

Perspective

Global analysis designed to keep you abreast of the latest economic and market changes.

May 16, 2012

OUTLOOK

Investor risk appetite continued to moderate during the last month, resulting in negative returns in equity markets, falling commodity prices, rising government bond prices and a rally in the U.S. dollar. Investors have been discriminating; income-related assets have performed well and U.S. equities are just 5% below recent highs. Corporate credit spreads were relatively unchanged from last month, reflecting strong corporate financial health. The decline in commodity prices is tied to a more muted growth outlook and reduced risk premium for Iran, and we think the risk of a supply shock to oil prices has fallen. The downside risk to global growth this year should be cushioned by the prospect of falling inflation rates across the developed world.

We have been expecting European economic growth to disappoint expectations, and this is now leading to some discussion around tempering austerity measures. U.S. economic data has turned mixed as the services sector and labor markets have failed to match the strength of the manufacturing sector. While we don't expect substantial

weakening from here, we do think the Federal Reserve will implement additional quantitative easing should the U.S. economy falter. Emerging-market central banks are easing policy, but the People's Bank of China so far has been a limited participant. With worries growing about the Chinese economy, we expect China's monetary policy to become increasingly accommodative.

Investor concerns about Europe have reignited in recent weeks, and we expect continued incremental policy accommodation. While a disorderly departure of Greece from the European Monetary Union is clearly undesirable, programs implemented to date would help mitigate the fallout. French politics, in the wake of the country's Socialist Party win in its recent presidential election, will be heavily influenced by the parliamentary elections in mid-June, but we don't expect a lurch to the left in French policy. And recent losses by German Chancellor Angela Merkel's CDU party actually serve to increase the power of her more pro-European political competitors.

REPORTS OF THE BOND MARKET RALLY'S DEATH ARE GREATLY EXAGGERATED

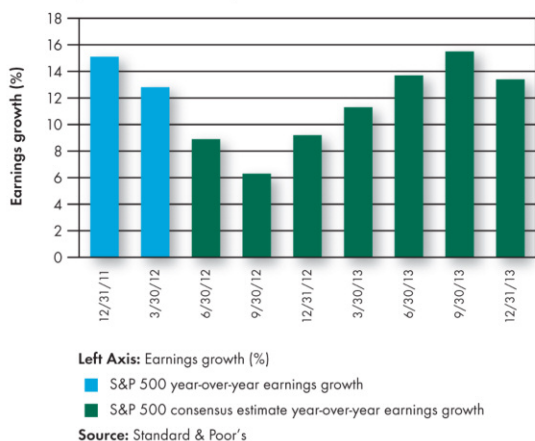
Interest rates continue to fall and are at 300-year lows in the United Kingdom.



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RELOADING

Slowing earnings growth is expected to pick up toward year end, driven by revenues.



U.S. EQUITY

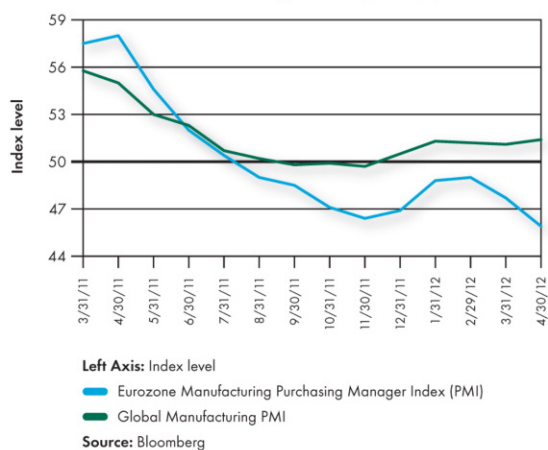
■ Companies exceeded first-quarter expectations.

■ Revenue growth and multiple expansion should drive stock gains.

First-quarter earnings results demonstrated improving trends, with positive surprises exceeding historical averages. Analyst-estimate-revision ratios now reflect more upward than downward revisions, and management-guidance ratios have returned to historical levels. Margins remain stable, and net margins are near peak levels. However, we see some risk to margin expectations in the second half of the year, with analysts expecting margins to expand in the fourth quarter. We view further expansion as difficult to achieve, and instead expect revenue growth and valuation multiple expansion to drive further market appreciation potential. U.S. companies continue to greatly benefit from, and depend on, global growth to fuel revenue and earnings growth. We continue to view U.S. equities as the least risky way to gain exposure to global equity markets.

FALLING BEHIND

Eurozone manufacturing is slowing sharply.



