



INVESTMENT STRATEGY COMMENTARY

2010 OUTLOOK: WHAT CENTRAL BANKERS GIVE, THEY CAN TAKE AWAY

December 23, 2009

SUMMARY

While final performance for the year is not yet complete, we look certain to have just finished the second worst decade of the last century. Through the end of November, the Standard & Poor's (S&P) 500 had generated an annual price return of -2.9%. Only the decade of the 1930s was worse, with an annual price return of -5.3%. The two major bear markets experienced this decade – the “Tech Wreck” which started in 2000 and the “Mortgage Carnage” which started in 2007 – were separate but related financial events sharing the common feature of easy money run wild. The purpose of this report is not to review the past decade but to discuss key developments in 2009, review our actions in response to these market conditions and share our thoughts on important investment themes that should influence our portfolio construction in the new year.

We think that targeted risk-taking will be rewarded in 2010, but asset class returns are likely to pale in comparison to those realized in 2009. The risk of a material decline in financial markets is primarily tied to the risk of botched monetary policy; hence, an extraordinary focus on central bank policy is warranted in 2010. What central bankers give, they can take away.

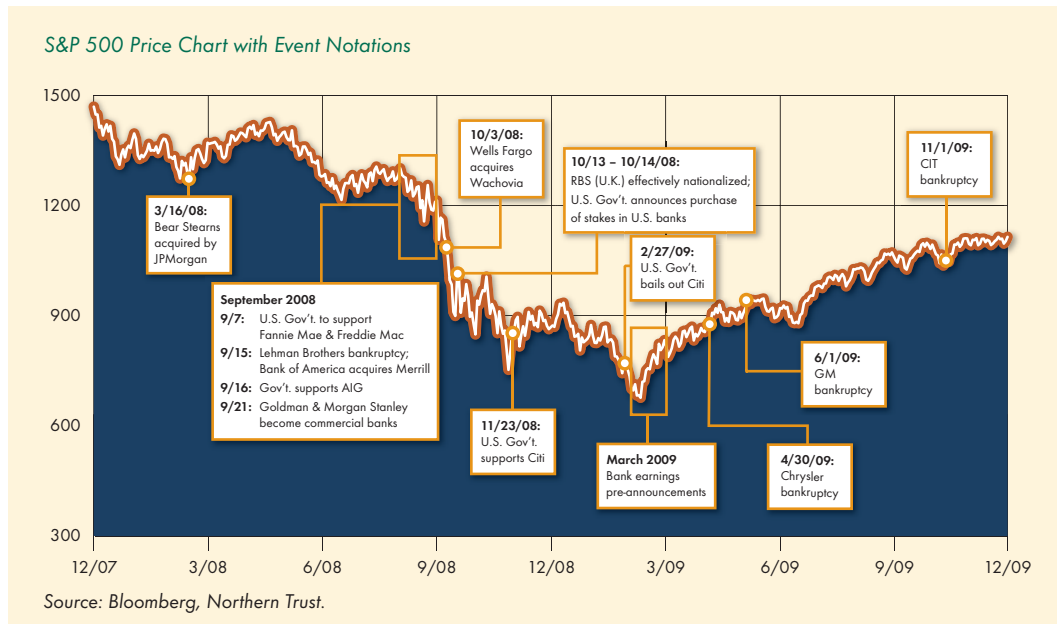
We came into 2009 with momentum in the stock market, as the S&P 500 rallied 20% from the third week in November 2008 through year-end, as U.S. government support of Citigroup and Fannie Mae/ Freddie Mac gave investors hope that the end of the financial crisis was in sight. From an investment policy standpoint, we remained concerned about the continuing freeze up in the credit market and didn't

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CHART 1: MAJOR EVENTS OF 2008/09



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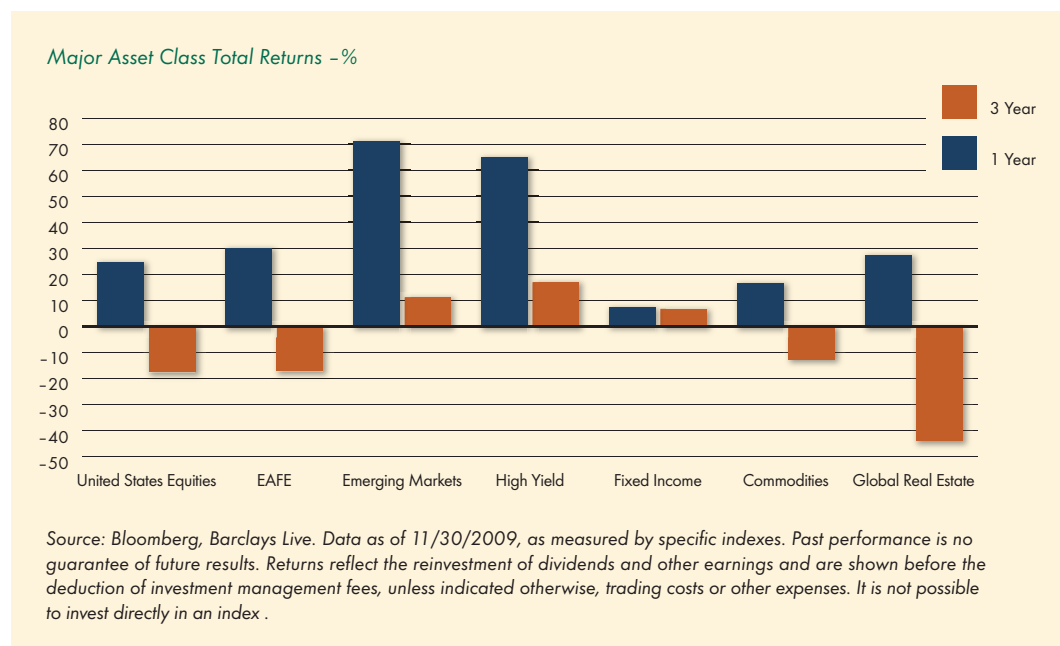
Throughout 2008 and much of 2009, the U.S. government would introduce more than 30 programs, totaling over \$16 trillion in potential scope, to try to unfreeze the capital markets.

