

INVESTMENT STRATEGY COMMENTARY

Let Freedom Ring?

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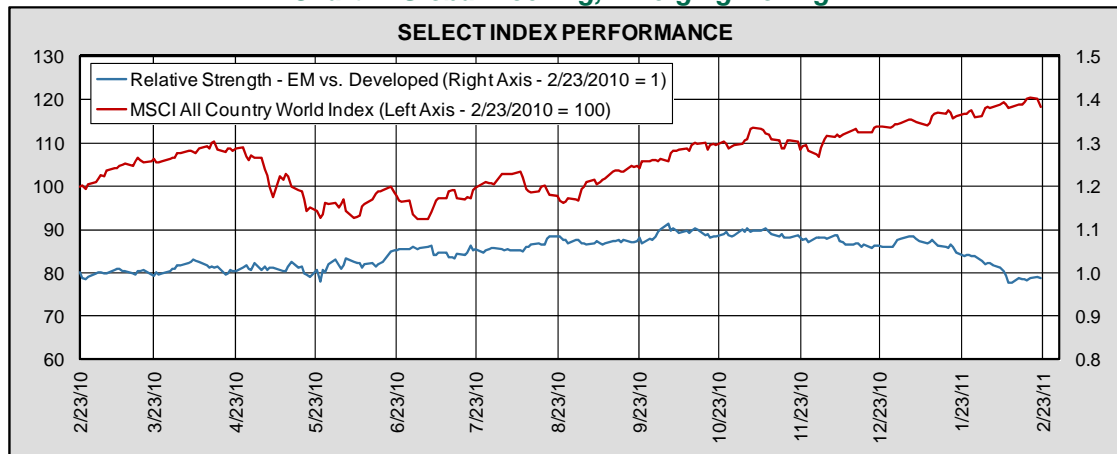
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Summary

Political and civil unrest has continued to spread throughout North Africa and the Middle East after the fall of the Tunisian government on January 14. To date, the turmoil has been relatively well handled by financial markets, with major selloffs in global equities of just 2.3% on January 28 (protests in Egypt, spike in oil prices) and 2.7% on February 22 (mayhem in Libya, spike in oil prices). Because of the strength of the current global expansion, global equities actually set a new cycle high last Friday. However, reflecting increased inflationary pressures and some increased political risk premium, emerging market stocks have been underperforming developed markets over the last several months.

Chart 1: Global Rocking, Emerging Rolling



Source: Northern Trust Global Investments, Bloomberg.

The upset caused by the Egyptian power change was due to investor uncertainty about the change in a stable power structure, the peace agreement in place with Israel and concerns about the potential spread to other nations. While Egypt controls the Suez Canal, which is key for global trade, it is not an important energy producer. Libya, however, is more important as an oil exporter and is also high risk due to the unpredictability of the head of state, Colonel Gaddafi. A commonality among the uprisings so far has been long-time autocratic regimes being challenged by young citizens who do not feel they have their deserved level of political or economic freedom. These protests don't seem to be driven by religious factions, nor are they particularly driven by current commodity price pressures. Considering no one was predicting these changes a year ago (let alone three months ago), it is folly to believe one can boldly predict the future course of events in North Africa and the Middle East.



While the protestors are central to starting the upheaval and pressuring the governments, the military and the police are the key to the outcome. In Egypt, the military took a very measured approach and seemed to retain the respect of the citizenry. They were central to the eventual departure of President Mubarak. In Libya, the situation is more chaotic as senior diplomats and military officials have defected and certain port cities are reportedly in the control of opposition forces. Therefore, it is very hard to be confident in a projection of a timeline of developments in Libya.

What does this outbreak of protest and governmental change mean for financial markets? Specifically, are we likely to see a further spike in oil prices? If so, will that be inflationary or recessionary? Finally, what does this mean for investor risk appetite and asset allocation? While there is spare capacity available within OPEC to cover any Libyan shortfall, it won't be as simple as just flipping a switch in the event of a major disruption in production. Libyan oil is "lighter" and "sweeter" than Saudi crude (making processing less expensive) and transportation to Europe would be an increased challenge.

Table 1: Brother, Can You Spare a Barrel?

