NORTHERN TRUST
Perspective℠

January 18, 2012

OUTLOOK

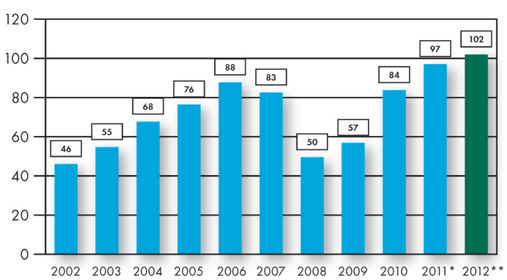
Our 2012 outlook calls for a "tug of war" between the prospects for improving growth from the G-2 (United States and China) and the European sovereign debt crisis. Economic growth continues to be stunted by the depressive effects of deleveraging across the developed markets. Inflationary trends have begun to recede in emerging markets, which we believe sets the stage for a sustained period of easier monetary policy. Investor risk appetites remain low, as high volatility and headline risk from Europe offset an attractive valuation picture for equities. A positive surprise in European fiscal policy, in an environment of stable global growth, is a potential upside risk for global stock markets.

Monetary policy in Europe has become significantly more accommodative under new European Central Bank (ECB) head Mario Draghi. While European politicians continue to fumble an aggressive policy response, the ECB recently introduced an unlimited three-year liquidity facility for European financial institutions. This has led to a significant improvement in yields on shorter-term bonds from Spain and Italy, while progress on longer-term bonds has been slower. The ECB's action has bought some time for politicians to advance their policy plans, while also measurably reducing the odds of a financial accident. The overall magnitude of the debt burden hasn't been reduced, however, and it will take improved growth and spending plans to entice private investors back in force.

U.S. growth has been surprising to the upside, as we anticipated. We expect Europe, however, to undershoot the relatively benign consensus growth forecasts for 2012. Markets don't stand still, however, and the euro's 14% decline over the eight months improves the outlook for Europe's exporters. While near-term trends still show deceleration in emerging market economies, we expect this to stabilize and then reaccelerate as the year progresses with continued easing of monetary conditions. The prospects of stronger G-2 economic growth would help Europe buy time for further progress in developing its "fiscal compact" and calming the bond markets.

CENTURY CLUB

S&P 500 operating earnings are expected to break through the $100 per share level this year.



Left Axis:
- S&P 500 operating earnings
- Northern Trust estimate

Sources: S&P, Northern Trust

Note: *Contains fourth-quarter 2011 consensus estimate, **Northern Trust estimate

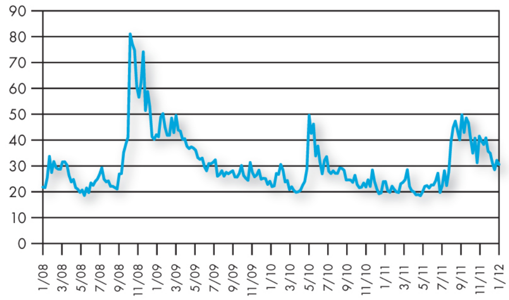
U.S. EQUITY

- Flat S&P 500 performance in 2011 masked considerable volatility.
- We have established our 2012 S&P 500 earnings per share (EPS) estimate at $102.

Market performance in 2011 was marked by considerable volatility. Although companies reported strong earnings despite the relatively weak economy, multiples contracted, reflecting economic concerns, and the market largely favored defensive, dividend-paying stocks. We've established our 2012 S&P 500 EPS estimate of $102 and price target of 1330. Although we don't believe the United States is heading for a recession, we've reduced our 2012 working estimate from 14 times to 13 times earnings to reflect continued global macroeconomic headwinds. We're expecting revenue growth in line with global nominal gross domestic product (GDP) growth and flat margins, following margin expansion during the past two years to what we believe are peak levels.

PUTTING A LID ON IT

European policy makers have gained some traction in containing uncertainty.



Left Axis: Dow Jones Euro Stoxx 50 Volatility Index

Source: Bloomberg

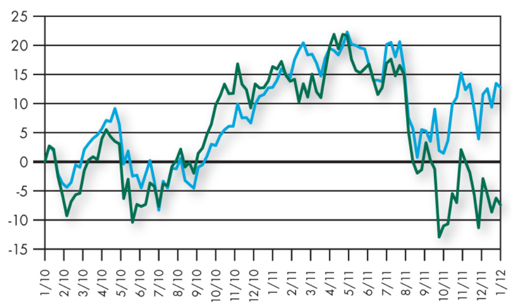
EUROPE & ASIA PACIFIC EQUITY

- Political factors pushed 2011 European Union (EU) market volatility to recent highs.
- Economic stability going forward will depend on development of clear EU roadmap.

