NORTHERN TRUST GLOBAL INVESTMENTS STRATEGY

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# Resilience

Asset prices reflect expectations. Anticipating when and how those expectations are likely to change is the key to successful investing. Markets have been adjusting to an acute change in economic and credit risk expectations.

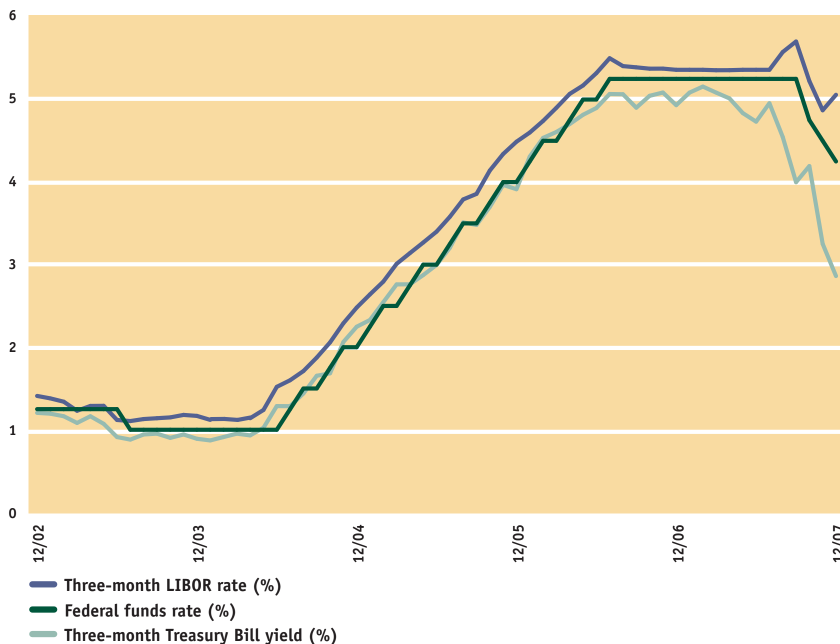
The root cause of this adjustment has been developments in the housing and mortgage markets. The United States is in the midst of the worst housing downturn in the postwar period. The associated subprime mortgage crisis has spread through credit markets, causing accelerating losses for lenders and record foreclosures for borrowers.

In effect, the economy is receiving two related shocks: one to growth via reduced residential investment and a negative wealth effect on consumption and the other to the financial system via the creation of bad assets and the mispricing of credit risk.

Potential consequences from these shocks are weighing on investor minds, and expectations are increasingly dire. But, arguably, expectations have, in fact, become too pessimistic. The economic system is likely to once again prove resilient, assisted by government policy responses to the crises and by the self-correcting nature of market capitalism. The case for anticipating this resilience includes:

**IS THE FED "BEHIND THE CURVE"?**

*The Federal Reserve must become bolder in its efforts to stimulate the economy.*




**Source:** Bloomberg

➤ The housing cycle is well advanced and probably approaching its nadir. Residential fixed investment began declining in the fourth quarter of 2005, and annual housing starts will soon have fallen more than 1 million units (-50%) from their cyclical peak — returning to the economy's underlying trend demand for housing, driven by household formation and employment and income growth. By comparison, the seven other housing recessions since 1960 lasted an average of 32 months and saw housing starts fall an average of 51%.

Federal home loan banks, meanwhile, are pumping billions of dollars into the mortgage industry (loans against mortgage collateral), cushioning the effects of credit tightening by private sources. And, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) are purchasing a record number of mortgages. Because of such efforts, U.S. mortgage lending actually increased at an annualized rate of $732 billion in the third quarter of 2007.

Market expectations reflect the current flow of negative news and the difficulty of forecasting a full recovery. The CEO of Fannie Mae, Daniel H. Mudd, believes such a recovery is unlikely until at least 2010. Expectations, in other words, are also near a nadir.

➤ Banks are at the center of the subprime mortgage problem and the associated turmoil in credit markets. They're now moving more quickly to deal with their exposure to questionable assets through disposals, write-offs or addition to their balance sheets. This process is often being accompanied by raising new capital to maintain or even strengthen capital ratios. Citigroup, UBS and Fortis, for example, all have raised new capital from strategic investors in the developing world.

