



Insights from Northern Trust

Commentary from Michael S. Wente, Chief Investment Officer, Southwest Region

March 8, 2010

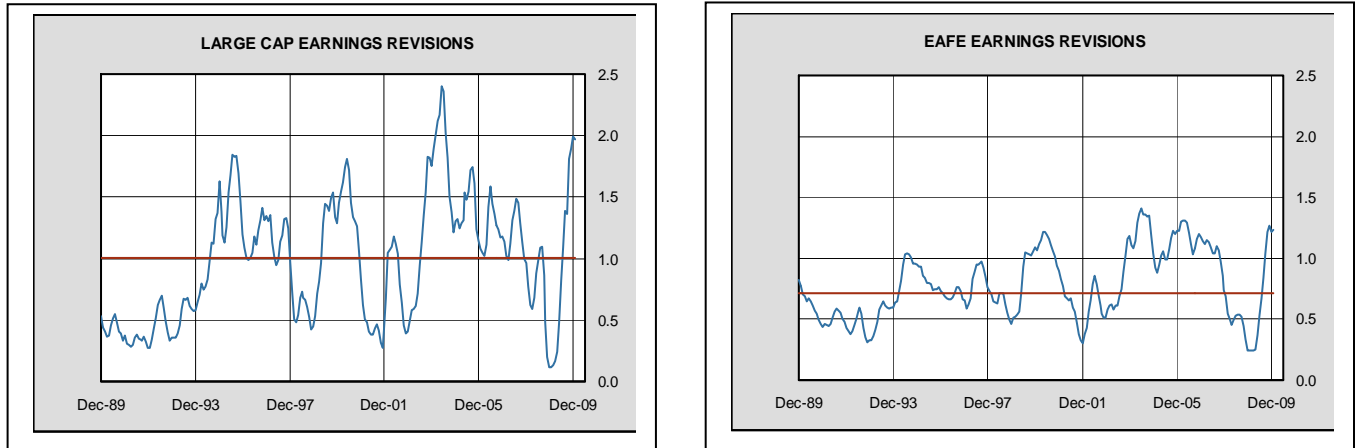
What a difference a year makes! As we approach the Ides of March, investors are able to put some distance – 12 months specifically – between themselves and the end of one of the worst market declines in history. Helping to return feeling to numb, nerve-frayed investors have been the stellar returns experienced over the last 12 months. Broad equity measures such as the Standard & Poor's (S&P) 500 and the MSCI Europe, Australasia, Far East (EAFE) generated returns of 53.6% and 54.6%, respectively – one of the best 12-month periods in history.

Bond investors also participated in this financial market rebound, with total returns in the range of 7% for tax-exempt bonds and 9% for a mix of investment-grade taxable bonds. In light of these robust short-term returns, investors are rightly questioning the reasonableness of maintaining a constructive outlook for risk-based asset classes, equities in particular. However, a longer-term review shows that, even inclusive of the last 12 months, domestic and developed international equity market performance over the last five and 10 years is break-even at best.

A study released last week by Duke University in conjunction with *CFO* magazine discussed earnings growth expectations. This study included a survey of 1,400 chief financial officers (CFOs) globally and indicated that CFO expectations for U.S. and Asian company earnings growth are 12% to 14% over the next year. These same CFOs also projected that capital spending will be up 9% next year, the strongest increase since 2003. Unfortunately, projections of meaningful employment gains remain modest, and most CFOs felt it would be two or three years before private sector hiring pushed unemployment back down to pre-recession levels.



Proper valuation of expected corporate earnings can be a protracted discussion, but by most measures current equity market valuations are at a slight discount to historical norms. A healthy outlook for corporate earnings with a tendency to surprise on the upside, combined with a slightly discounted valuation, forms the basis of our constructive outlook for both domestic and international equities.



Source: Bank of America Merrill Lynch; data through February 2010.

The first week of March was dominated primarily by positive economic news. Evidence of continued growth came from a number of economic releases last week. On Monday, the government reported U.S. consumer spending increased 0.5% in January, the fourth consecutive monthly gain and a sign that consumers may contribute more to overall economic activity in coming months. The Institute for Supply Management (ISM) manufacturing index came in at 56.5 on Monday, marking the seventh consecutive month of expansion in the manufacturing sector. On Wednesday, ISM's index of non-manufacturing rose to 53, a level that exceeded forecasts and signaled that prior gains in manufacturing may now be filtering through to the larger part of the economy, the service sector. Also on Wednesday, the Federal Reserve's Beige Book business survey showed the U.S. economy overcame a couple of large snowstorms and improved in nine of the Federal Reserve's 12 districts in January and February.

In the labor market, the productivity of American workers surged in the fourth quarter. According to the U.S. Labor Department, output per hour shot higher at a 6.9% annual rate, while unit labor costs plunged at a 5.9% annual rate! Productivity improvements of this remarkable magnitude simply cannot continue much longer without eventually requiring more full-time workers.