OPEC OIL PRODUCTION AND CAPACITY			
Country	Current Barrels/Day	% of World Prod.	Spare Capacity
Saudi Arabia	8.6	9.7%	3.5
Iran	3.7	4.2%	0.04
UAE	2.4	2.7%	0.33
Kuwait	2.3	2.6%	0.23
Nigeria	2.2	2.5%	0.26
Venezuela	2.2	2.5%	0.14
Angola	1.7	1.9%	0.19
Libya	1.6	1.8%	0.22
Algeria	1.3	1.4%	0.03
Qatar	0.8	0.9%	0.18
Ecuador	0.5	0.6%	0.02
Total OPEC	27.3	30.8%	5.14

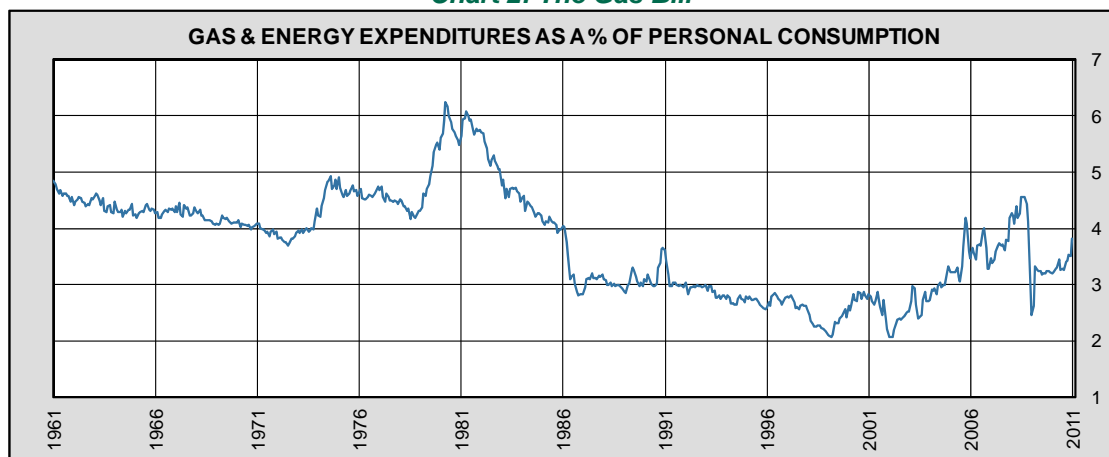
Source: International Energy Agency. Production and capacity figures in millions.

Of course, another major risk case involves a spread of unrest to those countries with excess production capacity, specifically Saudi Arabia. We do think that a longer-term spike, should it occur, would prove to be a tax on growth and not inflationary. This would mean a global economic slowdown, to the likely detriment of equities and the benefit of fixed income. Due to increased uncertainty over emerging market inflation and investor risk appetite, we believe

there may be better opportunities in U.S. large caps as opposed to non-US equities. Also, gold can provide a hedge against geopolitical and economic uncertainty.

We think it is in OPEC's interest to try to moderate oil price increases – the surge in oil demand in 2010, despite relatively high prices, has only occurred because of the economic recovery. But the path to increased production may not be so smooth. OPEC's presidency is currently held by Iran, so reaching consensus may not be easy and individual producers may have to boost production on their own.

Chart 2: The Gas Bill

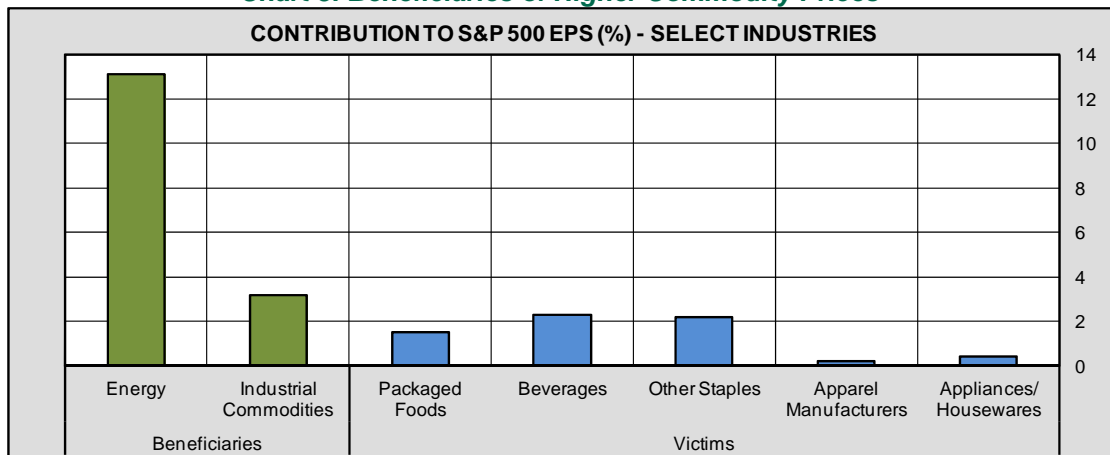


Source: Northern Trust Global Investments, Bloomberg.