EUROPE & ASIA-PACIFIC EQUITY

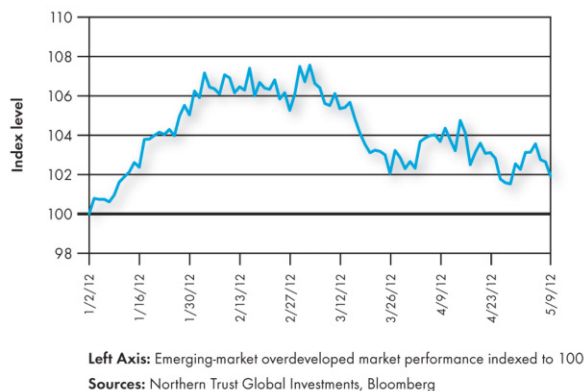
■ The eurozone is in flux as political crises occur throughout the region.

■ The Asia-Pacific region is still benefiting from slowing, but solid, Chinese growth.

A growing backlash against austerity measures has contributed to increasing economic and political risks throughout Europe. Greece is struggling to construct a coalition government, the Dutch cabinet resigned over budget talks and France elected its first Socialist Party president in 20 years. Germany maintained its hard-line requirement of austerity measures, but signaled the potential to accept higher domestic wages and inflation. Continued austerity is likely to keep the Eurozone at risk of recession — a recession we see as more structural than cyclical. This raises the concern that what may appear to be cheap valuations in European shares will turn out to be justified. Globally, growth is somewhat better — led by the United States and China — and that strength has provided support to Asia-Pacific economies such as Australia's.

RIDING THE WAVE

Emerging-market equities remain a leveraged bet on global risk appetite.



EMERGING-MARKETS EQUITY

■ Emerging-market stocks have led global equities in both directions this year.

■ Sustained outperformance will require stronger global growth.

Emerging-market equities are leveraged to both global growth and investor risk appetite, both of which have been moderating of late. As growth has slowed in key economies such as China, Brazil and India and inflationary trends have moderated, central bankers have begun easing monetary policy. With export markets slowing and domestic infrastructure spending growing at a slower pace, economic growth has yet to show signs of reacceleration. When this begins in earnest, it could be the harbinger of another up-leg in global growth and risk taking. At that point, emerging-market equities could benefit from both stronger earnings growth and increasing valuation. In the meantime, we expect emerging-market equities to perform in line with global equities as investors favor the lower-risk U.S. stock market.

U.S. FIXED INCOME

- April's Federal Open Market Committee (FOMC) meeting resulted in maintained policies.
- The Fed's consistent outlook has kept longer-term government rates in check. The FOMC continues to see slow growth and an unchanged Fed Funds rate into at least late 2014. We believe short-term bonds currently offer little value based on our current belief that the Fed Funds rate will remain at a very low level for the next few years. Longer-term investment-grade bonds benefit from pristine balance sheets and a persistently low Fed Funds rate. Despite the constructive outlook for these longer-term bonds, we continue to underweight investment-grade fixed income in our global tactical asset allocation model, as we believe the positive funding environment is more positive for U.S. equities and high yield corporate debt. These assets offer the potential for higher income and total return with, of course, a commensurate increase in risk.

U.S. HIGH YIELD

- The quarterly Senior Loan Officer Survey provided evidence of easing loan standards.
- Easing in lending standards has historically been supportive of high yield valuations.

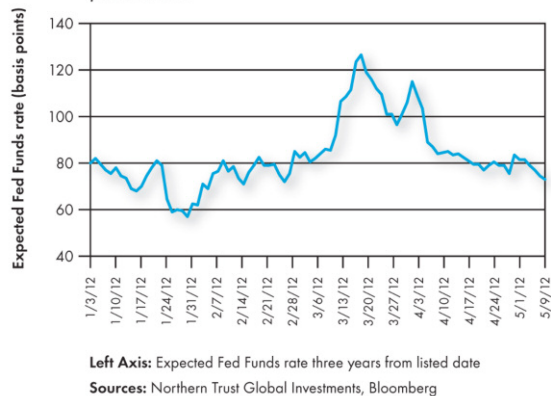
The accompanying chart shows the net tightening or easing of bank lending standards plotted against high yield credit spreads. Throughout the history of the high yield market, bank lending standards have been a good indicator for the direction of high yield spreads. Access to credit is supportive of the economy and is critical for high yield issuers. Since 2009, we've witnessed moderating tightening of loan standards, followed by a spike up in those lending standards in response to the European debt crisis. Thus, it's notable that the most recent survey showed the first net loosening of lending standards since 2006. We believe this is supportive of high yield valuations, as easing lending standards have historically improved high yield valuations.