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Other evidence of continued economic strength came later in the week with retailers reporting that their sales jumped 3.7% in February, the largest gain since November 2007. But the most anticipated statistics of the week were included in last Friday's employment report. Investors had been expecting another disappointing jobs report due in large part to snowstorm effects. Earlier in the week, ADP Employer Services had indicated that U.S. companies had cut the fewest jobs in two years. Nonetheless, consensus expectations headed into Friday's Department of Labor report were for a 68,000 decline in non-farm payrolls and a slight increase (from 9.7% to 9.8%) in the national unemployment rate. Instead, the Labor Department's report indicated that payrolls only dropped 36,000 and the unemployment rate remained unchanged at 9.7%.

This upside surprise on the employment front provided more support for equity markets: the S&P 500 climbed 15.7 points or 1.4% Friday, finishing a week-long rally up 34.2 points or 3%. This positive follow through on the back of good performance in February has pushed all the major equity indexes back into the black for the year. In addition, and another good sign for equity investors, the Chicago Board Options Exchange Volatility Index (otherwise known as the "VIX" or fear index) dropped to 17.6, well below its long-term average of 20.3.

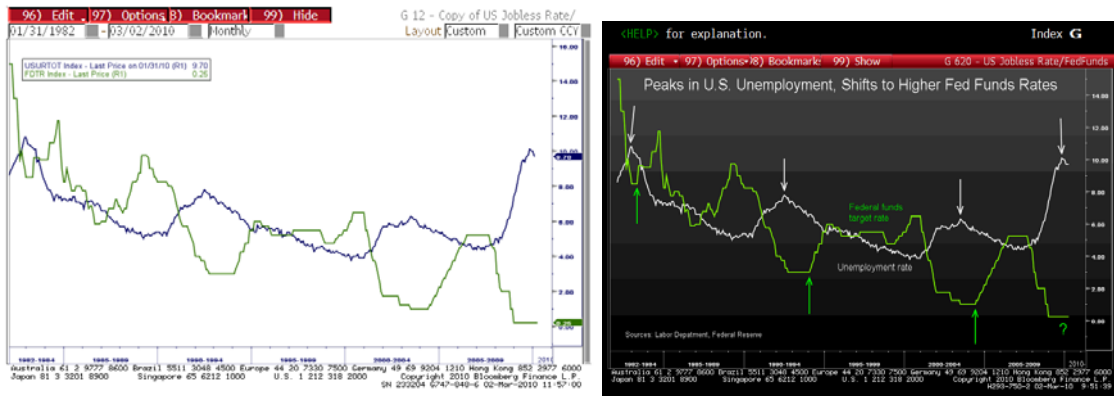
Last week's economic and financial market progress was not unblemished, however. Most challenges surfaced under the banner of deleveraging, either at the government, corporate or consumer level. The most obvious example last week was Greece and its struggle to implement a credible deficit reduction program. As Greece will likely be joined by one or more other European Union members in the austerity ward, financial markets remain vulnerable to news headlines documenting this long and painful fiscal process.

Here in the United States, investors are acutely focused on the daily developments in financial and healthcare legislation. Despite increasing signs of bipartisan participation, last week ended without news of any meaningful advance in the path of financial regulatory reform. And while President Obama pushed hard on Congressional Democrats to approve the Senate's version of a sweeping healthcare overhaul bill, lingering questions about the bill's true cost to both consumers and employers are keeping several key Democrats uncommitted at this time.



Finally, and in anticipation of the Federal Open Market Committee meeting on March 16, the release of the Fed's Beige Book last week reignited the debate on when the Federal Reserve should begin to raise interest rates. Just recently Fed Chairman Ben Bernanke reiterated his long-standing view that the Fed would leave rates very low for an "extended period." Conversely, Kansas City Fed President Thomas Hoenig purportedly wants to eliminate the "extended period" language in light of improving economic and financial conditions.

Financial markets would likely react adversely to a Fed rate hike anytime soon. Historically, the Fed does not begin raising rates until 12 months after the peak of unemployment. If we assume (perhaps optimistically) that unemployment peaked in October 2009 at 10.1%, the Fed (following its traditional protocol) would not raise rates until the fourth quarter of this year. Indeed, rate hike probabilities assigned by interest rate futures markets currently indicate that the Fed will wait until its November meeting before raising the federal funds rate this year.



Source: Bloomberg; data through 2/28/2010.

Financial and healthcare reform legislation, premature rate hikes and other perceived headwinds have and will periodically disrupt investors' confidence in both the economic expansion now underway and the prospects for continued corporate earnings growth. In the aggregate, the data released last week support our view that the current economic expansion will prove durable, and the near-term outlook for risk-based assets – equities in particular – remains constructive.

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