: THE OUTLOOK FOR THE FEDERAL DEBT



Source: Congressional Budget Office (CBO); Northern Trust Global Investments.
Note: Represents the CBO's Alternative Budget Scenario.

THE DEAL: AVOIDING DEFAULT, BUT RISKING DOWNGRADE

Table 1 includes the key items agreed to in the debt ceiling plan. Importantly, the agreement includes provisions that allow an increase in the debt ceiling totaling $2.4 trillion, which should allow funding of the deficit through 2012. It is critical to understand that this is not the authorization to spend additional monies – it is just creating the ability to pay bills we already have incurred or will agree to incur going forward. The collective spending cuts of $2.417 trillion agreed to modestly exceed the debt ceiling increase, but are heavily dependent on the $1.5 trillion of cuts that a Congressional committee must agree to by November 23. The plan includes, as a trigger for action, an automatic $1.2 trillion in budget cuts (half from defense, half from domestic spending) if the committee doesn't meet its deadline.

TABLE 1: KEY ELEMENTS OF DEBT CEILING DEAL

Item	Plan Amount	Timing	Notes
Debt Ceiling Increase	$400 billion $500 billion additional Up to $1.5 trillion additional	Immediate September 2011 During 2012	Avoids risk of near-term default President Obama can enact these two increases, only overridden by two-thirds vote from Congress
Discretionary Spending Cuts	$917 billion $1.5 trillion additional	Over next decade Over next decade	Defense and non-defense spending Congressional committee to identify by November 23, 2011; vote by December 23, 2011. If agreement isn't reached, $1.2 trillion in cuts enacted (half defense, half domestic spending).

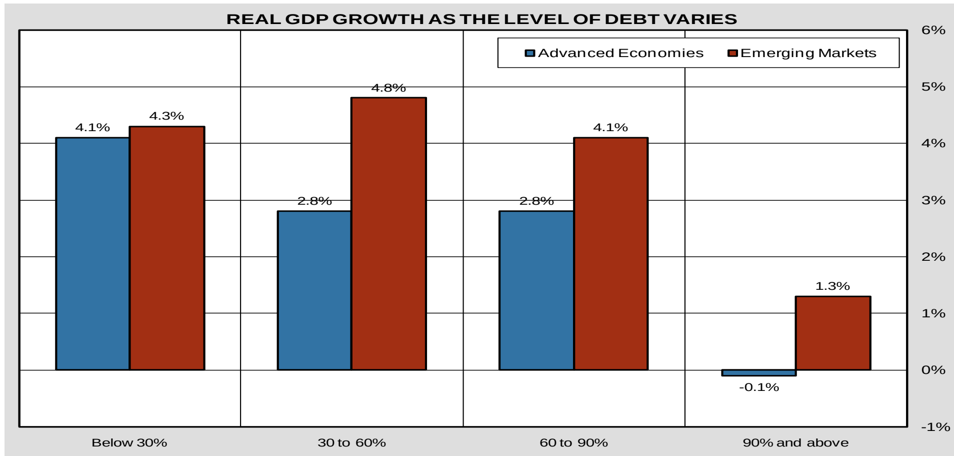
Source: ISI; Northern Trust Global Investments.

The AAA rating of the U.S. government debt has been placed under watch for a potential downgrade by Standard & Poor's (S&P), depending on the budgetary specifics of the debt ceiling deal. While S&P previously stated a positive view toward the $3.7 trillion in deficit reduction in the "Grand Bargain," the agency has not been entirely clear about what level of deficit reduction will be required to stave off a downgrade. It seems logical that they may wait for the results of the Congressional Committee agreement on November 23 to make their decision. We don't see a downgrade as a major negative event for U.S. Treasuries. It would surely create substantial noise in the media and in political circles, but we think many global investors have been pricing in this possibility for some time.