REAL ASSETS

- Gold prices have given back year-to-date gains.
- We believe gold should be an effective hedge against central bank profligacy. After reaching year-to-date highs of near \$1,800 per ounce in late February, the price of gold has returned to beginning-of-the-year levels of around \$1,600 per ounce. This recent price drop has coincided with somewhat softer economic data and an uptick in European debt crisis worries. However, inflationary worries have concurrently receded, oil prices have declined and the U.S. dollar has rallied. We believe the further economic weakness likely will trigger additional central bank easing. To wit, recent comments from German officials that the country may have to tolerate slightly higher inflation to rebalance the eurozone are notable. We believe central bankers are committed to easy monetary policy as an answer to structural deleveraging, and we expect gold to benefit from this environment.

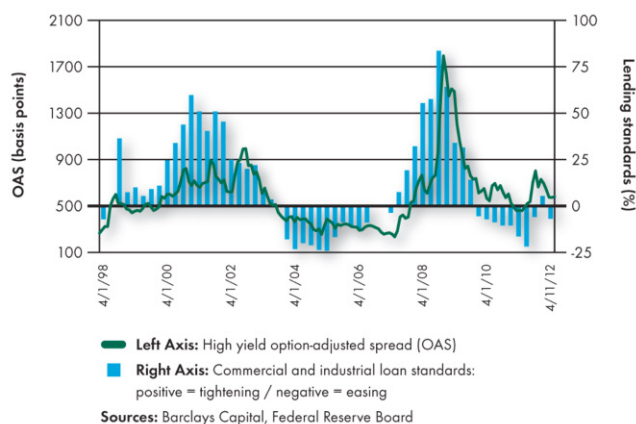
NOT SO FAST!

Investors' expectations of rate increases continue to be pushed out.



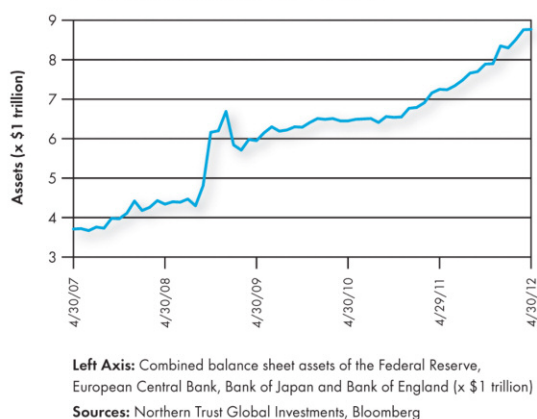
OPENING THE PURSE STRINGS

Easing of bank lending standards is a positive sign for high yield spreads.



CURRENCY OF LAST RESORT

As central bank balance sheets continue to grow, gold looks more appealing as a currency.



CONCLUSION

The softer economic growth being experienced thus far this quarter is consistent with our view of the post-financial crisis world — fits and starts in growth are to be expected as the credit-creation process remains stunted and fiscal austerity bites. Global central banks will remain accommodative in this environment, with the emerging markets having greater room to move. There are limits, however, to the impact the central banks can have in this environment. In both European and U.S. fiscal discussions, central bankers have protested about their limited toolset and the resulting necessity of action by the political class.

In recent months, the tone around European austerity has started to moderate. Discussion has begun about the potential of pushing back the deadlines for Spanish deficit progress, while this card could also be played in the upcoming Greek drama. In the United States, we believe neither political party sees advantages in shutting down the government or raising the risk of recession by slamming on the spending brake. We believe this view increases the likelihood of a short-term extension of much of the fiscal policy that is currently scheduled to expire on Jan. 1, 2013. Doing so would allow the new Congress and administration to negotiate this complex topic in the first half of 2013.

We made no changes to our Global Tactical Asset Allocation policy this month. We remain in a global economy dependent on substantial central bank support, where the private sector has done a much better job than the public sector in managing its finances. We expect the low-interest-rate environment to persist through at least 2014, which leads us to favor corporate credit and high yield bonds over sovereign debt. We also continue to expect U.S. equities to outperform their developed-market counterparts as Europe struggles with its fiscal crisis. We continue to view economic growth in the United States and China as the key variable in global investing today, with increased volatility surrounding the European debt crisis likely during the next several months.

Jim McDonald
Chief Investment Strategist

INVESTMENT PROCESS

Northern Trust's asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where our Investment Policy Committee sees either increased opportunity or risk. The tactical recommendations are highlighted on the first page of this report.

Our asset allocation recommendations are developed through our Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees. The membership of these committees includes Northern Trust's Chief Investment Officer, Chief Investment Strategist and senior representatives from our fixed income, equities and alternative asset class areas.

If you have any questions about Northern Trust's investment process, please contact your relationship manager.

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