



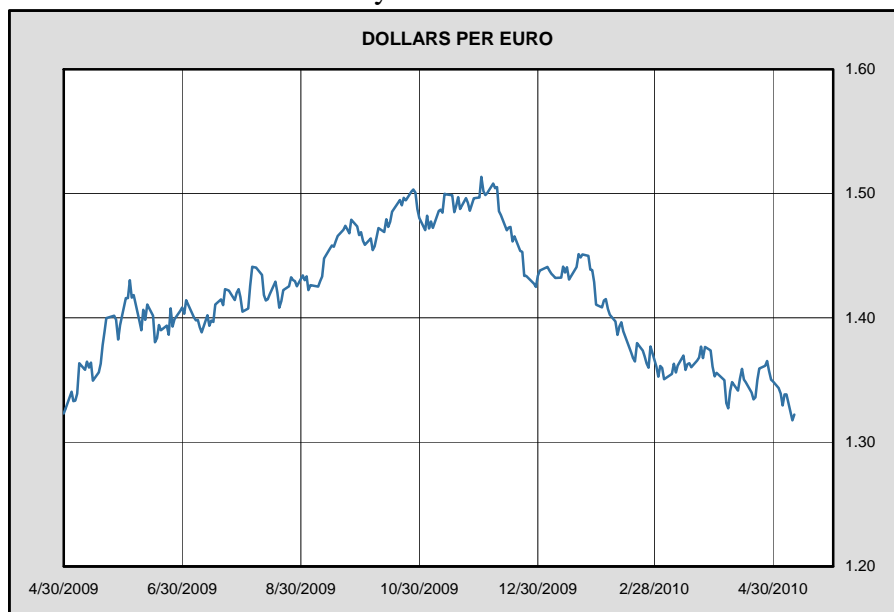
## Insights from Northern Trust

### Commentary from Jim McDonald, Chief Investment Strategist

May 12, 2010

After financial markets reached a peak in volatility late last week in the wake of the European debt crisis, European leaders announced a plan over the weekend to address the problem. Specifically, the eurozone has agreed to provide loan guarantees to troubled countries of €440 billion, provide an additional €60 billion in balance-of-payment facilities, received a commitment from the International Monetary Fund for a reported maximum loan value of €250 billion, and received a commitment from the European Central Bank (ECB) to buy (in unspecified quantity) public and private debt to boost eurozone bank liquidity. While leaders have agreed to these terms, we think that national approvals will be required from each of the European Union (EU) member countries before this becomes effective. We believe that Germany will grudgingly approve it, with France and Italy passing it more easily. Loans issued under the eurozone-backed loan guarantee program are guaranteed by each member of the eurozone – including those troubled countries whose debt is under question – in proportion to their share capital of the ECB. In effect, this socializes the debt problem across the eurozone – a move one step closer to a fiscal union.

Market reaction to the plan has been generally positive, with European financials rallying 12%. But the euro hasn't been able to gain traction because the plan does little to address overall debt levels – it just reduces some of the individual country risk.

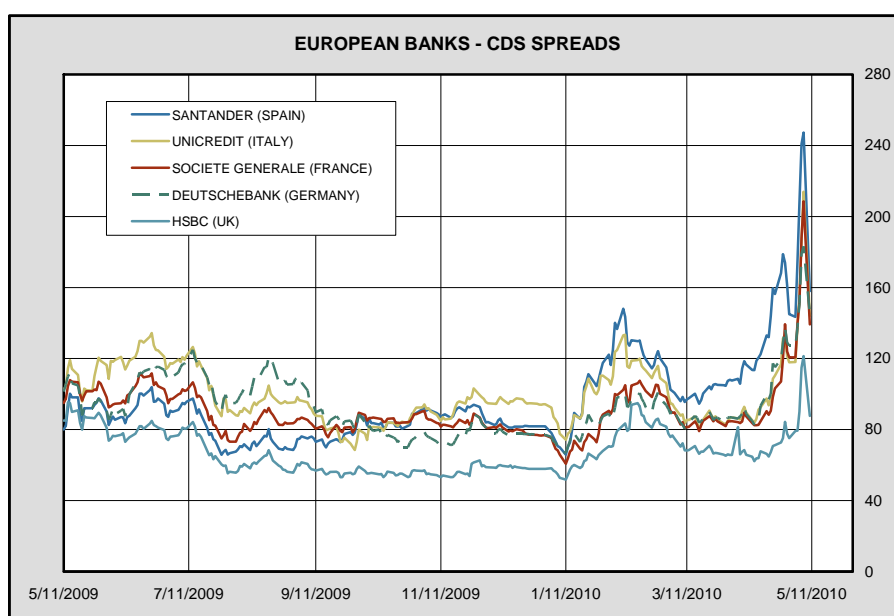


Source: Bloomberg. Daily data as of 5/11/2010.



