



Insights from Northern Trust

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The capital markets became more complicated last week, with new dynamics entering the mix in just four days of a holiday-shortened trading week. Stock prices fell as investors considered new levies and restrictions on banks while the week's corporate earnings results were mixed. Uncertainty increased dramatically as China moved to cool bank lending, the Democrats lost a key Senate seat, and the reappointment of Federal Reserve Chairman Ben Bernanke came into question.

Stocks suffered their worst week in almost a year, with the Standard & Poor's (S&P) 500 retreating 3.9%, the Dow Jones Industrial Average falling 4.1%, and the NASDAQ losing 3.6% for the week. Equity markets around the world followed suit, falling 2% to 4% by week's end. In the United States, many financial sector stocks dropped by 10% or more as President Obama proposed new restrictions on banks, a proposal quickly referred to as the "Volcker Rule" in honor of Obama advisor and former Fed chief Paul Volcker.

In Asia, China reported that its international currency reserves had grown 24% to reach a record \$2.4 trillion in 2009, an indication that recent moves by the Chinese government to slow its economy have so far not been effective. The People's Bank of China then raised its reserve requirement ratio by 50 basis points to 16% in an attempt to further constrain bank lending. Demonstrative of the growing strength and momentum of emerging markets, the U.S. government continues to look for ways to encourage bank lending, while in China authorities are trying desperately to curb credit growth.

The closely watched Chicago Board Options Exchange Volatility Index, or VIX, has now completed a round trip over the past two weeks. The VIX dropped sharply the week of January 11 to close at a historically low 17.8%, then spiked to 27.3% by the end of last week, jumping 55% in the last three trading days alone. This volatility jolt marked the end of investor complacency and demonstrated a rapid change in investor psychology. Consistent with higher risk and volatility in equities markets, prices of U.S. Treasury securities advanced for the third consecutive week as investors predicted another flight to quality in the wake of the Volcker Rule proposal and other political uncertainties. Most commodity prices fell, however, on concerns that Chinese demand will slow as that country tightens its monetary policies. For example, crude oil for March delivery closed at \$75.64, down 2.6% for the week.



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On Tuesday, Republican Scott Brown was elected to the Massachusetts Senate seat long held by Ted Kennedy in a race that was widely considered a lock for Democrats. This astounding political upset has immediately altered Democrats' legislative agenda, as Mr. Brown's election denies them their previous filibuster-proof supermajority in the Senate. Indeed, President Obama acknowledged that healthcare reform, his top priority, had "run into a bit of a buzz saw" and opened the door for a less-ambitious, scaled-back version that might attract bi-partisan support. The Brown victory in Massachusetts also threatens the current form of the President's other legislative priorities, including cap-and-trade, card check and financial regulatory reform.

Late in the week, President Obama's nomination of Ben Bernanke for a second term as chairman of the Federal Reserve appeared in jeopardy as several Senators spoke out against *Time* magazine's 2009 Person of the Year. Bernanke's current term as Fed chairman ends at the end of this month, and the vote on his reappointment could come as early as Wednesday. Over the weekend, the Obama administration and influential Democrats rallied behind Bernanke, and at this time it looks likely that Bernanke will be approved for a second term at the Fed's helm.

Yesterday, *Bloomberg News* estimated that the primary measure of domestic economic activity, gross domestic product (GDP), expanded by 4.6% in the fourth quarter of 2009, more than double the third quarter growth rate, and perhaps indicating a better-than-anticipated economic recovery. While the government's official estimate of fourth quarter GDP growth will be released this Friday, investors are now focused on whether or not this strong momentum will extend into 2010. Importantly, our base case forecast is built on steady (e.g., 2.5%) but not robust economic growth for all of 2010, enabling the Federal Reserve to begin to unwind its accommodative monetary policy stance at a measured, market-friendly pace.

And while low interest rates, low inflation and rebounding economic growth continue to support our constructive outlook for global financial markets, another pillar of the recent market recovery – stability – took a major hit last week. The certainty and predictability markets crave were buffeted by several important political and economic events, and markets' reaction to these developments suggests investors should prepare for a heightened period of volatility.

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