think risk taking would be rewarded until this started to improve. The stock market resumed its losing ways in the first quarter of 2009, with the final sell-off driving stocks down 24% through the final capitulation on March 6.

Throughout 2008 and much of 2009, the U.S. government would introduce more than 30 programs, totaling over \$16 trillion in potential scope, to try to unfreeze the capital markets. In effect, the government was substituting its balance sheet for the balance sheets of the damaged commercial banks, investment banks and other financial institutions (also called the “shadow” banks). The Federal Reserve had also cut the fed funds rate from 5.25% in mid-2007 to a range of 0.00% - 0.25% by the end of 2008. One objective of this policy was to facilitate the return to profitability of the commercial banks through borrowing at low short rates and lending/investing at higher long rates. It was the market’s realization in March 2009 that these efforts were starting to bear fruit – crystallized through the positive earnings indications from Bank of America, Citigroup and JP Morgan – that started the advance in the S&P 500 in the second week of March.

The Federal Reserve upped the ante in the third week of March, with its quantitative easing program to buy up to \$300 billion in U.S. Treasuries, up to \$750 billion in agency mortgage-backed securities and an additional \$100 billion of agency debt. To use betting parlance, we felt that the Fed had finally gone “all in” to ensure the stability of the financial system through this extraordinary intervention in the debt markets. In combination with the improving bank earnings picture, we felt that this quantitative easing program had finally tipped the odds toward an improvement in the credit markets and eventually the economy. We thought that some of the early beneficiaries of this huge slug of liquidity would be emerging market equities, commodities and high-yield fixed income securities.

CHART 2: WHICH ASSETS DID BEST?



As the year progressed and signs of repair accumulated, we gained further assurance that the outlook for risk assets was improving. This led to increased confidence in the outlook for emerging markets and commodities as evidence mounted that the developing economies were going to lead the global economy out of the recession. Our caution through the summer toward EAFE equities (Europe, Australasia and the Far East) was not rewarded, as those

markets rocketed back with the global markets, and U.S. investors got the additional benefit from the declining value of the U.S. dollar. We also underappreciated the valuation opportunity in global real estate, instead focusing on the significant fundamental challenges facing this asset class. But on an overall basis, our interest in redeploying cash after the Fed went “all-in” with its quantitative easing program was on the mark.

The tremendous dislocations in the financial markets during this period, through both the uncertainty of the economic outlook and the illiquidity of the markets, led to unprecedented valuation anomalies. As one example of this, Chart 3 shows a measure of the valuation differentials within the U.S. large-capitalization stock market. At its peak in the first quarter of 2009, the difference between the cheapest and most expensive stocks reached record levels, which created significant opportunities for stock picking. Similar valuation differentials occurred in numerous other markets – including investment-grade and high-yield bonds, municipal bonds and global real estate. As the efforts of global central bankers to restore market liquidity began to bear fruit and investors started to gain the confidence to take risk again, these valuation opportunities started to be reduced.

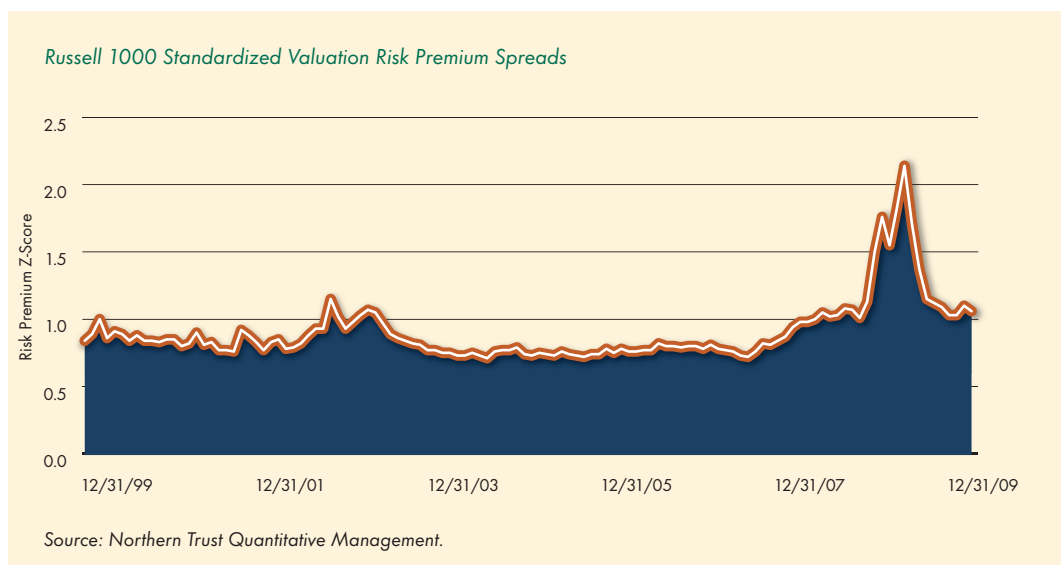
As we enter 2010, the gaping valuation differentials have been normalized, so investment returns going forward will be much more dependent on the fundamental outlook for an asset class as opposed to the correction of valuation anomalies.