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Interest costs on outstanding debt from some of the most challenged countries did improve sharply – with the yield on two-year Portuguese debt dropping from a high of 6.05% last Friday to 2.26% on May 11, while Greek two-year debt dropped from an 18% yield at its heights last Friday to 6.96% yesterday. So some relief has been brought to government financing markets, no doubt partially tied to the ECB’s direct commitment to buy government debt. This has improved the outlook for the all-important European financial system, where leading banks and insurers were being pressured by market concerns about their exposure to troubled sovereign debt. As a result, credit default swaps on leading European banks have fallen in value since the announcement. Continued improvement here is critical; these firms need to be in a position to provide credit and liquidity if the eurozone economy is to share in the global rebound being experienced in the United States and emerging markets.



Source: Bloomberg. Daily data as of 5/11/2010.

However, we have seen limited improvement so far in credit market liquidity. Offsetting the above-mentioned gains in European government bonds are continued elevated London Interbank Offered Rates (LIBOR) – with three-month LIBOR rising from 0.30% to 0.42% yesterday – and reduced liquidity in corporate bond markets. We think that increased market volatility has caused market-makers to reduce their risk levels, significantly widening the spreads on 10-year investment grade bonds, for example, while measurably cutting the size of their trades.

So while the announced plan has taken some of the pressure off the markets, what does it actually accomplish? First, it has pushed the ECB from an inflation-only mandate to a more Federal Reserve-oriented lender of last resort. With this move being contentious among EU members (particularly the German inflation hawks), the ECB has indicated that it intends to “sterilize” its purchases over time to control the money supply. With current money supply growth hovering near 0%, there may not be much near-term pressure (or need) to do this, but the message is targeted to

the inflation hawks. Another outcome is to move the EU closer to a fiscal union, with a socialization of the debts of the weaker states leading to forced fiscal tightening measures being drawn by the EU.

This move toward fiscal union has been grudging due to the lack of cohesiveness among the EU nations. While there has been intellectual buy-in among the European citizenry about the benefits of the common currency, there has never been closer integration among the nations, and this seems culturally unlikely. When push comes to shove, the German people had little interest in bailing out the Greeks – while in the United States, there is no question that the states are part of a federal system. It is also hard to not find something perverse in the fact that the troubled countries that receive loan guarantees will be benefiting from a proportionate guarantee from all nations – including the weakest (i.e., Italy and Spain will be participating in the guarantee of Greece’s obligations!).

FISCAL SITUATION & PROSPECTS - AS A % OF GDP									
Country	FISCAL BALANCE			STRUCTURAL BALANCE			GENERAL GOV'T DEBT		
	2007	2010	2011	2007	2010	2011	2007	2010	2011
Austria	-0.7	-5.5	-5.8	-1.4	-3.3	-3.6	62	78	82
France	-2.7	-8.6	-8.0	-3.5	-6.8	-6.3	70	92	99
Germany	0.2	-5.3	-4.6	-0.8	-4.0	-3.7	65	82	85
Greece	-4.0	-9.8	-10.0	-4.5	-6.9	-6.8	104	123	130
Ireland	0.2	-12.2	-11.6	-1.3	-9.0	-9.0	28	81	93
Italy	-1.5	-5.4	-5.1	-2.2	-2.6	-2.8	112	127	130
Japan	-2.5	-6.2	-9.4	-3.4	-7.4	-9.0	167	197	204
Netherlands	0.2	-5.9	-5.3	-0.6	-3.6	-3.1	52	77	82
Portugal	-2.7	-7.6	-7.6	-2.8	-6.1	-6.8	71	91	97
Spain	1.9	-8.5	-7.7	1.6	-5.2	-4.5	42	68	74
UK	-2.7	-13.3	-12.5	-3.4	-10.5	-9.9	47	83	94
US	-2.8	-10.7	-9.4	-3.1	-9.2	-8.2	62	92	100
Asia	0.1	-3.5	-3.6	-	-	-	37	40	41
Cent. Europe	3.7	-4.4	-3.9	-	-	-	23	28	29
Lat. America	-1.5	-2.4	-2.0	-	-	-	41	37	35

Source: Northern Trust Economics Dept., B.I.S. March 2010.

