



Insights from Northern Trust

Commentary from Bob Browne, Chief Investment Officer

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The month of May could not have ended soon enough for investors. It was hard to enjoy the Memorial Day weekend barbecues while nursing losses of 8.2% from the Standard & Poor's (S&P) 500, 9.2% from emerging market equities, 3.6% from high yield bonds, 7% from commodities and – worst of all – 12% from non-U.S. equities. Perhaps the carnage in the financial markets allowed some Wall Street types a few somber moments of reflection, forcing them to appreciate the enormous sacrifices of our soldiers, past and present. We investors certainly have a lot to think about after the events of the past month, but I would much rather be worrying about the unemployment figures due this Friday than preparing for a combat patrol in Afghanistan. Let's not forget those brave men and women who have the really hard jobs.

For those of us in the financial industry on the home front, the focus once again will be on Europe and, as always, on the U.S. employment data due out Friday. The Institute for Supply Management (ISM) Manufacturing data released this morning also merits attention since it is the manufacturing sectors in the United States and rest of the world which have been driving so much of the cyclical recovery of the past year. The market's recent decline in risk appetite has heightened concerns that the recovery is starting to wane, but this morning's ISM number came in at a healthy 59.7. While some data suggests momentum is slowing down, this is not the same thing as an actual slow-down, let alone a double-dip recession, a term that is frequently reappearing on the lips of many market commentators. We do not number among them. We still believe that the cyclical recovery is underway as strength in corporate profitability unleashes a virtuous cycle: corporate profits lead to employment growth and investment, which lead to more consumption which in turn leads to more corporate profits. This is happening when equity valuations have just gotten cheaper. Finally, it's unlikely that the Federal Reserve and the European Central Bank will be raising rates any time soon, and this also helps the case for equity markets.

But as you all know, we also felt it was a good time to take some money off the table a few weeks ago, and so we recommended raising cash and even stocking up on that ultimate store of value: gold. There is enough going on in Europe to give us pause, and we want to see how all this turmoil shakes out before deciding how cheap things really are. Widening credit spreads, increased funding costs for financial institutions, talk of dissolution of the euro (a major reserve currency for goodness' sake) and concerns about China overdoing it on its policy-tightening cycle are not events we take lightly. The various austerity measures announced by Greece, Portugal and Spain may very well augur the beginning of the end of the European welfare state, or we may be about to kick off years of political turmoil and social strife. Markets reacted favorably when Ireland announced



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meaningful and believable fiscal reform late last year. The problem is that if most of Europe hastens into austerity measures at the same time, it could lead to years of below-trend growth. Longer term, it should also lead to a more efficient deployment of capital and give more confidence to bond investors. (They may be criticized by politicians, but it's the bond investors who finance fiscal deficits. Note to borrowers of all types: be careful when you criticize your lenders. They can always lend their money to someone else.) What we don't know yet is whether the politicians and their constituents really want to accept years of below-trend growth. There probably is no alternative, but folks might start thinking the euro is a cause of their problems rather than a cure.

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