As we assess the outlook for financial markets broadly, we think the state of the credit markets and the progress toward self-sustaining economic growth are two of the most important topics.

The credit markets have healed more than the broad economy, due to the government’s liquidity programs and also due to the discounting of future improvement in the growth outlook. Spreads on high-yield bonds, an indication of investor uncertainty about the financial outlook for non-investment grade corporations, have tightened from 18% to less than 8% this year. This reflects not only an increased risk appetite among investors but also an improved outlook for these corporations. Moody’s reduced its expected default rate for September 2010 from 15.5% to just 4.5% in October, as the improved credit markets allowed companies to refinance upcoming maturities, and the improved economic outlook boosted cash flow projections. This is real progress. Even the “next shoe to drop” in the financial markets – commercial real estate – has seen a rally in

As we enter 2010, the gaping valuation differentials have been normalized.

CHART 3: BIG VALUATION DIFFERENTIALS SUBSIDE



Economic data indicate a U.S. economy lumbering out of recession.

its bonds. Spreads on commercial mortgage-backed securities peaked at 14% in late 2008 and since have tightened by roughly 50%. This is against a backdrop where the Moody's National All Property Index has fallen by 44% since its high in October 2007.

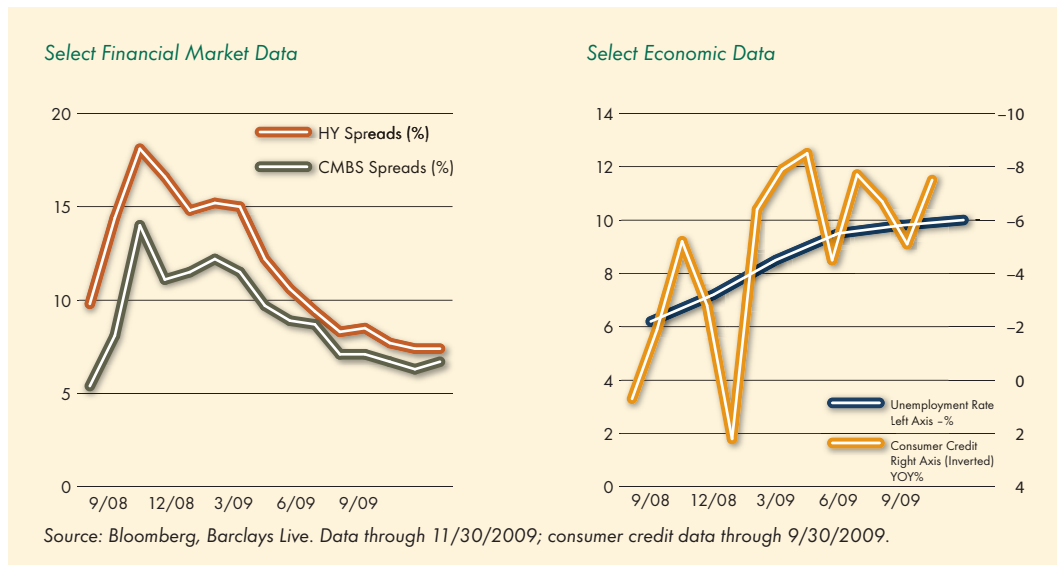
The reported economic data this year indicate a U.S. economy lumbering out of its recession. The labor markets may finally be improving, as corporations were brutal in reducing jobs and have been parsimonious in hiring. Credit creation, as depicted in Chart 4 by the contraction in consumer credit (shown inverted on the chart to parallel the unemployment data) has been problematic, as banks are hesitant to lend in this economic environment and consumers are finally rebuilding their balance sheets through increased savings. The most likely path forward for U.S. growth seems to be through increased corporate spending, as strong profit margins and high free cash flow could

combine with increasing "animal" spirits to restore risk taking.

The current state of the U.S. credit markets and economy can be summarized as clearly improving but still tethered to governmental involvement and support. The expansion of the Fed's balance sheet through its quantitative easing program leaves it with a balance sheet that must eventually be shrunk without upending the financial markets. The involve-

ment of the Obama administration and Congress in health care and climate change regulation has been a significant uncertainty hanging over the markets and corporate planning. But as attention turns to the mid-term elections in 2010, the opportunity exists for both groups to focus more on economic growth and fiscal responsibility – which would be well-received by the financial markets.