DEBT ACTS AS A GROWTH SUPPRESSOR

The importance of the debt debate can be analyzed through a historical lens, looking at the impact growing debt levels have had on economic growth over time. A study by renowned economists Carmen M. Reinhart and Kenneth S. Rogoff (December 2009) analyzed the economic experience of 44 countries over a 200-year timeframe. The results are highlighted in Chart 2. The research shows that while the linkage between economic growth and debt levels is weak when debt is below 90% of GDP, median growth falls by one percentage point when debt is above 90% of GDP. Average growth falls considerably more in this circumstance. Reasons for this range from the negative fiscal drag caused by governmental budget cuts to the suppression of animal spirits as businesses and consumers are unsure what taxation and legislative environment will emerge from government in response to the debt problems.

CHART 2: ECONOMIC GROWTH SLOWS AS DEBT LEVELS RISE



Source: Reinhart & Rogoff, December 31, 2009; Northern Trust Global Investments.

"BELT-TIGHTENING" IS THE MOST COMMON RESPONSE

So how have countries historically dealt with unsustainable debt growth? A January 2010 study published by McKinsey Global Institute examined the 45 episodes of deleveraging that have occurred since 1930. Of these periods, 32 followed financial crises. Four paths to deleveraging were identified, with the most common being "belt-tightening" that leads to years of sub-par economic growth. The two pernicious paths, "high inflation" and "massive default," usually occurred in countries with weak central banks or after a country experienced a currency crisis. We think the United States' path toward belt tightening is the right one. But without a focus on increasing growth, it will be incomplete. After all, the key ratio investors worry about is debt as a percentage of GDP – so reducing the debt levels while growing GDP is the quickest path toward fiscal health.

TABLE 2: DELEVERAGING PATH WILL DRIVE GROWTH AND INFLATION OUTLOOK

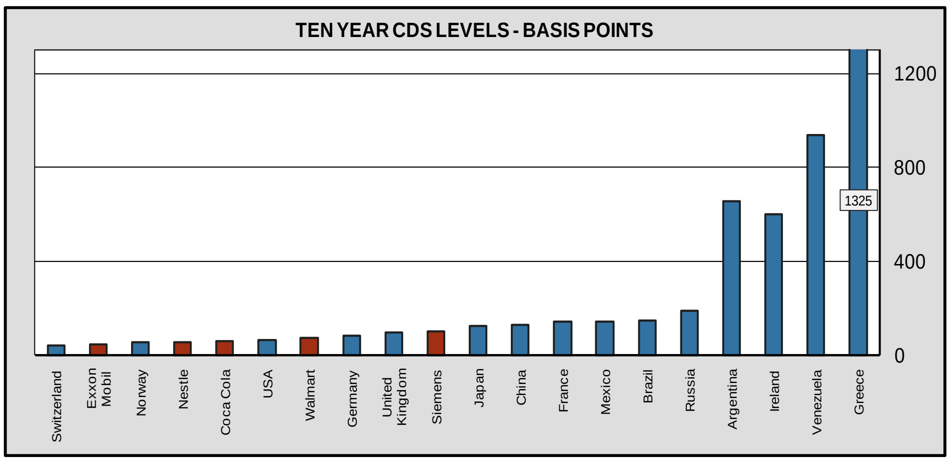
Path	Description	Frequency	Examples	
Belt Tightening	Most common path. Rate of growth of debt is slower than nominal GDP growth.	23/45	Finland Malaysia United States S. Korea	1991-98 1998-08 1933-37 1998-00
High Inflation	Usually occurs with weak central banks. High inflation increases nominal GDP, reduces debt/GDP rations.	12/45	Spain Italy Chile	1976-80 1975-87 1984-91
Massive Default	Often after a currency crisis. Debt outstanding decreases due to massive defaults.	7/45	United States Argentina Mexico	1929-33 2002-08 1982-92
Economic Growth	Often after war or oil boom. GDP grows well above trend, reducing debt/GDP ratio.	3/45	United States Nigeria Egypt	1938-43 2001-05 1975-79

Source: McKinsey Global Institute; Northern Trust Global Investments.

