



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Global equity markets were broadly roiled last week, with the source of the investor angst being growing credit concerns. While global central banks have been roundly successful in eliminating systematic risk through aggressive monetary and fiscal stimulus measures, it is becoming clear that such policies are not effective in eliminating all risks. The situation unfolding in Dubai is a case in point: the highly leveraged Dubai World (the Middle Eastern state's flagship holding company) and its property subsidiary Nakheel announced on Wednesday that it was unable to meet required debt repayments of almost \$60 billion and requested immediate restructuring. While the highly leveraged nature of Dubai World was widely known, there was the expectation that Dubai's wealthy neighbor, Abu Dhabi, would ride to the rescue in case of any credit issue and effectively bail out the credit holders. When the Abu Dhabi intervention was not forthcoming, and in fact the announcements out of Abu Dhabi were perplexingly vague, global markets reacted quickly and in concert.

Consistent with correlations that have been in place since the market nadir in March, global risk assets traded in tandem on the startling news out of the Middle East: equity markets around the world sank dramatically, commodity markets sold off in concert and the dollar staged a rally. The U.S. Treasury market was also a beneficiary with the two-year note yield falling to levels last seen almost a year ago. Complacency was the short trade of the day, and the VIX — the Chicago Board Options Exchange Volatility Index, a widely viewed barometer of market volatility — rose over 20%. The thin trading associated with a holiday-shortened trading week likely contributed to the “shoot first, ask questions later” attitude of investors. Once the questions began to find answers late in the week and into the weekend, markets stabilized. Yesterday, the Central Bank of the United Arab Emirates announced that it will offer additional liquidity to banks to prevent any potential run on banks or credit seizure. It is widely believed at this point that it is in Abu Dhabi's best regional interest to provide some sort of support in order to maintain confidence; however the nature of this support remains to be seen.

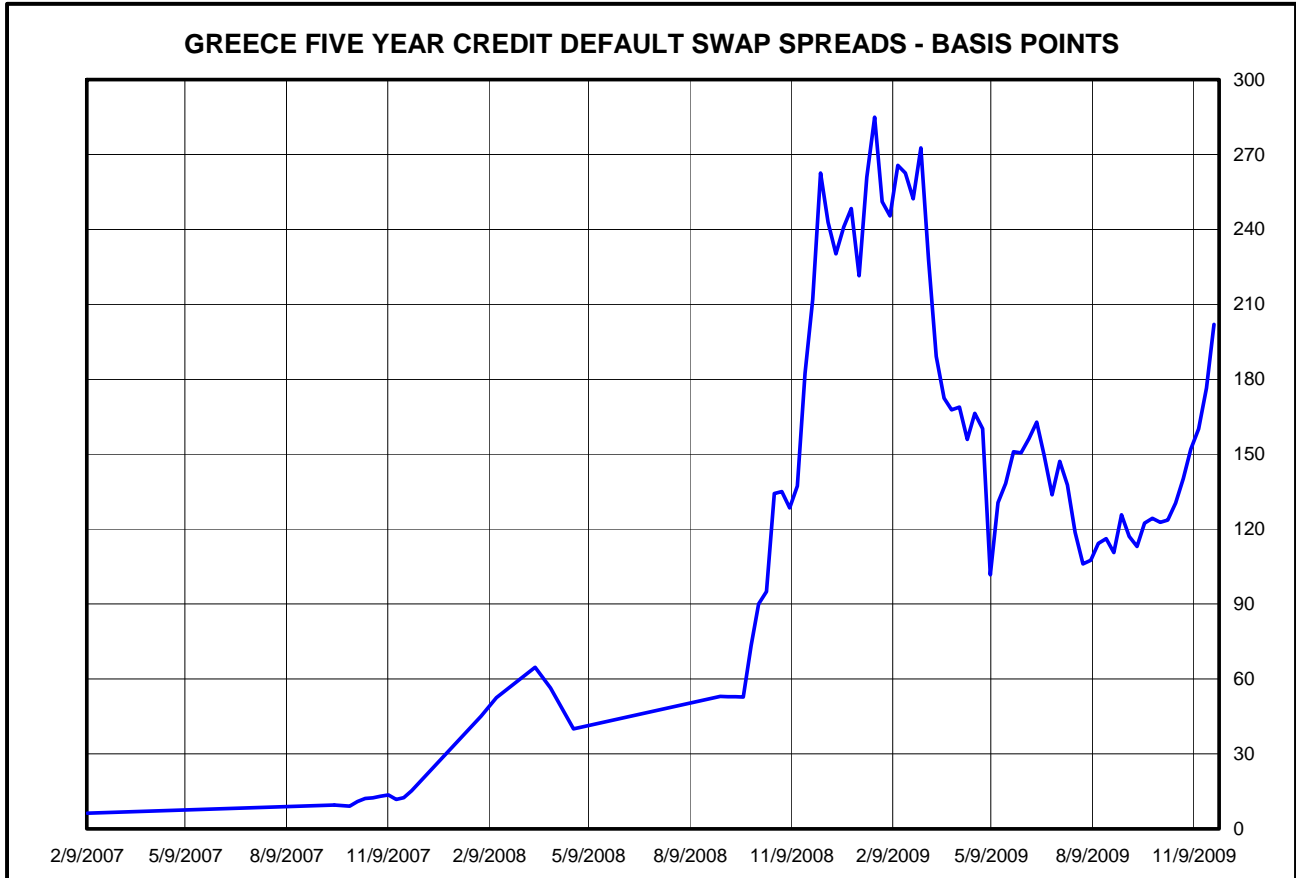
While we await the ultimate decision as to whether and how Abu Dhabi will provide support to Dubai's creditors, the situation has highlighted the fact that risk is not dead. As banks around the world have worked in tandem with central banks to repair fractured balance sheets and meet capital requirements in an environment of significant credit deterioration, and as lenders have restricted credit growth and tightened formerly loose standards, the healing process has relied significantly on extremely low interest rates. While central banks remain “all in” with regard to stimulative and supportive measures, there is growing discussion around exit strategies which has resulted in investors focusing on the post-stimulus world and particularly how banks will maintain their balance