CHART 4: WHAT IS THE STATE OF REPAIR?



OUR OUTLOOK INTO 2010

With global central banks and treasury departments playing the definitive role in restoring functionality to the credit markets in 2009 and allowing the stock market and then the economy to start to heal, foremost attention must be directed their way as we look into 2010. Because of the overwhelming breadth of programs implemented during the financial crisis, analysis of the tightening cycles goes beyond what the Fed and other central banks do with short-term interest rates. The Fed, for example, has already indicated the wind-down of several liquidity vehicles that had shrunk in usage as the respective markets healed. These are the easy measures; shrinking the Fed's balance sheet, which has swollen to more than \$2 trillion through the purchase of mortgage-

backed securities and U.S. Treasuries, will prove much trickier. The Fed will also have a new tool to use this cycle – its ability to pay interest on excess reserves. To the extent that the Fed raises this interest rate, banks will have incrementally less incentive to utilize those reserves through loan creation – an effective tightening of monetary policy.

THE IMPORTANCE OF GETTING THE FED RIGHT!

While the pace of loosening of monetary policy was fairly coordinated globally, the timeline of tightening is already showing much greater variety. Emerging economies, and some developed economies closely linked to the high-growth emerging regions, are already tightening policy either directly through raising short-rates or more indirectly through bank lending constraints. Because these economies have less excess capacity and less deleveraging to overcome, we expect them to continue to be the leaders in normalizing monetary policy. We expect developed nations, specifically the United States, Europe, the United Kingdom and Japan, to be more deliberate in the tightening process. We think a weaker growth outlook in these regions should temper inflation concerns, and in combination with high unemployment rates, lead to low rates continuing for quite some time.

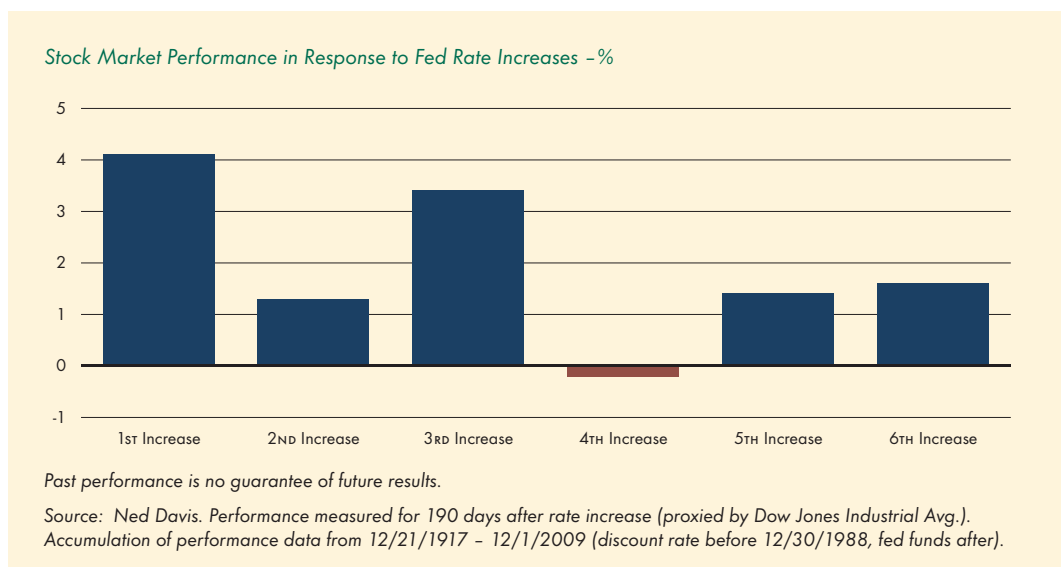
Global bank tightening cycles are, in general, negative for the stock market. Historically, the Fed’s tightening has been in response to concerns that the economy is at risk of overheating and creating undesired levels of inflation. As shown in Chart 5, the subsequent return of the stock market declines as Fed rate hikes accumulate. From the period of 1917 forward, the subsequent return of equities over a six-month period after the sixth rate increase is just 1.6%. This reflects investor concern that if the Fed has gotten this far along in raising rates, the odds of an economic downturn have increased measurably.

This cycle, the tightening process will be unusual for two major reasons. First, rates are at extraordinarily low levels, and some increase can be viewed as mere normalization of short-term interest rates. Second, the tightening cycle will also include the wind-down of liquidity features enacted to fight the financial crisis. These efforts, such as the management of the Fed’s mortgage holdings, will be less obvious to the public but will be an important part of our analysis. The Fed has articulated its key criteria for eventual tightening of monetary policy to include capacity utilization (think: the unemployment rate), realized inflation and inflation expectations.

Investment Implications: We think that the Fed will be very deliberate in removing liquidity support and raising interest rates. A period of continued

We expect emerging economies to continue to be the leaders in normalizing monetary policy.

CHART 5: THE EFFECT OF TAKING AWAY THE PUNCHBOWL



A Fed at risk of falling behind the curve would be a problem for most assets.

