



Insights from Northern Trust

Commentary from Michael S. Wente, Chief Investment Officer, Southwest Region

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The belief among many economists, strategists and asset managers has been that President Obama would drift toward the center as his term matured, especially after the recent mid-term election results. However, few anticipated his willingness to compromise to the extent of reaching an agreement with Republican leaders in Congress on a tax package that would extend the Bush-era tax cuts for two years, give favorable treatment to business investment, reinstate the estate tax at 35%, reduce worker payroll taxes and extend jobless benefits for the unemployed.

Given that opening, the Senate moved quickly as Republican leaders unveiled a package that is scheduled for a key test vote today. The bill is expected to pass with support from most Senate Republicans and a substantial number of Democrats. The House, however, looks set to oppose the bill unless significant changes are made, which essentially represents a surprising "no confidence" vote in the White House on a very critical issue. Investors seem convinced that the White House can ultimately negotiate passage of a tax bill very similar to that proposed by President Obama last Monday. The market appears to need more proof before fully discounting the proposed changes. We await future developments.

A number of major investment banks and asset managers raised their growth forecasts last week for the U.S. economy in 2011. Goldman Sachs raised its 2011 U.S. real gross domestic product (GDP) forecast from 2.5% to 4% by the end of 2012. Pacific Investment Management Company raised its growth forecast for the U.S. economy to between 3% and 3.5%, up from 2% to 2.5%. JP Morgan moved its 2011 U.S. economic growth prospects to a year-over-year growth rate of 3.5%. In early November our economic team at Northern Trust moved its year-end 2011 U.S. real GDP growth rate expectation to 3.5%, based extensively on the second round of quantitative easing. Northern



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Trust believes there is a much better likelihood that U.S. growth will surprise on the upside versus disappoint on the downside in 2011. Any certainty about the passage of a tax bill along the lines of those proposed by the White House should only support the recent optimism of future growth.

Following through on stronger economic outlooks, a number of firms also became more optimistic on the equity market outlook. Last week Goldman Sachs forecast that the Standard & Poor's (S&P) 500 would move to a level of 1,450 over the next 12 months; JP Morgan was nearly as optimistic in its projection of a 1,425 target for the S&P 500 before year-end 2011. At the basis of these revised forecasts are increased earnings expectations and reasonable valuation assessments. Northern Trust has been – and continues to be – optimistic on the outlook for equities. We believe that earnings growth prospects look positive, while valuations of those earnings look attractive.

Earnings expectations now for 2011 are ranging, in many cases, above \$100 for the S&P 500. Historical valuations would place a multiple of 15 to 16 on those earnings. A reasonable expectation for 2011 earnings appears to be around \$100. Applying a conservative valuation of 14 times earnings projects a year-end 2011 S&P of 1,400. The S&P closed at 1,240 last Friday. While we prefer not to talk about specific price targets, a 1,400 estimate on the S&P begins to define the direction and the magnitude of change we are looking for in 2011.

We recently increased our recommended exposure to U.S. equities for clients with an appropriate risk tolerance. Another significant supporting argument for increasing equity exposure in portfolios is the current equity premium. Stocks represent a historically attractive tradeoff between potential return relative to the risk.

Missing from last week's headlines were many of the potential risks to the world economies. The risks are there, they just receded to the background last week. On the European debt crisis front, while Ireland's and Greece's problems have been dealt with somewhat, they are far from being resolved. The debt contagion most likely will spread through Portugal and Spain, and then, in all probability, Italy. The potential magnitude of problems in Italy would certainly challenge the capacity of any solution. We expect the debt issue to surface again this week, as Germany and France have indicated they are against increased funding to quell the sovereign debt crisis before



next week's summit of European Union leaders. Potential restrictions to the Chinese economy periodically threaten the growth expectations of global demand. We acknowledge these risks and expect them to periodically weigh on the markets in varying degrees over time.

Last week, we continued to receive confirmation of an advancing U.S. economy. Thursday, according to the Federal Reserve's Flow of Funds report, household net worth in the United States rose by \$1.2 trillion in the third quarter to \$54.9 trillion from \$53.7 trillion. The improvement was driven equally by rising wealth and falling debt. Retail sales comparisons came in well above expectations across retailers. The number of workers filing first-time claims for unemployment insurance payments fell more than forecast, showing the labor market continues to improve. Applications for jobless benefits decreased to 421,000 from 438,000 the prior week, according to the U.S. Labor Department. The report also showed the four-week moving average dropped to its lowest level in more than two years. On Friday, Thomson Reuters/University of Michigan index of consumer sentiment rose to 74.2 from 71.6 at the end of November. A Commerce Department report showed the U.S. trade deficit shrank more than expected in October to \$38.7 billion as growing economies overseas propelled U.S. exports to a two-year high.

Many of these signs of economic strength, while supporting the equity market, have depressed bond prices over the last several weeks. Yields on the 10-year Treasury have risen from about 2.5% as of the beginning of November to close well above 3.25% on Friday. Total returns on intermediate bond portfolios will most likely struggle to remain positive over the next year.

As we wind down 2010, it has become evident that the U.S. economy is recovering, although it is a slow motion recovery. Quantitative easing (both 1 and 2) is now discounted in the market. The mid-term election outcome appears to be discounted. The third year of an expansion generally trends positive. A positive outcome from the proposed tax bill is probably not yet fully discounted and should continue to support the economy and bring a degree of certainty to the markets. There are still major hurdles that will need to be dealt with: the European debt crisis may become systematic, China will struggle to maintain growth while constraining inflation, U.S. employment and housing are recovering slower than desired and fiscal austerity will likely rear its head in Europe initially, then eventually in the United States.



In light of this uncertainty, fundamentals should continue to support the equity market, especially given historical valuations and equity risk premiums. Companies are flush with cash, earnings growth is healthy, and mergers and acquisitions and initial public offerings currently reflect good value in the equity market. Bonds have recently experienced unusual volatility and may be volatile for some time. Prices in some of the real assets, specifically gold, may be getting a little frothy but still serve a good function in portfolio construction.

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