UNITED STATES LOOKS GOOD COMPARED WITH ITS PEERS

The debt explosion in developed countries after the most recent financial crisis has changed the whole analysis of the global economy, growth and credit risk. One of our long-term themes is the increasing creditworthiness of top-quality global corporations, such as Nestlé and Coca-Cola, which are currently viewed as less risky than the United States, Germany and the United Kingdom. These companies benefit from much greater control over their own destinies – moving operations to favorable geographies, controlling their own balance sheets, and managing their long-term pension and healthcare liabilities. These are issues in which developed countries, in particular, are handicapped by addressing their fiscal positions.

CHART 3: CREDIT DEFAULT RISK AMONG COUNTRIES AND COMPANIES



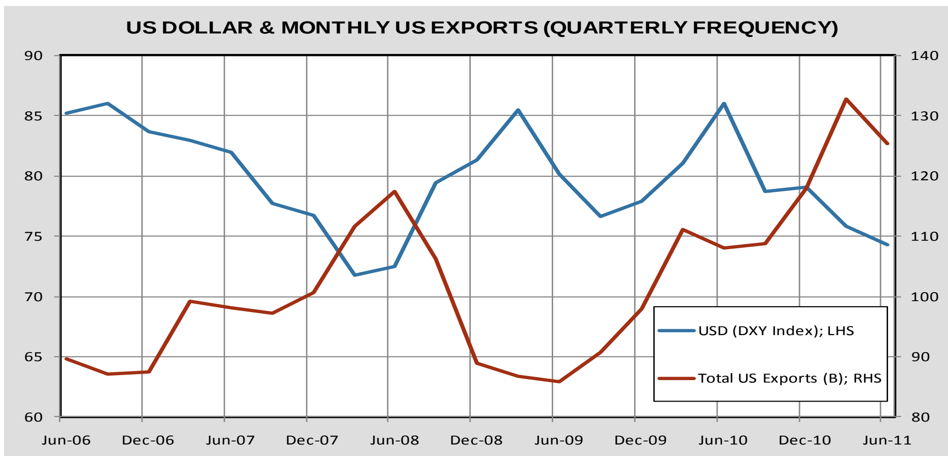
Source: Bloomberg; Northern Trust Global Investments. Data as of 8/01/2011.
Note: Corporate CDS levels in red, sovereign levels in blue.

Relative to other major economies, the expected default risk (as measured by the credit default swap level) of the United States is relatively low. The United States stacks up well against its major currency competitors (the euro and yen), as credit default swaps on Germany are higher than in the United States (due to Germany's contingent liability for much of the rest of Europe), and Japan's are measurably higher (due to the high level of debt and weak demographic outlook). We think this is an indication that the market continues to give the United States some leeway to tackle its debt challenges, a break it is receiving due to its reserve currency status and its better long-term economic prospects.

DOLLAR WEAKNESS: A LIKELY POLICY OBJECTIVE

Investor concerns over the value of the U.S. dollar have been high since even before the peak of the financial crisis. Surely, the United States' large trade deficits, fiscal imbalances and loose monetary policy should lead to a falling currency. Relative to our trading partners (as measured by the trade-weighted dollar exchange rate), the dollar has fallen from a level of 88 in February 2009 to the current level of 74, a decline of 16%. Declines against currencies such as the Brazilian real and the Swiss franc have exceeded 30%. So the U.S. dollar has been losing relative purchasing power versus these currencies, yet U.S. policy makers have expressed no great discomfort with this depreciation. Why is this so?