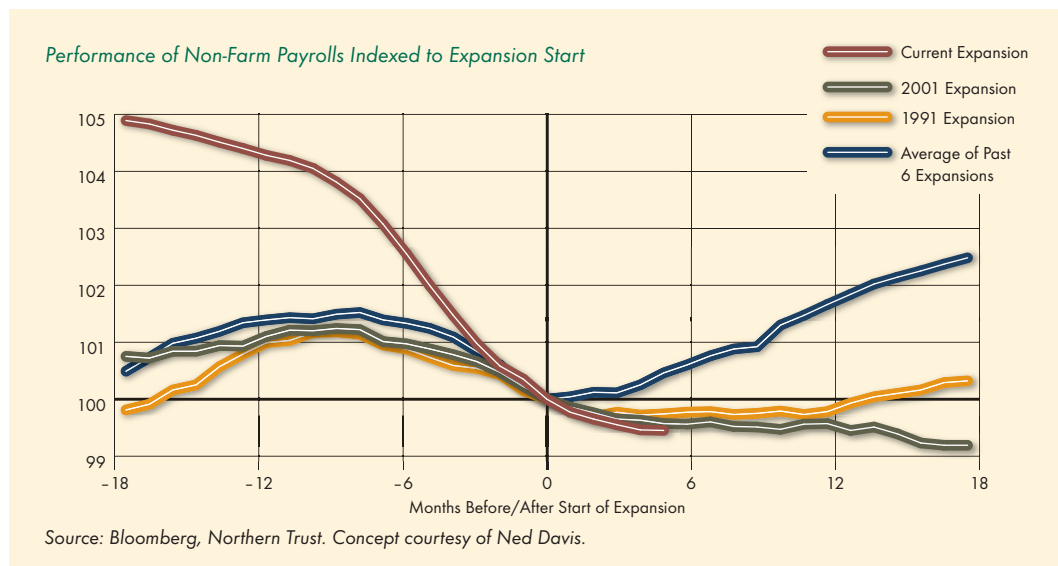
low interest rates, in conjunction with reasonable global growth, should continue to support the equity markets. We think that as the year progresses, inflation expectations could rise based on this accommodation, and we believe commodities and inflation-protected securities may benefit in an inflationary environment. Finally, we'll pay particular attention to how the eventual tightening cycle is likely to play out. A Fed at risk of falling behind the curve (with market interest rates rising well beyond current levels) would be a problem for most assets.

THE JOBLESS RECOVERY 3.0

As we assess the likely composition of the economic recovery, our expectation is that the pace of job creation will be slow, and thus we will experience our third consecutive “jobless” recovery. In the average of the last six economic expansions, the economy started creating jobs at a rapid pace once the economy started growing. However, starting with the March 1991 recovery and accelerating with the recovery starting in November 2001, the pace of job gains has been disappointing. Research written by the Federal Reserve Bank of San Francisco (*Jobless Recovery Redux?* June 5, 2009) posits that the rate of job loss during these two recessions had been relatively normal, but the lack of new job creation is what led to the poor net job picture. During this recession, we have experienced both high levels of job loss and low levels of job creation, leading to the 10% unemployment rate.

The more difficult employment picture over the last three cycles has occurred during a period of significant globalization of the world economy. Industry realignment has led to the permanent movement of certain industries to lower-cost countries, leaving behind workers needing retraining for new careers. We also have relatively high uncertainty within the U.S. business community about the regulatory environment they face. With health care and climate change costs up in the air, it is understandable why businesses are reluctant to hire. Additionally, with the average work week near historic lows, employers can extend the hours of their current workforce before adding new permanent workers.

CHART 6: TRACKING ANOTHER JOBLESS RECOVERY



Investment Implications: The flip side of the high unemployment rate is that corporate productivity has soared, and profit margins have correspondingly jumped. In addition, we believe incremental demand should generate further significant profitability gains, if marginal profit margins remain high. The macro-implication

of this is that we may be setting up for an investment-led recovery in the economy (see Play the Capex Cycle, below), so companies oriented toward investment should perform better than those leveraged to consumer spending. We also think this bolsters the case for low realized inflation, as wage pressures aren't going to build when job creation is weak. Finally, we don't think that a jobless recovery by itself will discourage risk-taking by investors, although the experience of the last two such episodes is mixed. The S&P 500 advanced 11% in the first 12 months of the 1991 recovery, but it fell 17% in the first year of the 2001 economic recovery as starting valuations were still too high. With current valuation levels on the S&P 500 at a reasonable 14 times 2010 expected earnings, we think U.S. equities have the potential to perform well through 2010.

