



Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

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In late March, we wrote about the importance of restoring investor and corporate confidence (The Confidence Game). Without some improvement in these measures, we thought improvement was unlikely in either economic conditions or risk-taking in financial markets. What were the key developments we felt could help bolster confidence? First, stabilization of the major banks was discussed as key to both investor confidence and for the support of economic growth. Second, clarification of government's role in the financial markets and economy was viewed as critical to investor willingness to participate in government programs aimed at improving market liquidity (e.g., the Term Asset-Backed Securities Loan Facility aimed at improving the securitization markets). Finally, an ability to forecast a durable economic recovery was reviewed as essential to a sustained financial market recovery. So how have we progressed on these fronts over the last six weeks?

The outlook for the major banks has continued to improve upon the initial better tones in late March. This past Thursday, the Federal Reserve announced the results of its Supervisory Capital Assessment Program (the "bank stress tests") and investors were generally relieved at the outcome. The KBW Bank Index of bank stocks rose 36% over the last week, including 12% on Friday – the day after the final results were announced. Of the 19 banks reviewed, 10 will need to raise a total of \$75 billion in common equity – and a couple of the banks successfully raised the money by Friday. While the banks that still need to raise capital have up to six months to accomplish it, it seems likely that the risk surrounding the banks has diminished materially, and bank executives can now focus on managing through the current credit cycle. This should also allow investor focus to move beyond the survival of the banks to determining which are best-positioned to prosper in the new environment of less leverage, higher regulation and a return to more traditional forms of credit creation.

The role of government in the financial markets and the economy remains in focus, as recent developments have been both concerning and constructive. The bankruptcy process surrounding Chrysler has reignited investor concern about the treatment of debt holders, as a non-traditional path to reorganization has resulted in agreements being reached outside of traditional channels and process. This will likely lead to elevated credit premiums going forward, as fixed income investors have to assess the risk of adverse developments in financial turnarounds. The Obama administration has also indicated an interest in raising taxes on international income from U.S. multinationals – without offsetting these increases with corporate tax cuts elsewhere. On the more constructive side, prospects have faded on certain legislative and judicial efforts that are viewed



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warily by many investors (e.g., mortgage cram-down, card check unionization and cap-and-trade legislation).

Our confidence in forecasting an economic recovery has improved over the last six weeks, but its longer-term durability remains unclear. After experiencing gross domestic product (GDP) declines in the fourth quarter of last year of 6.3% (annualized) followed by a -6.1% GDP (annualized) report for the first quarter of 2009, we are setting up for a turnaround in the economy. U.S. purchasing manager index data indicate that after bottoming at a reading of 32.9 in December 2008, the overall index rose to 40.1 in April. The new orders component, which we believe is a good leading indicator, has jumped from 23.1 to 47.2 during this timeframe. We have seen similar improvement outside the United States, but more concentrated in developing countries (such as China) as opposed to developed regions like Europe or Japan. Similarly, we are seeing signs of some initial improvement in labor markets. Despite the unemployment rate hitting 8.9% in April (possibly on its way to 10.0%), initial unemployment claims have now started declining and may at a minimum have peaked for this cycle.

Finally, one shouldn't underestimate the restorative effect of a stock market recovery – the nearly 40% jump in the Standard & Poor's 500 index from its intraday low on March 6 has led to a positive year-to-date return of nearly 3%. In a recent conference presentation, Alan Greenspan expressed his view that stock prices have an underappreciated effect on economic activity – and that the seminal event in this economic cycle will be the turn in the stock market.

So how is The Confidence Game playing out? The banks have moved from intensive care to a private room, and by this time next year may be making outpatient visits to their HMO. Less progress has been made with respect to better defining the government's role in the financial markets and economy – but this issue will be with us for years as we deal with the aftermath of the financial market crisis. Finally, the evidence of an economic recovery has clearly started to build over the last six weeks – and now the focus will turn to the durability of this recovery. Over the last two months, the S&P 500 has rallied nearly 40% - so it wouldn't be surprising to see some near-term weakness as investors digest this advance. But in looking at all of these developments, it seems likely that the environment for risk-taking has improved.

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