In the fourth quarter of 2011, market volatility hit levels last seen in 2010 at the beginning of Greek debt crisis (later to turn into the euro debt crisis). Debate around the future of the euro captured the world's attention as ECB and EU politicians considered various approaches. As part of its response, the ECB lowered interest rates for the second month in a row and offered three-year loans to banks at 1%. Although most of the €489 billion borrowed still rests on bank balance sheets, the move helped settle European equities. Steps toward a fiscal union are a positive, but the lack of a road map or stricter rules around sovereign deficit still leave investors with questions. Continued headwinds to growth make equities from Europe, Australasia and the Far East (EAFE) less attractive in our opinion.

NO BENEFIT OF THE DOUBT

Macro uncertainty hit emerging market equities particularly hard in late 2011.



Left Axis:

S&P 500 price return (%)

MSCI emerging markets price return (%)

Source: Bloomberg

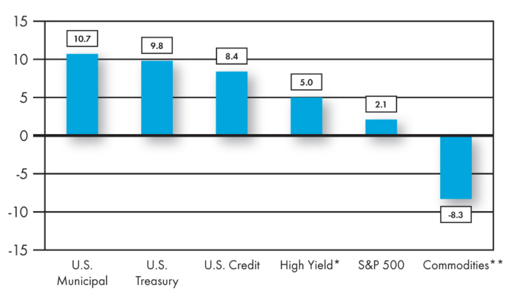
EMERGING MARKETS EQUITY

- Emerging market equities relative performance lagged heavily in late 2011.
- Evidence of China's economic rebound, and overall investor risk appetite, will drive 2012 performance.

Emerging market economies, and their stock markets, remain a leveraged play on global growth. While emerging market equities held up fairly well through mid-2011, they were hard hit by the global equity market selloff that started in late July. With global growth slowing into year end, and concerns in some quarters about the vulnerability of the Chinese economy, emerging market shares have lagged of late. We think a durable easing cycle for monetary policy is a potential catalyst for improved performance. We're in the early days for easier policy, as the negative effects of inflation are still holding back policy makers in China and India. More aggressive policy actions by these two high-profile countries would be an important support to emerging market equity performance.

WHERE WAS THE BIG BAD WOLF?

2011 U.S. municipal bond returns defied some dire predictions.



Left Axis: 2011 returns

Source: Bloomberg

Note: *2% Issuer Cap, **Thomson Reuters Commodity Index

U.S. FIXED INCOME

- Declining interest rates and improving fundamentals drove strong municipal bond returns in 2011.
- Our steady interest-rate outlook should support continued solid returns in 2012.

Municipal bonds, which some predicted would experience mass defaults in 2011, turned out to be one of the best performing asset classes, beating U.S. Treasuries, stocks, corporate bonds and commodities. The negative sentiment on municipal bonds at the beginning of the year caused some investors to sell their investments in municipal bond funds. As the year progressed, many politicians made difficult decisions to raise taxes, reduce benefits and cut spending to plug budget gaps. These decisions reinforced the benefit of municipal bonds, and brought investors back to the asset class in the second half of the year. We continue to think a well-researched, diversified municipal bond portfolio is a prudent strategy for capital preservation.

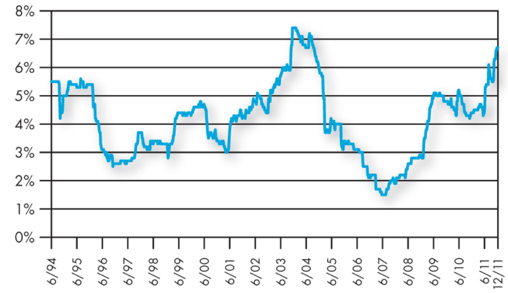
U.S. HIGH YIELD

- High yield fund flows have become increasingly volatile during the past four years.
- Investment strategies based on fund flow volatility can result in investment opportunities.

Flows in and out of high yield funds have become increasingly volatile. The overall volatility of financial markets and macroeconomic uncertainty is one driver. Structural changes, such as the influence of exchange-traded funds (ETFs), have also made fund flows more volatile. Flow volatility affects the behavior of market participants, with funds more likely to increase cash balances and hold more liquid securities. ETFs will also be forced to trade more actively. This can result in opportunities for funds with more stable investor bases. Being able to provide liquidity for accounts forced to trade can provide profitable opportunities. In addition, less liquid securities often offer attractive yields with less price volatility for those able to reduce their overall portfolio liquidity.

