



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Greece continued to occupy the center stage of the global capital markets last week, although we saw the power of the understudy on Friday as Goldman Sachs grabbed the leading role in what amounted to a drama-filled week across the asset class spectrum.

The Greek financial crisis accelerated last week as Standard & Poor's (S&P) lowered its credit rating of Greek government bonds to junk status, and uncertainty increased regarding both the extent and structure of the proposed joint eurozone and International Monetary Fund (IMF) rescue package. To add even more uncertainty to the already tenuous situation among the peripheral European Union (EU) countries, S&P also downgraded the credit quality ratings of both Spain and Portugal. Suddenly what had been the specter of contagion became all too real, and the market reaction was fast and furious as short-term Greek bond yields exceeded 20% and the euro fell to a 12-month low of US\$1.31. Risk markets around the world declined, with the S&P 500 retreating on the week more than 2.5% after eight weeks of advances, the Russell 2000 (small capitalization index) falling 3.4% and the Europe, Australasia, Far East index falling 1.7% in U.S. dollar terms. Gold surged to \$1,180 an ounce on the uncertainty, and the flight to quality brought more support to U.S. Treasury markets. In fact, new issuance of two-, five- and seven-year Treasury bonds was met with robust demand, and rates fell across the curve, with the 10-year benchmark bond yield falling 18 basis points to 3.63%.

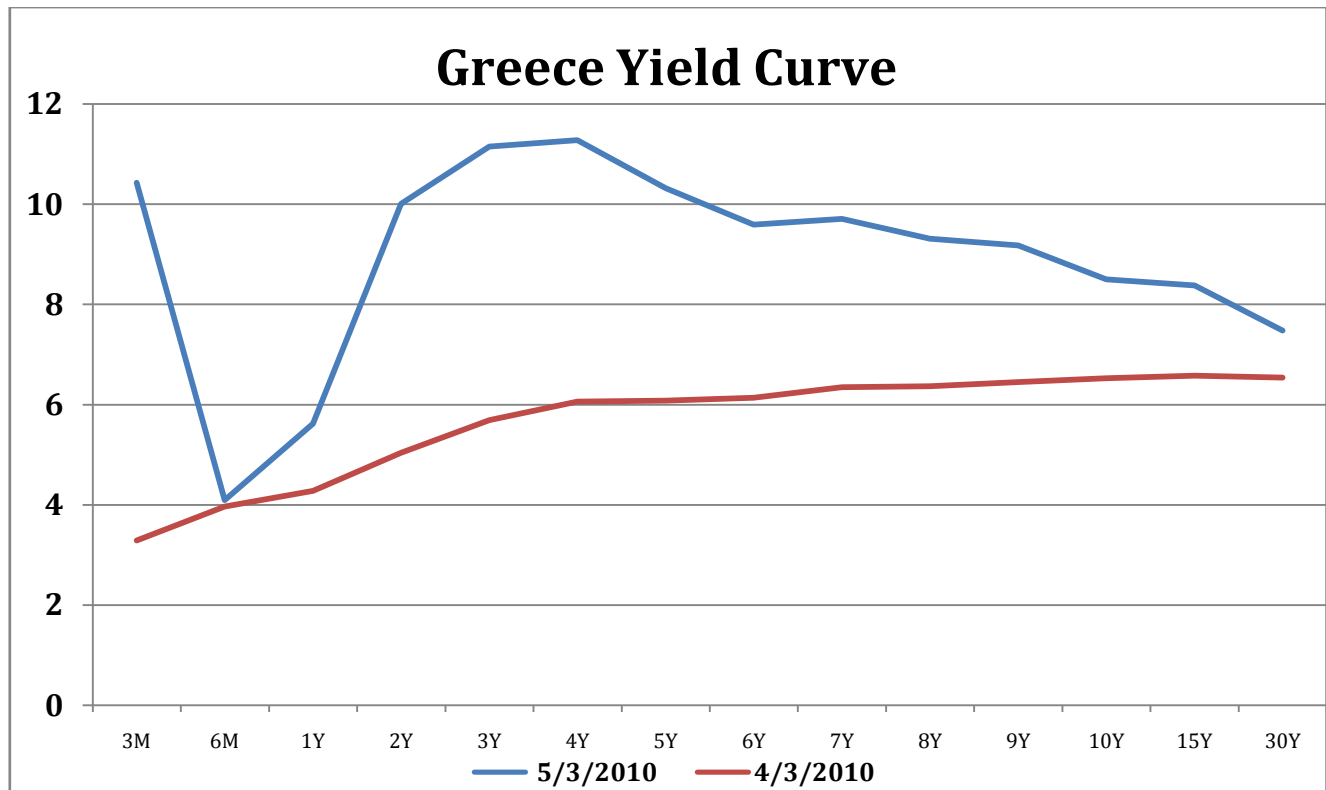
We learned over the weekend that a deal has been struck between Greece and the euro-region brethren/IMF. The rescue package announced includes €110 billion (US\$145 billion) in emergency loans. The financial support, however, is coupled with an expected austerity program designed to bring the Greek budget deficit to within the acceptable EU limit of 3% of gross domestic product (GDP) by 2014. With the current deficit at almost 14%, that may be a herculean task. A combination of significant tax increases and spending reductions – neither popular policies – will be required for the measures to succeed, and certain spending cuts being discussed are focused at the very core of the Greek social contract. Wage cuts, a freeze on pensions and amending long-standing labor rules are expected, and populist anger is sure to follow. The jury is most definitely “out” on the probability of success.

