

INVESTMENT STRATEGY COMMENTARY

IT TAKES TWO TO MAKE A DEAL

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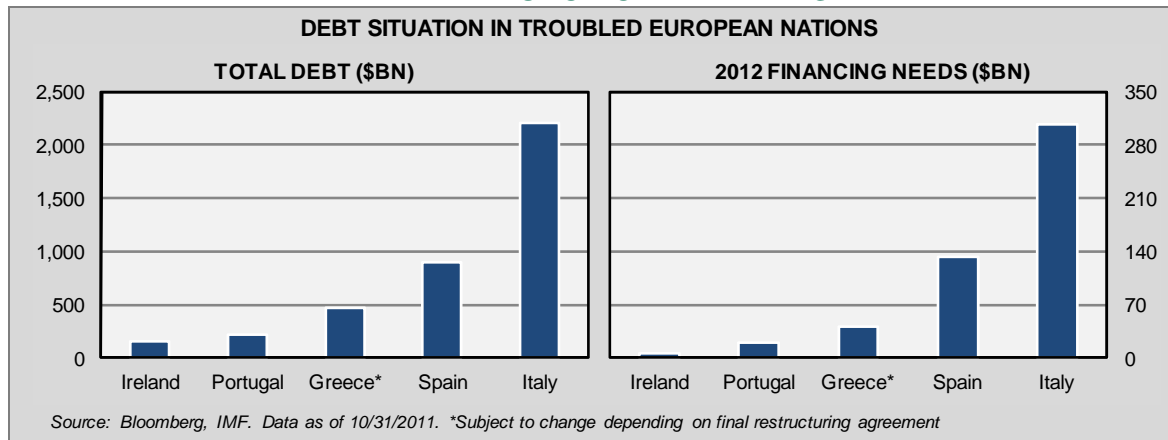
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We have been of the view that European leadership – along with the International Monetary Fund (IMF) – would provide the required financial support to facilitate an orderly restructuring of Greek debt. That view still holds today, but a changing political atmosphere in Greece may mean that the support isn't accepted and the restructuring becomes disorderly. Facing continued protests and political isolation in Greece, Prime Minister George Papandreou decided yesterday to ask for a national referendum on the most recent bailout package. He also faces a confidence vote on Friday. Change in Greek political leadership could lead to a wholesale renegotiation of the European Union (EU) bailout packages, which throws considerable uncertainty into the restructuring process. Additionally, if a national referendum vote is held in January, market volatility will be high through this period, as the structure of the referendum and the politicking around it will be heavily scrutinized. These developments raise the risk of unmanaged default in Greece, with the potential for investors to apply this template to the much-larger Italian bond market.

EXHIBIT 1: EURO BOND MARKETS



Shocking markets, Papandreou calls for confidence vote, referendum

Monday evening Greek Prime Minister Papandreou unexpectedly announced that a parliamentary confidence vote will be held this Friday and requested that the Greek president hold a referendum vote in January. If the PM receives a no-confidence vote, an early election will follow within 30 days, potentially ending the possibility of a referendum. Just today, the prime minister's slim majority has apparently slipped from 153 seats to 151 out of 300 total seats. The primary opposition party, New Democracy, has already suggested it would not support a referendum; however, a change in government could lead to a disruptive renegotiation of the current agreement. If Papandreou retains confidence, the current president may agree to hold a referendum to put this divisive issue in front of voters. Current polls suggest that Greeks are firmly against the proposed austerity measures but support remaining a member of the Eurozone. Therefore, how the vote is framed – either as anti-austerity or pro-euro – may have a significant impact on the outcome. Meanwhile, the third tranche of financial support to Greece has been approved by the



EU but not yet by the IMF. We expect some additional clarity on the situation after the G-20 meetings and the regularly scheduled European Central Bank meeting this week. Any commentary about the ECB's bond purchase intentions and liquidity support plans will be critically important.

Greek developments impede European rescue plan

The uncertainty surrounding the no-confidence vote and referendum raises the risks of a hard default, exit from the euro and contagion toward larger Eurozone members. A quick review of the key points put forth by European leaders last week is in order. Bondholders have agreed to a 50% haircut of Greek debt in a voluntary restructuring, without triggering credit default swap payments (and the unknown consequences of that event). The agreed debt reduction, which is forecasted to reduce Greek debt/gross domestic product (GDP) to 120% by 2020, will still leave its debt burden very high. A recapitalization plan for Euro-area banks was agreed, using a 9% Tier One capital ratio on Basel "2.5" guidelines. All bank sovereign debt holdings are to be marked-to-market as of September 30, 2011. Additionally, agreement was apparently reached to leverage the European Financial Stability Facility (EFSF) to increase its impact. Press reports indicate leveraging by a factor of four or five times, but details are lacking so this can't be considered a done deal yet.