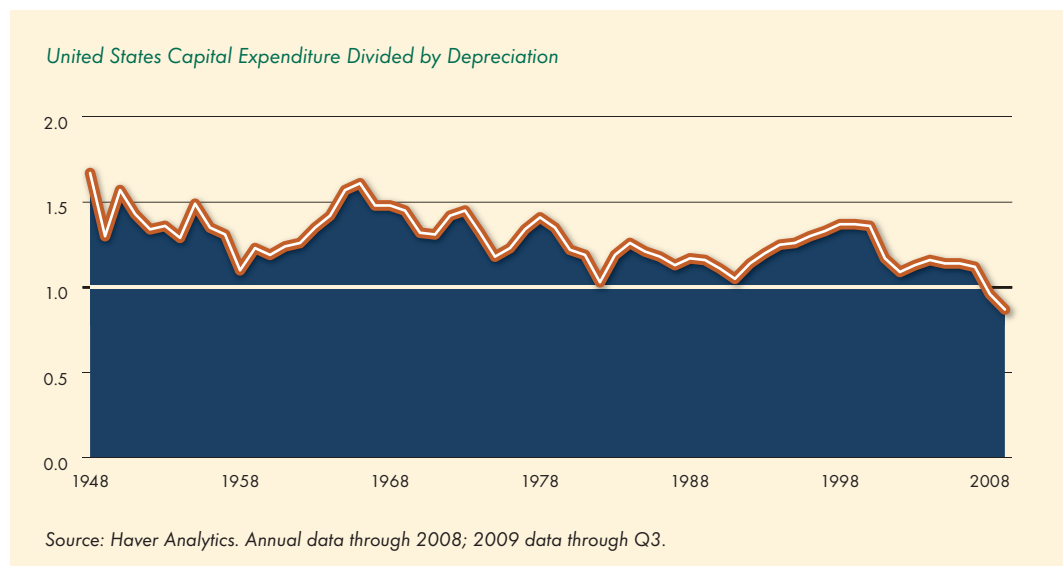
Corporate executives were united in their efforts to slash expenses in the wake of the financial crisis.

PLAY THE CAPEX CYCLE

Just as central banks were relatively coordinated in their easing cycle, corporate executives were united in their efforts to slash expenses – be it employees, inventory or capital expenditures (capex) – in the wake of the financial crisis. In fact, managements in the United States got so excited by cutting capital expenditures that they forgot to stop. For the first time since World War II, capital expenditures fell below the level of depreciation. Said another way, our current plant, property and equipment stock is wearing out faster than we are replacing it. This is a phenomenon that can persist only for a short period of time, especially as the economy is recovering and labor productivity is at astonishingly high levels. The impact of this frugality on broad economic growth is significant – in the first half of 2009, the investment portion of the gross domestic product (GDP) fell at a 38% rate. With investment representing around 14% of GDP, this by itself led to a 5.4% decline in GDP!

Investment can be broadly categorized in three groups: business investment, inventory stocking or de-stocking, and housing. Housing is the easiest component to discuss – we don't expect this area to add significantly to growth for several years as the “shadow” inventory of homes should keep inventories relatively high. Business investment is likely to continue to grow from here, with high corporate profitability supporting investment in those areas either wearing out or promising productivity gains.

CHART 7: CAPITAL EXPENDITURES HAVE PLUMMETED



We think the upturn in capital spending will be global in nature and amplified in emerging markets.

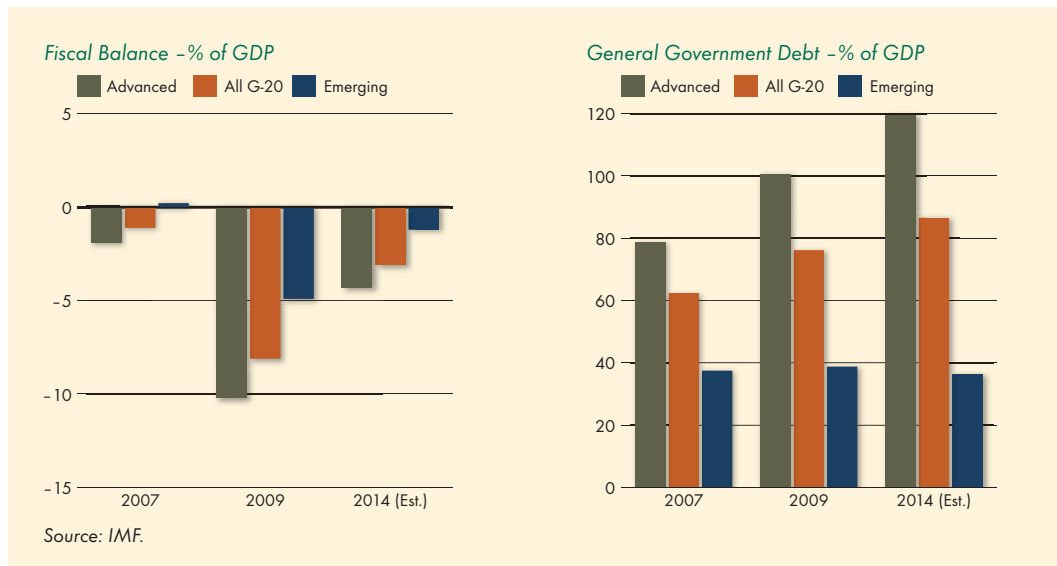
Capacity expansion-related spending looks like a bad bet for the foreseeable future. Finally, inventory levels continue to decline through the third quarter and must stop falling if the economy continues to grow. It seems likely that inventory de-stocking will become less of an economic drag fairly soon.