The test of reasonableness will have to wait, however, as investors have embraced this news, and the yield on the two-year benchmark Greek bond has fallen to 11.74%. While the near-term risks inherent in potential inability to refinance a large May refunding requirement have abated, few are convinced that this is the end of the Greek tragedy. It is interesting to note that the futures market is clearly forecasting that the euro will pay the price for this bailout and could face continued downward



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pressure. As you can see in following chart, the current yield curve for Greek sovereign debt reflects continued concern.



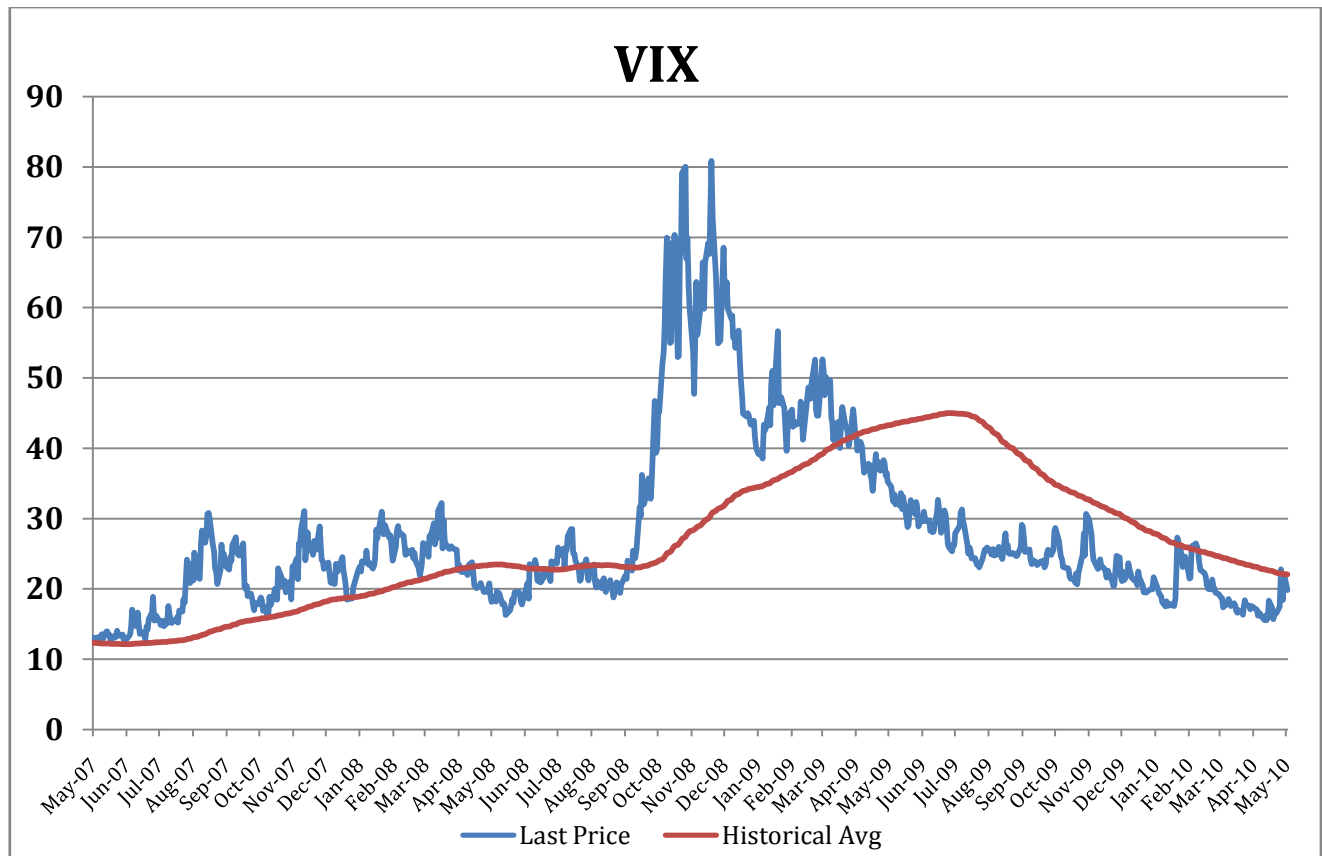
Source: Bloomberg Finance L.P.