The retreat by Greek politicians throws these accomplishments into question. While the Institute of International Finance (representing global financial institutions) proclaimed their continued support today for the previously agreed deal to haircut Greek bonds, this has to be considered open to discussion if the Greeks are potentially going to renegotiate. Additionally, the ability to leverage the EFSF becomes more difficult due to diminished European support and a reduced appetite from third-party investors (such as the Chinese) to fill the void. Finally, Greece has internal payments due within weeks, and its next external payment is due in December. IMF approval of the next bailout tranche will likely be contingent on agreement of Greece's financing plans for the next year.

While Greece is worrisome, the market is more concerned about the potential impact of difficulties in the Italian bond market. Italian leaders were asked to provide a plan to European leaders to improve competitiveness and reduce deficits, and the resulting communications have not yet increased the confidence of bond investors. While Italian 10-year yields had a brief rally after the deal was announced, they have resumed increasing and breached 6.2% today. Italy has a significant refinancing need of slightly more than \$300 billion in 2012 and can only lean on its relatively low current fiscal deficits for so long. Without increased growth and reduced social spending, Italy will be unable to reduce the growth of its debt level as a percentage of GDP. Risks have increased that investors, after seeing the deterioration of Greek politics, increasingly view the Italian risk through this prism.

Longer-term, governance and growth challenges for the European Union remain. The agreement from last week does contain language discussing the enactment of balanced budget legislation in national constitutions, and work is apparently ongoing on common corporate and transaction taxation policy. More importantly, the transition to an economic union on par with the monetary union is critical, but the resulting loss of sovereignty is a painful cost – as the current travails of Greece show.

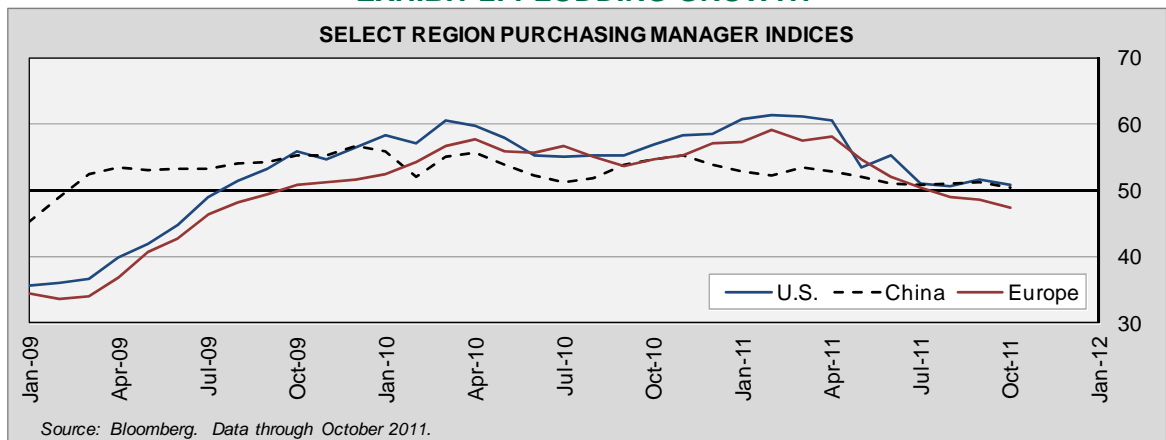


European growth hurt by continued turmoil

European economic growth must be reinvigorated longer-term to help service the high debt loads. Near-term, the European economy has been losing momentum in the wake of austerity programs and appears to be slipping into recession. Increased uncertainty around the rescue plan, including attendant pressures on European financial institutions, will raise pressures on growth. European banks are already being pressured to increase capital ratios, which they can accomplish by raising capital and/or reducing risk assets. The more worried bankers become, the more credit may contract at a time the economy can least afford it.

The United States and China face somewhat unique circumstances with respect to their current economic cycles. In the United States, despite Europe's woes, we continue to think recession will be avoided. The most cyclical parts of the U.S. economy (housing, commercial construction and consumer durables like autos) are not elevated and thus do not have far to fall. In fact, the most recent Purchasing Manager Index still shows expansion, including a fall in inventories and a rise in new orders. To note, however, prices paid in the month of October fell to 41.0 from 56 – mirroring a fall that appeared in the Chinese data. In China, official government statistics showed economic growth slowing to 9.1% in the third quarter after numerous tightening of monetary policy over the last year. More worryingly, the price of copper (down 20% year-to-date) and the recent input cost data (at a level of 46.2 versus 56.6 last month) indicates deceleration of growth. Where China is unique, relative to its large economy peers, is in its ability to engage in substantial monetary and/or fiscal policy stimulus. As we think emerging market inflationary trends, and monetary policy, have now moved toward easing (note the input cost data above), China is in a better position to supplement growth if necessary.

EXHIBIT 2: PLODDING GROWTH



Conclusion

With the risk of a disorderly default of Greek debt rising over the last day, and the attendant consequences of rising risk aversion and worsening European growth, we strongly favor U.S. equities versus EAFE equities. In the fixed income market, we believe high yield bonds are more attractive than investment grade bonds and cash. And we continue to view gold as a potential hedge against currency debasement and geopolitical instability.



The asset allocation changes mentioned in this report were developed by the Tactical Asset Allocation Committee, and approved by the Investment Policy Committee, on November 1, 2011.

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