CHART 4: DOLLAR DEPRECIATION DRIVING EXPORTS



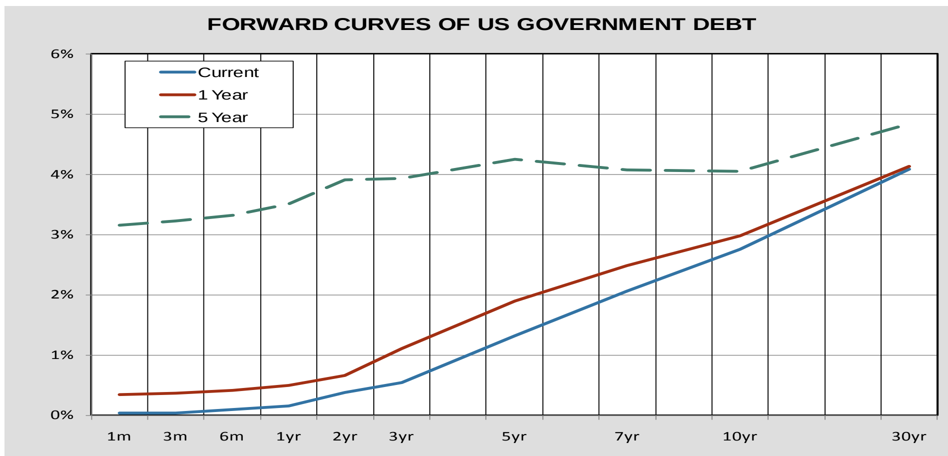
Source: Bloomberg; Northern Trust Global Investments. Data as of 8/01/2011.
Note: Shaded region denotes recessionary period.

To start, the currency depreciation has caused no meaningful negative implications to the U.S. economy so far. Interest rates have remained remarkably contained (more on this later), while inflationary trends also are not worrisome. Instead, the United States has enjoyed booming exports – a lonesome outperformer in our otherwise torpid economic recovery. One of the significant benefits of flexible exchange rate systems is the rebalancing effect currency adjustments can facilitate. Conversely, this points out one of the key weaknesses of the European Monetary Union – where countries in financial difficulties (e.g., Greece) are tethered to a relatively strong currency that doesn't adjust to improve their international competitiveness. They are left with "internal adjustments," such as punishing austerity measures, as their primary policy path. The U.S. dollar seems likely to see continued pressure over the medium term from several fronts – large trade deficits, sovereign wealth fund currency diversification and interest rate differentials disfavoring the United States. When coupled with our expectations of muted inflation and interest rates during the next several years, depreciation of the U.S. dollar is likely to continue to serve as a catalyst for export growth.

MUTED GROWTH AND INFLATION TO CAP INTEREST RATES

We continue to believe the outlook for interest rates in the developed economies is fairly benign during the next five years. As we highlighted in our April 2011, paper, *The Specter of Rising Interest Rates*, we believe the outlook for growth and inflation are the primary drivers of interest rates. Historical evidence in both the U.S. and U.K. bond markets does not indicate a correlation between deficit levels and interest rates. Chart 5 shows the current expectations in the fixed income markets for future interest rates, as evidenced by forward interest rate contracts.

CHART 5: INTEREST RATE OUTLOOK IS RESTRAINED



Source: Bloomberg; Northern Trust Global Investments. Data as of 8/01/2011.

As stated earlier, we believe the effect of a ratings downgrade on U.S. interest rates will be relatively minor. We do not see money market funds being forced sellers of U.S. debt, while there is some potential for an increase in the term premium for longer-maturity bonds. So we could see a modest steepening in the yield curve, but we emphasize the term modest. We continue to see a surfeit of global savings looking for a home, and this is especially acute in shorter-dated maturities, which also have experienced shrinkage in supply of available securities. But the volatility in the Treasury market may be elevated during the next couple of years, similar to the European experience, as legislators address the longer-term budget challenges. There will likely be some increasing diversification by global investors away from Treasuries; however we do not expect a stampede due to the continuing reserve currency status of the U.S. dollar and the level of savings being created by deleveraging.