Many ask, why this continued preoccupation with Greece? With an economy that contributes only 3% to eurozone GDP, slightly more than the contribution of Massachusetts to U.S. GDP, is it really a big deal? The answer is decidedly “yes,” but the reasons are more indirect than direct. Of course we worry about contagion and the impact of increased credit costs and loss of confidence in other peripheral countries in Europe. Although Greece is only 3% of regional GDP, the combination of Greece, Portugal, Italy and Spain represents a meaningfully higher percentage: more than 25%. Clearly the impact of higher credit costs on these peripheral states will likely affect economic growth – potentially significantly. Further, learning the lesson from Greece, these countries with high budget deficits probably will have to enact similar austerity measures, which could dampen growth in and of itself.

The general level of uncertainty has indeed risen, and this is apparent in the always-popular fear index, the Volatility Index (VIX). The VIX is the Chicago Board Options Exchange’s S&P 500 index that measures the market’s expectation of future volatility. The VIX increased significantly last week as investors sorted through the turmoil, erasing any sense of complacency as the flight from risky assets to the safe havens of the U.S. dollar, treasuries and gold took hold in earnest. The VIX had the largest one-day move since the onset of the global financial crisis back in September 2008.



As indicated below, however, this measure still remains fairly low by historical standards, so we need to keep this in perspective.



Source: Bloomberg Finance L.P.

Of course there was another “G” in the news last week – Goldman Sachs. After officials spent a rather grueling day in Washington on Tuesday answering charges for a Senate subcommittee that Goldman had put its own interests ahead of clients’, and having been formally charged in a civil complaint by the Securities and Exchange Commission just two weeks prior, Goldman Sachs probably thought things could not get much worse. Well, Friday brought news of a federal investigation by the U.S. attorney in Manhattan and possible criminal charges stemming from its mortgage business. The tea leaves are clear here: financial regulatory reform will become a reality, and now it is just a question of how far the regulatory pendulum swings. Despite Warren Buffet’s supportive words over the weekend, the heightened scrutiny over not only Goldman but also over the global banks is here to stay.

Unfortunately, the events abroad and on Broad Street overshadowed some fairly constructive news on the U.S. economic front, from a 3.2% first-quarter GDP figure which was accompanied by even more news that corporate spending is improving, to the release of the April Federal Reserve minutes which reflected the maintenance of the “extended period language” along with an upgraded assessment of the U.S. economy. Finally, we continue to be surprised by the strength in the quarterly earnings announcements, which are exceeding expectations on the bottom line but more importantly are reflecting some top line, or sales, momentum as well. We expect to see the good fundamental



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news continue in the United States, although at a measured pace, and the extension of the zero interest policy continues to support risky assets.

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