When considering the U.S. consumer, gasoline is a very volatile portion of consumer spending and tends to rob other spending categories during price spikes. There is also a strong history of oil price surges preceding recessions – and current expenditure levels are approaching more worrisome levels. We don't know what a tipping point is for U.S. consumption, but \$4 for a gallon of gasoline would be both economically and psychologically harmful. The \$3-per-gallon handle just doesn't have the shock value that it did before.

While we do see rising oil prices as an economic tax, we do not see it as an inflationary catalyst. How can we be sanguine about this when prices of many commodities have been on a tear? For starters, corporate profits have historically tended to be positively correlated with commodity prices. The same economic growth that increases demand (and prices) for commodities also leads to good revenue (and profit) growth for most companies. Additionally, the U.S. stock market has a greater share of earnings from companies that benefit from higher commodity prices (energy and materials) than are hurt by them (food, beverage and apparel).

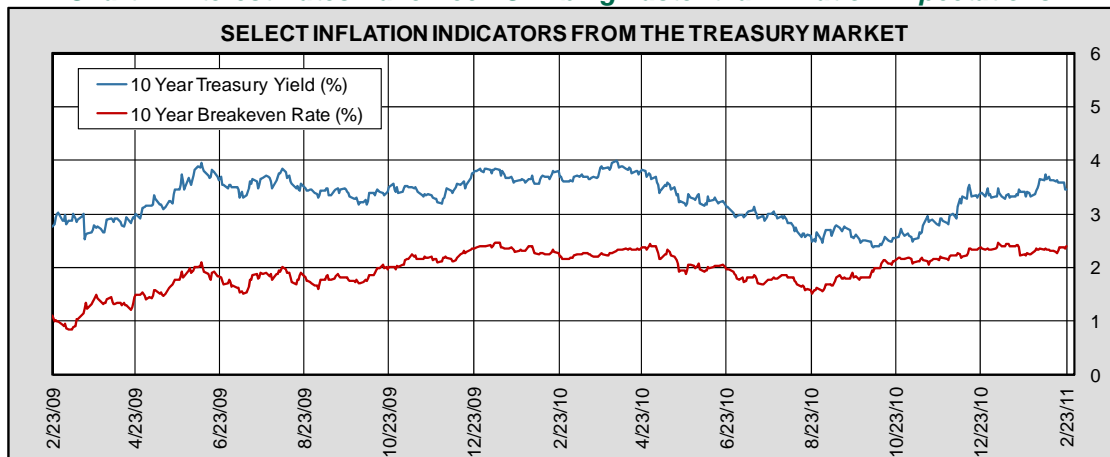
Chart 3: Beneficiaries of Higher Commodity Prices



Source: Northern Trust Global Investments. Chart concept courtesy of Empirical Research Partners.

The impact of rising input costs on food companies is probably misunderstood, as research by Empirical Research and the United States Department of Agriculture (USDA) indicates that the percentage of total expenditures that food companies spend on raw materials has fallen steadily from more than 35% in the 1950s to 20% today (which is a little worrisome!). The remaining expenditures are for manufacturing, marketing and administrative costs.

Chart 4: Interest Rates Have Been Climbing Faster than Inflation Expectations



Source: Northern Trust Global Investments, Bloomberg.

Some investors believe that inflationary problems are upsetting the market for sovereign bonds, citing the jump in yields over the last six months as the Federal Reserve undertook QE2 (second round of quantitative easing), and global commodity prices took off. While some individual buyers may have been motivated by this concern, we think that bond markets were mostly responding to the stronger growth outlook. Looking at the increase in 10-year Treasury yields since October 31, 2010 – increased 88 basis points (bps) to 3.48% – and

changes in the expected inflation rate (breakeven rate) in the 10-year Treasury Inflation Protected Securities (increased 26 bps to 2.41%), one sees that much of the increase has come from real interest rates. This also occurred during a period where Brent crude oil jumped 35% to \$112/barrel.

What does this all mean for asset allocation? The challenge in assessing geopolitical events is determining whether events will be short-term disruptions without economic consequences (e.g., the assassination of John F. Kennedy in 1963) or longer-term events with significant economic implications (the Arab oil embargo in 1973). There is no way to confidently predict the outcome of the events in North Africa and the Middle East today. The pace of deterioration in Libya seems to argue for a change in control sooner rather than later, but there is no clear opposition party to assume control. Should change happen soon, and world oil markets remain well-supplied, financial markets could settle down and resume their focus on the global economic expansion. Should the unrest spread to other major OPEC nations, oil would most likely continue its rise and risk assets such as equities would likely sell off.

We think the prudent approach here is to have some portfolio positions that may benefit from continued turmoil, but to not significantly remove risk exposures across the portfolio.

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