

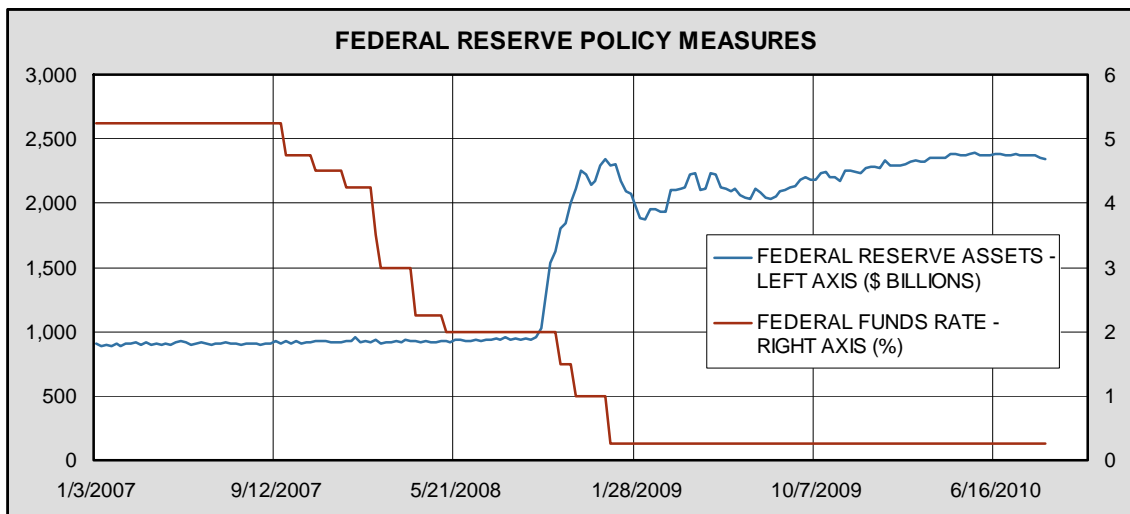


## Insights from Northern Trust

### Commentary from Jim McDonald, Chief Investment Strategist

August 30, 2010

The world's leading central bankers and economists who gathered late last week in Jackson Hole, Wyoming, helped describe the current challenges the global economy faces but broke little new policy ground. Federal Reserve Chairman Ben Bernanke indicated a willingness to expand quantitative easing measures should economic conditions deteriorate. He commented that it is "reasonable to expect some pickup in growth in 2011 and in subsequent years" and also said there was a low risk of either deflationary or inflationary problems for some time. Perhaps the one new insight came from Bernanke's comment that "central bankers alone cannot solve the world's economic problems." With Washington in no mood to supply major fiscal support, and Europe having already decided that fiscal austerity is the correct path forward, this comment just highlights the fact that the Fed is today's primary firefighter, and its pumper engine may not be big enough. As shown in the chart below, the Fed's primary interest rate tool (the Fed funds rate) is already near zero – leading the Fed to conduct quantitative easing (the targeting of lower interest rates through purchasing debt in the open market). This has ballooned the Fed's balance sheet from \$962 billion in September 2008 to \$2.3 trillion in August 2010. While this is a very large increase, we think the Fed could somewhat easily expand this further should economic data warrant such action.

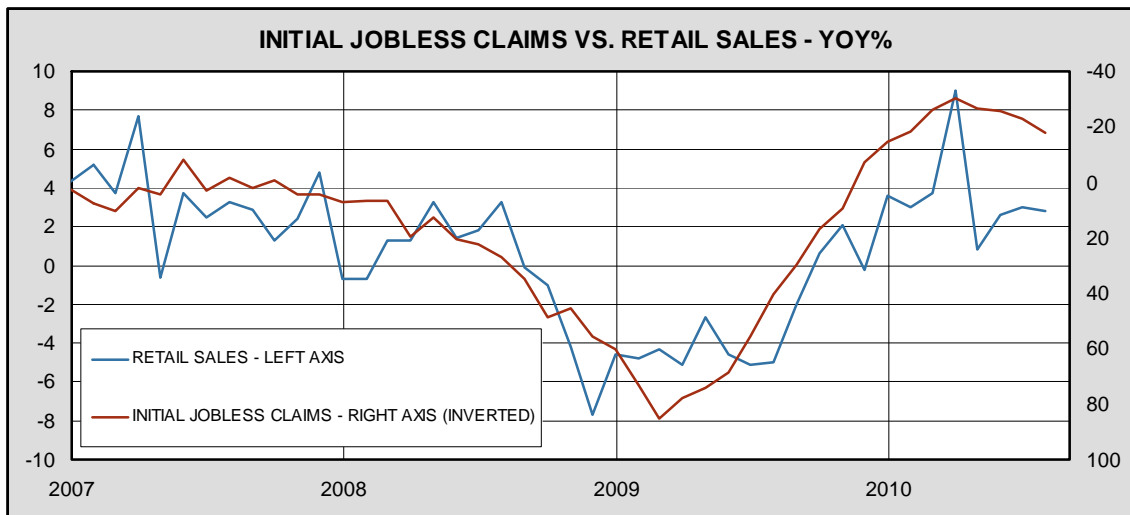


Source: Bloomberg. Weekly data through 8/27/2010.