STOCK IMPLICATIONS: DEFENSE AND HEALTH CARE LOSE

Many areas of the market will feel the secondary effects of future efforts to reduce our debt burden, including the potential closing of corporate tax loopholes, expiration of payroll tax cuts and their related effect on corporate and consumer spending. However, a few sectors are affected more directly – most notably, healthcare and defense. We also see an impact on the financial sector, which has avoided the destructive effect of a default, but remains exposed to possible actions that could dampen a housing recovery. While we don't see any industries that will particularly benefit from the debt ceiling deal, over the long term we continue to favor those sectors benefiting from global growth and a depreciating dollar, such as energy, industrials, materials and technology.

The good news for the healthcare sector is that some areas remain sacrosanct under the proposed legislation. These include individual benefits under Social Security, Medicare and Medicaid; veterans' benefits and pensions; civil and military pay; and Women, Infants and Children's (WIC) programs. However, while individual benefits under Medicare and Medicaid are protected, providers of medical services, such as doctors and hospitals, would be subject to cuts. The overall cut to Medicare is expected to be about 2%. In terms of publicly traded companies, the principal victims of the legislation appear to be hospitals and other direct service providers. It appears direct federal spending on drugs, biotech and high tech medical devices will remain largely intact.

We note two other risk factors. The joint House/Senate committee that must find an additional $1.5 trillion in savings over a decade might not view Medicare and Medicaid as sacred. It could make cuts in those programs, hurting healthcare broadly, and Congress is currently expected to just give a yes or no vote on the entire package. A second risk is that, if the committee cannot agree on at least $1.2 trillion in budget cuts, spending cuts would automatically take place across the federal budget – again affecting doctors and service providers. As is currently being discussed, however, Medicare and Medicaid (as well as Social Security, certain veterans' benefits, and federal employee retiree benefits) are exempt from cuts.

In general, we think the psychological pressure on healthcare share prices will be greater than the financial impact, at least as the proposed budget changes now stand. Hospitals and other health care providers face a somewhat greater financial risk, as do to those selling low-tech (commodity) goods to those healthcare providers.

Regarding the defense industry, initial cuts to defense spending of $350 billion over 10 years are roughly in line with the $400 billion over 12 years proposed by President Obama this past spring (and likely priced into stocks). The worst-case scenario for a second round of cuts is another $500 billion over nine years, assuming the joint commission is unable to come up with a plan. Veterans' benefits and military pay are both exempt from the second round of cuts, indicating procurement accounts will bear the brunt of the cuts – a negative for defense companies. The total $850 billion of cuts over 10 years is well above the $400 billion suggested by President Obama, but not as bad as the $1.1 trillion suggested by an earlier Senate plan. A possible offset to this negative news is that the cuts come over 10 years, and the world is still a dangerous place (unfortunately). These are not post-Cold War spending reductions like we saw in the 1990s. Events during the coming years may require higher spending on defense to ensure our military capabilities can handle threats to U.S. interests at home and abroad.

Following healthcare and defense, the next most affected sector is likely to be financial services. We see the most important issues for the sector being potential rating agency actions against U.S. debt, and any effect on housing from changes to the mortgage interest deduction or the operations of

Fannie Mae and Freddie Mac. The debt deal is clearly helpful to the financial sector, as a default would have had an unquantifiable, but significantly negative, impact. While a downgrade of U.S. debt remains a possibility, we believe the financial sector would find it manageable. A downgrade may increase collateral needs, reducing leverage, but the overall effect should be limited (if our broader call on the effect on interest rates proves correct). In the short term, we do believe the investment banks likely pulled back risk, being unwilling to bet on political outcomes, which will weigh on trading revenue in the third quarter. The longer-term concerns from the debt ceiling increase may come in the form of negotiated reductions in the government support of the housing market, potentially in the form of smaller deductions for mortgage interest or changes to the support of Fannie Mae and Freddie Mac. This could dampen the housing recovery, raising credit costs for the banking industry.

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