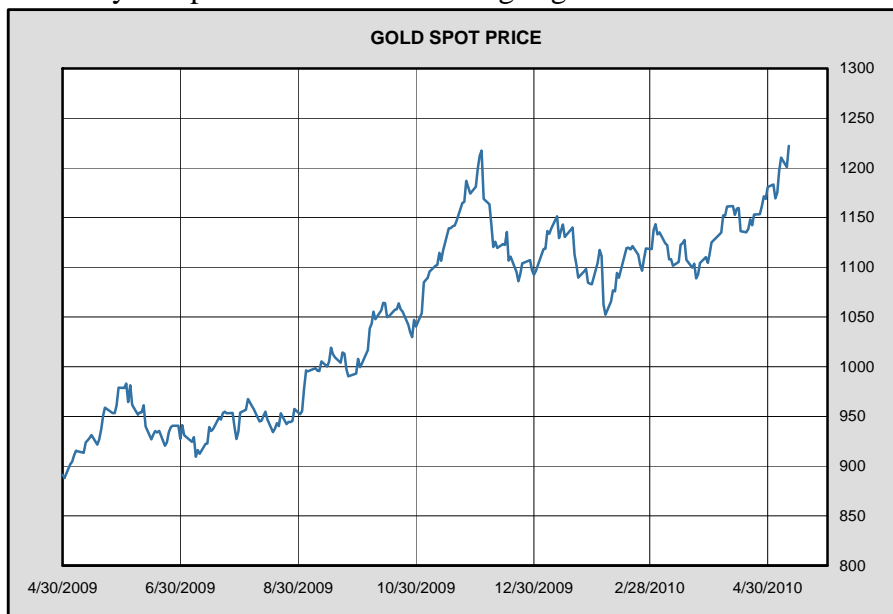
The acceleration of the crisis will also lead to a speed-up of the fiscal rebalancing the troubled countries must undertake. This will be an incremental drag on growth, as public wages, benefits and spending programs are slashed to improve the structural balances of countries like Greece. One of the euro’s limitations has been the inability of an individual country to devalue its currency when economic circumstances warrant it. But this is now something that is occurring and will benefit all of the eurozone. We do think the euro is likely to survive this financial markets test – we would estimate that two years ago, the markets discounted a relatively small likelihood of a euro breakup (say 3% or so). We would estimate that this probability has moved up to an 8% to 10% probability currently.

But the impact of a euro breakup would depend on the nature of the change. If the strong countries throw out a weakling, the euro would most likely appreciate. Conversely, if a strong northern European country were to go it alone and leave the euro, the euro would likely suffer. We do believe the fact that a euro breakup is being discussed, however unlikely it may be, will affect the willingness of global investors to commit to euro-denominated investments. Not only are corporate risk managers going to do extra due diligence on these investments, but financial exposures to European banks and insurers (who are frequently criticized for a lack of transparency) seem likely

to be pared back. It also seems likely that the Chinese aren't all that happy with their diversification into euros over the last six months, as the currency depreciation has likely overwhelmed any interest income. Maybe the dollar doesn't look so bad anymore to those central banks or sovereign wealth funds.

From a portfolio standpoint, the developments of the last couple of weeks have led us to conclude that portfolios should start moving toward long-term strategic norms, reducing outsized bets, due to the increasingly uncertain environment. Our longer-term "partly cloudy" view of the economy and financial markets has accelerated into focus as the bond markets force the weakest nations to address their debt levels sooner than we expected. Make no mistake about it, near-term cyclical strength in the global economy is leading to increasing growth estimates and underpins continued involvement in risk assets like stocks and high-yield bonds. However, there is increased risk that policy uncertainty in Europe creates a drag on not only their growth but potentially on investor risk appetite. While evidence of growth emanating from China remains broadly strong, we also see continued reports of over-investment in real estate that may lead to further monetary tightening in that crucial market.

We think another implication of the euro bailout plan is a further extension of the easy money policies of the Federal Reserve and the ECB. With the global financial system still benefiting from artificial support, including reestablishment of foreign exchange swap lines between the Federal Reserve and the ECB, monetary authorities will remain reluctant to tighten monetary policy. All of this we believe increases the attractiveness of gold. Gold, which just yesterday hit a new cycle high, has historically benefited in times of low interest rates and high sovereign risk. With both likely to continue over the coming year, this asset seems well positioned to potentially benefit in this period of uncertainty and provide a continued hedge against macro risk.



Source: Bloomberg. Daily data as of 5/11/2010.

### **Important Information**



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