Since July 21 when Chairman Bernanke described the economic outlook as "unusually uncertain" and the Fed's August 10 meeting, incoming economic data has been broadly disappointing. Labor markets have deteriorated, with both weekly unemployment claims jumping and the monthly labor report



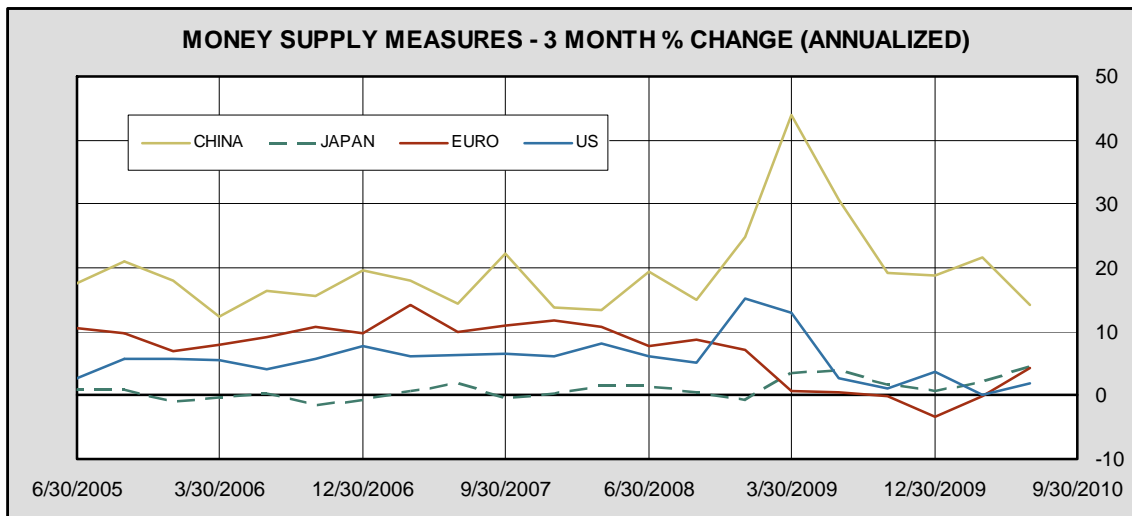
showing poor job creation. Unsurprisingly in this context, consumer spending has been soft, with retail sales slowing in July and Wal-Mart reporting a 1.8% decline in same-store sales. The corporate sector has also shown some signs of moderation, with durable goods orders (ex-transportation) falling in July by 3.8%, and technology bellwethers Cisco and Intel cautioning investors about future growth prospects. This week we will receive the global purchasing manager surveys and, on Friday, the August U.S. payroll report. With the Fed now being very “data dependent,” these reports carry a high level of importance for future policy decisions.



Source: Bloomberg. Monthly data through 7/31/2010. Initial Jobless Claims are the 4-week average.