Investment Implications: The most important implication from this development may be the rebound effect it will have on macro-economic growth. This has already helped, by boosting third-quarter growth in the United States, where an 11% rise in investment spending added 1.3% to growth (as compared with a 5.4% decline in the first half 2009, representing a 6.7% swing in overall growth). We think the upturn in capital spending will be global in nature and amplified in emerging markets where economic growth is roughly twice as capital intensive as in the United States. Therefore, providers of capital goods in non-capacity-related areas, especially those with a special focus on those exporting to higher growth markets, potentially should be very well positioned to prosper.

BEWARE THE BUDGET DEFICITS

The aftermath of the global financial crisis has left many nations with significantly deteriorated budget outlooks, due to both their stimulus efforts and the negative effect of the recession on tax receipts. This isn't surprising (if that is any comfort), as the banking crises over the last 30 years have on average led to an 86% increase in the representative countries' real public debt in the three years following the crisis (Reinhart and Rogoff, *The Aftermath of Financial Crises*, December 2008).

CHART 8: ADVANCED COUNTRIES COULD SEE BOOMING BUDGET DEFICITS



Major countries have had a relatively easy time financing the deficits so far, as the demand for private credit has been contracting and there has been a wall of cash seeking "risk-free" sovereign debt. But this picture could change over the next several years in a couple of ways. First, if the global economy grows more quickly than consensus expectations, private credit issuance would pressure the demand

for sovereign credit, and rates would rise in response. Second, governmental issuers have benefited from the low rate environment – we estimate that the United States has seen its effective interest rate decline from 6.5% to 4.4% over the 10-year period from 1998 to 2008, helping cushion the

jump in debt outstanding, which rose from \$3.7 trillion to \$5.8 trillion over this time period. The United States is expected to see its interest tab more than triple over the next 10 years due to a combination of higher interest rates and increased debt outstanding.

Investment Implications: The emerging market countries entered the global recession with budgets roughly in balance, as compared with the advanced countries which were collectively running a fiscal deficit of around 2% at the end of 2007. With much smaller losses being taken by emerging market banks through the crisis, the amount of government assistance to the overall economy has been more limited, and government debt is projected to remain relatively stable as a percentage of GDP. This should be supportive to emerging market growth over the longer term. Conversely, growth in the advanced economies will be constrained not only by the remaining cost of the financial repair but also by the systemic costs of aging populations. This suggests higher interest rates to come, especially if the global economy surprises to the upside and private credit demand grows more quickly.

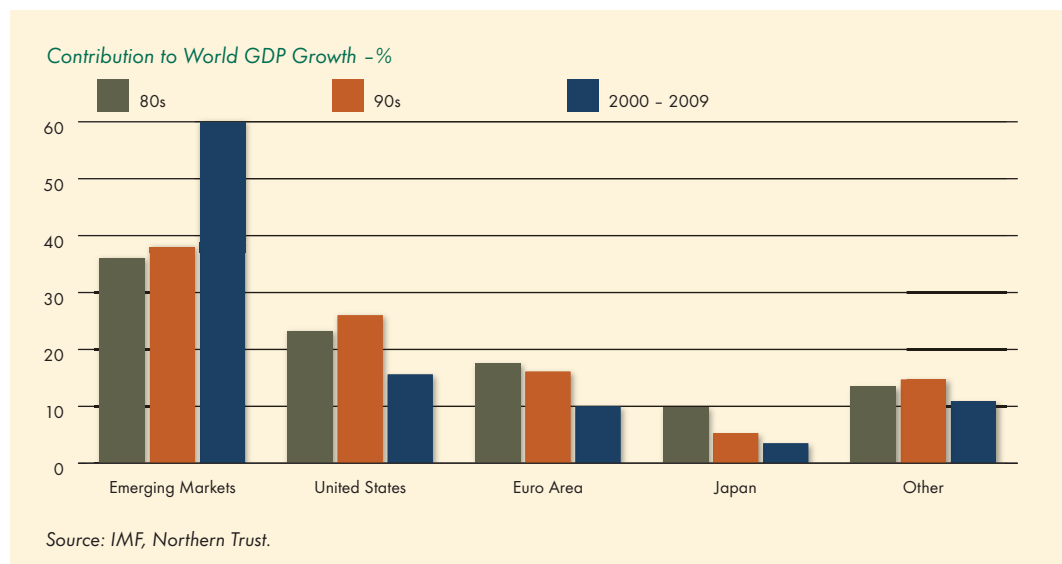
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BE POSITIONED FOR GLOBAL REBALANCING

Global rebalancing, as we think about it, includes not just the changing composition of growth between countries over time but also the changing components of economic growth within countries. The dramatic increase in global growth coming from emerging markets was a primary driver of global growth over the last decade but also facilitated the global financial crisis. As Asian and oil-exporting countries enjoyed boom economic times, with growing current account surpluses as a result, these funds got increasingly recycled into the United States as it lived beyond its means. The resulting low interest-rate environment allowed the leverage-fed investments in the housing market to continue until they could continue no more.