TAKING ADVANTAGE OF TURNOVER

Volatile high yield fund flows generate opportunities for patient investors.



Left Axis: Rolling three-month high yield fund flows volatility
Source: Barclays Capital

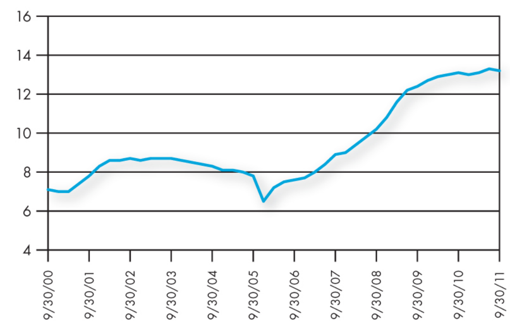
GLOBAL REAL ESTATE

- 2011 marked a poor year for global real estate investment trusts (REITs), which fell 8%.
- Vacancy rates tell a mixed story for 2012.

Full-year 2011 global REIT returns were lackluster, as the strength of the U.S. market (+8%) was unable to offset the broader global REIT universe. Notably, Asian and European REITs were down 19% and 13%, respectively (U.S. dollar terms). Even within the United States, sector returns were widespread, ranging from returns of -18% in lodging REITs and -5% in office REITs to returns of 12% and 9% in residential and retail REITs, respectively. Clear fundamentals backed the gains in residential REITS, where vacancies ended 2011 near 5% — well below previous cycle lows. The gains in retail are perhaps more based on hope as vacancies are still elevated and face a number of headwinds in 2012 — notably, continued competition from nontraditional retail, such as online purchasing.

IT MAY NOT BE A PEAK, BUT A PLATEAU

Retail REITs appear to be pricing to a peak in vacancies – but might hit a plateau instead.



Left Axis: Retail vacancy rate (%)
Source: Bloomberg

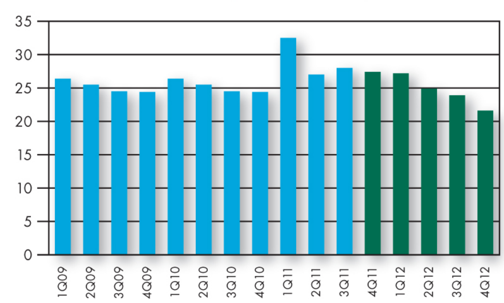
NATURAL RESOURCES

- Commodity-intensive, fixed-asset investment has been a key growth driver in China.
- We see technically complex, softer, industries as the next growth driver.

We think the next leg in China's growth may come from industries that are less commodity intensive and more technically complex, spanning the areas of energy conservation, environmental protection, alternative energy, composites, biotechnology, next-generation information technology and high-end equipment manufacturing. China's government has deemed these industries to be strategic, with $1.5 trillion in planned spending between 2011 and 2015. While the annual growth rate in "hard asset" spending decelerates from the low-30s to the low-20s, we project the rate of capital allocation to the more technically complex industries to accelerate. This changing composition of spending should continue to support the Chinese economic growth (which is needed for a constructive global growth environment) but may have less impact on commodity demand.

A DIFFERENT KIND OF STIMULUS

As Chinese stimulus targets specific industries, fixed-asset investment-growth rates may fall.



Left Axis:
Actual year-over-year (yoy) fixed-asset investment-growth rates (%)
Projected yoy fixed-asset investment-growth rates (%)
Source: ISI Group

CONCLUSION

We entered 2012 with a neutral stance, as we see continued deleveraging capping upside potential, while easy monetary policy and attractive equity valuations help cushion the downside risk. Growth in the United States and emerging markets should modestly beat expectations, offsetting a likely disappointing result from the eurozone. With the Federal Reserve promising to keep short-term interest rates near zero through mid-2013 at a minimum, we see a steady interest-rate picture in 2012. Along with strong corporate fundamentals, we think this makes U.S. high yield bonds particularly attractive. We still favor U.S. equities over their developed-market counterparts, because of less systemic risk. Disappointing G-2 growth in 2012 is our biggest potential concern, as steady growth in the United States and emerging markets helps buy European policy makers more time to get their fiscal house in order. We also think that evidence of a reacceleration of emerging market growth could be a key driver of an eventual increase in investor risk appetite.

Jim McDonald
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