These bank efforts are key to calming credit markets and improving credit flow to the real economy. The widening of credit spreads and lack of liquidity in inter-bank funding markets are directly attributable to prior bank behavior. The lack of information about the ultimate size and location of credit losses on subprime mortgages and other lending increased counterparty risk. Banks worried about their own access to liquidity in turbulent markets, and they wanted to retain control over their capital positions. This is now changing.

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- The Federal Reserve is already easing to stimulate economic activity and also implementing new tactics to stabilize funding markets. But the Fed must become bolder in its efforts to stimulate the economy because it is well "behind the curve."

  The policy-driven yield curve — measured as the spread between the 10-year Treasury yield and the Fed funds rate — is still inverted. The market-driven yield curve, in contrast, has steepened sharply. This difference suggests that the Fed funds rate is 70 to 80 basis points behind what is required by financial markets. The Fed, in our judgment, will be forced to close this gap to ease financial conditions.

- Capitalism's self-correcting mechanism — market transactions — is moving into gear. Recent examples include Lennar's agreement to sell an 80% stake in 11,000 home sites to Morgan Stanley; Citidel's deal to buy $3 billion in asset-backed debt from E-Trade; and Blackstone's announcement of a $1.3 billion fund, raised to buy collateralized debt obligations and bonds backed by mortgages. Such transactions will facilitate the price discovery, mark-to-market and return of liquidity, which should restore stability to credit markets.

The inevitable recovery in housing markets, banks getting their act together, a more aggressive Fed and stability in credit markets all will contribute to the resilience of the U.S. economy. This outcome will surprise markets that increasingly are expecting much worse.

*Orie L. Dudley Jr.*
*Chief Investment Officer*

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### What Has Changed

- Monetary authorities in developed economies acknowledged renewed financial markets stress has tightened "financial conditions" and could slow growth.
- Major central banks used coordinated and unconventional tactics to restore liquidity and stressed their willingness to intervene even more radically if necessary.
- The Federal Reserve cut the Federal funds rate by a quarter-point to 4.25% but offered no guidance on what it might do next.
- Developing economies have seen limited fallout from the financial turbulence in developed markets.

### A Weak Fourth Quarter Will Start an Extended U.S. Economic Slowdown, But Negative GDP Growth Is Unlikely

- Employment growth has slowed, but job creation remains positive.
- The trade balance, excluding oil, narrowed for the seventh straight month in October and should add more than .5% to the gross domestic product (GDP) in the fourth quarter.
- Core inflation is likely to be contained well into 2009, with the core personal consumption expenditures (PCE) deflater remaining near the Fed's 1.5% to 2% target.

### Turmoil in Credit Markets Has Persisted; Markets Are Convinced the Fed Is "Behind the Curve"

- The Fed's new Temporary Term Auction Facility should help stabilize Interbank lending markets.
- Banks are dealing with their exposure to bad assets and raising capital.
- Markets are pricing in the expectation of another 100 basis points of Fed easing in 2008, as economic growth slows and inflation remain benign.

### Equity Market's Volatility Increased; Prices Eased Because of Falling Financial and Consumer Discretionary Stocks

- Equity valuations should be supported by low interest rates and monetary easing.
- The third quarter U.S. Flow of Funds Accounts revealed more aggressive financial positioning by businesses, including a record in net equity buybacks ($846 billion).

### The Developing World's Domestic Demand Is Altering Global Growth

- Emerging Asia now surpasses the United States as a percent of global GDP.
- Emerging markets' internal dynamics appear able to offset an economic slowdown in developed countries.
- Oil-rich countries and Asian central banks are now among the world's major finance sources, and are deploying their capital strategically.

### Conclusion

- Financial market turmoil and fears of an economic slowdown have increased overvaluation of government bonds and undervaluation of many riskier assets. We would continue to underweight bonds and overweight stocks, particularly equities of companies that will benefit from globalization.

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