The changing components of economic growth within countries going forward will be in direct response to these imbalances. The United States needs to increase its savings and reduce its budget deficit, while emerging economies have learned that they need to rely less on exports and more on domestic consumption and investment. These changes in behavior are a multi-

CHART 9: CHANGING COMPOSITION OF GLOBAL GROWTH



We think investors should consider the new sectors of growth within each economy.

year process, although the United States has already seen its savings rate increase from 0.8% in April 2005 to 4.4% as of this October. This is roughly half of the adjustment needed to restore savings to long-term trend levels. Increasing consumption in the emerging markets has also been underway, and emerging market consumer spending is now comparable in size to U.S. consumer spending. With savings rates in many emerging economies remaining very high, a longer-term process of building out the social safety net through broader retirement benefits, unemployment insurance and national health care remains of significant importance.

Investment Implications: We think the best long-term growth opportunities over the next 10 years are likely to continue to be tied to the emerging markets, either directly or indirectly. Emerging market equities remain of high interest as direct plays on this growth and at valuation levels still reasonable despite their tremendous performance in 2009. We also think that commodities are appealing, due to attractive supply/demand dynamics, their particular exposure to emerging market growth, and the potential inflation hedge they offer. With respect to the changing composition of growth within countries, we think investors should consider the new sectors of growth within each economy. We discuss our outlook for equity sectors in the next section but would also highlight that large-cap stocks could benefit from greater export sensitivity than small caps. Investments in developed Europe and Japan may also benefit from similar trends, while emerging markets investments oriented more toward domestic consumption and less toward exports seem in order.

EQUITY SECTOR OUTLOOK FOR 2010

Our views on specific sectors are based on a combination of our overall views on the economy and financial markets (our macro view) and the specific fundamental and valuation developments within the sectors. Our macro view since the spring of 2009 has been that the reflation efforts of global central banks were going to restart economic growth (first in emerging markets), and then also kick off concerns about inflation (which is what the bankers were trying to create after all!). Hence, we believe sectors with the greatest exposure to emerging market growth offer attractive investment opportunities, while we view those groups focused on domestic U.S. consumption less favorably.

As a result of this, the sectors we believe offer opportunities include industrials, materials and technology. We see all three groups as potential beneficiaries of emerging market growth due to its capital intensity and commodity orientation. Industrial shares had fallen out of favor with investors during 2009, which we think created an opportunity for appreciation in combination with the global recovery. The materials stocks have been great performers this past year as demand for commodities jumped, and our positive outlook for this group remains as long as the global growth outlook stays strong and valuations are supportive. Technology spending tends to correlate well with corporate profits, which are rebounding strongly. In conjunction with still-reasonable valuations, we have a favorable outlook on tech shares heading into the new year.

Our outlook on the energy and health care sectors is currently neutral. We were positive on energy shares until late last year, when concerns over inventory levels caused us to downgrade our outlook for these stocks. And with the final contours of the likely health care expansion bill

becoming more known, we feel the significant underperformance that had been realized in this group is likely behind us. Sectors we believe may underperform, including telecom, utilities, financials and consumer discretionary, share two major commonalities – heavy exposure to U.S. spending and defensive characteristics.

CONCLUSION

As we get set to leave this decade behind, we are spending much of our analytical time discussing the state of the global economic rebound, the likely course of policymakers and the state of governmental finances. We have upgraded our view of the prospects of the U.S. economy, based on improving labor market trends, better-than-expected consumer spending and evidence from the transportation sector that economic activity continues to improve through year-end.

In contrast to the United States, recent data from Japan and Europe has been less inspiring. Japanese GDP growth for the third quarter has been revised from an initial report of 4.8% annualized growth to just 1.3%, due to a significant reduction in corporate capital spending. In Europe, weak industrial production data for the Euro zone and soft German order and output data for October give slight pause to the generally improving growth outlook. With exports having only recovered around one-third of their losses from the recession, there still does appear to be room to run, but the journey may be more eventful than previously expected. The European Union is also finding itself increasingly dragged into discussions of member-country fiscal problems. On balance, the potential of a moderating growth outlook and sovereign credit problems should mean somewhat easier monetary policy.

As financial markets continue to mend, we are increasingly focused on the financial repair bill left behind. This sovereign budget issue has been heightened by the recent travails of Dubai and Greece, but is also of great discussion in the United Kingdom, United States, Spain and Ireland. We think the path to repair will start with governmental budget restraint, à la Ireland's tough love plan, and potentially improve with continued global economic growth.

So looking into the new year, we expect the combination of broadly accommodative central banks and improving global growth to continue well into 2010. Emerging market growth continues to impress, especially relative to developed markets. While the United States, Europe and Japan all generated less than 3% growth in the third quarter, major emerging countries like China, India, South Korea and Singapore all generated growth in excess of 10%.

So we do see shifting opportunities among the various asset classes, such as the current growth differential that may be developing between the United States and its developed cousins in Japan and Europe. The risk of a material decline in financial markets remains in the event of an early tightening by central bankers. Recent indications from the Federal Reserve have suggested a modest improvement to the growth outlook, with a renewed vow to keep rates “low for long.” We continue to think that emerging markets, including equities and commodities, provide the best opportunities for investors for not only the near term but also the long term, given the anticipated major shifts in the global economy.

The sectors that we believe offer opportunities include industrials, materials and technology.

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