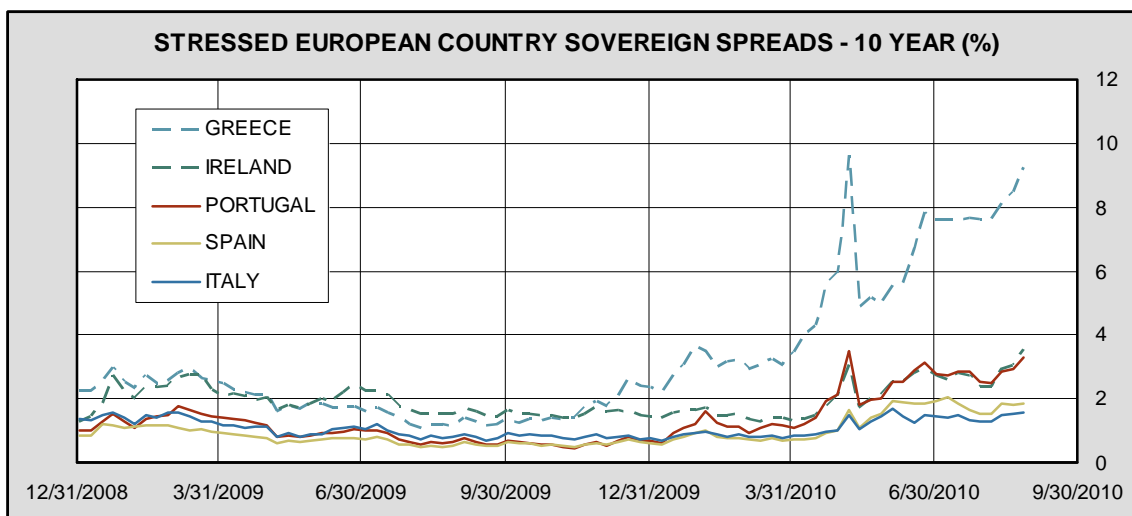
One of the key concerns surrounding the sustainability of the U.S. recovery is credit creation – and bank credit remains tight. Banks have been deleveraging – and facing regulatory uncertainty – since the credit crisis began in 2007. On a long-term basis, the money supply growth of an economy should move in line with nominal gross domestic product, supporting growth without creating inflationary pressures. As shown in the following chart, the major developed economies have been dealing with anemic money supply growth over the last year, while China has been deliberately pulling in its money supply in an attempt to control inflation. We are seeing very early signs of improvement in the money supply in Japan, the European Union and the United States. Work by our banking analyst, Chris Shipley, shows that banks now have sufficient capital to support credit growth and are showing tentative signs of willingness to use it. Banks no longer appear to be using their deposit growth to pay down borrowings, instead using it to buy securities. This is a first step toward taking more risk, which could lead to increased lending going forward. This is especially important for small business, which is more dependent on bank loans, as compared with large enterprises that find a very receptive audience for their financing needs (e.g., IBM’s recent ability to issue 3-year debt at just 1.0%).





Source: Haver Analytics. Quarterly data through 6/30/2010.

The ability of companies like IBM to access the debt markets is indicative of the strength in broader financial conditions, which should be supportive of growth. The low interest-rate environment, which has helped repair bank capital positions and pushed investors to take more risk, should continue to support growth. This investor risk appetite has reduced the risk premium corporations need to pay, decreasing the cost of financing and increasing current profitability. Financial markets are also functioning well, with good liquidity in the fixed-income markets a welcome contrast to conditions during the financial crisis. There is little doubt that the actions of central bankers to restore liquidity to fixed-income markets will go down as one of the great successes of the efforts to combat the financial crisis. One area where progress seems to be slipping is the European sovereign debt arena. Spreads on Greek, Irish, Portuguese, Spanish and Italian debt have all returned to levels near those reached at the height of the crisis this spring. This has happened despite the establishment of the European Stabilization Fund, a mechanism to guarantee the sovereign debt of the EU nations. To some extent, this widening in spreads is attributable to the drop in the German bund rates, but the majority of the impact is tied to increased risk aversion. This situation bears watching, as it appears that the likelihood of debt restructuring from some European country has risen significantly of late.



Source: Bloomberg. Weekly data through 8/27/2010; spreads relative to German sovereign debt.



As economic data has deteriorated over the last months, risk assets like the stock market have retreated. U.S., European and Japanese shares have declined 4% - 5%, and emerging market equities have declined by 3%. One standout has been Chinese stocks, where the Shanghai index has eked out a small gain over the last month. Reflecting this flight to safety, the U.S. 10-year bond has dropped in yield from 2.91% to 2.55% during this period. A recent survey of individual investors (from the American Association of Individual Investors) shows just 20.7% of investors are bullish, with bearish investors at 49.5%. This is the lowest reading of bullish investors since the market bottom in March 2009, and this indicator has a good track record of calling short-term market bottoms. Stocks should also get some support from asset allocators, as the dividend yield on the Standard & Poor's (S&P) 500 of 2.11% is approaching the 10-year Treasury yield, while the S&P 500 Value index yield of 2.50% nearly matches the 10-year yield.



Source: Bloomberg. Weekly data through 8/27/2010.

Our view remains that the U.S. economy will avoid a double-dip recession. Recessions are typically triggered by the Fed raising interest rates to cool off over-investment that has occurred in the most cyclical parts of the economy, such as housing, consumer durables or capital spending. None of these engines of economic growth have been robust, so the risk of a deceleration large enough to imperil the recovery seems low. But we do believe the risks to a steady economic expansion have risen over the last several months, starting with the European debt crisis shortly followed by our expectation of disappointing growth from the United States and Europe.

#### **Important Information**

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