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sheets in an environment of higher cost of funding coupled with potential credit quality issues, as highlighted by Dubai World.

Finally, in addition to continued worries about commercial real estate, we are beginning to see issues unfolding around the health and financial stability of certain sovereign states. The potential problems associated with the post-stimulus world came to light this week with a sharp increase in the cost of insuring against a sovereign default in Greece.



Source: Bloomberg; Data through 11/27/2009 (irregular frequency).

With Greece's public debt set to increase to over 120% of gross domestic product (GDP) next year, and with Greek banks having been among the most prolific in borrowing from the European Central Bank, the country is emerging an unfortunate poster child for what can go wrong. A recent report from the European Commission highlighted a general concern that the eurozone's public debt could reach 100% of GDP over the next five years and highlighted several countries in addition to Greece that are at excess risk in particular: Ireland, Latvia, Spain and the U.K.

Here in the U.S., we are also well on our way toward reaching, and perhaps breaching, a debt-to-GDP ratio of 100%.





Source: usgovernmentspending.com; annual data through fiscal year 2009.

Key here in the U.S. will be our ability to maintain economic momentum in the face of this mounting debt, and the signs have remained positive in that regard. Recently released minutes reflect that the Federal Open Market Committee has become more constructive on the economy, no doubt a result of the continued improvement in several important indicators, even on the employment front where initial claims breached the important 500,000 weekly level just this week. The recovery will not, however, be smooth.

Northern Trust continues to monitor global credit conditions, the importance of this ongoing analysis highlighted by the announcement from Dubai last week. We continue to consider global bank balance sheets in order to determine ongoing capital adequacy. We continue to focus on global central bank exit strategies and the consequences, both intended and unintended, of removing the proverbial punch bowl. We are mindful that risky asset correlations are exceedingly high, and that when investors run from one side of the boat to the other in unison it can create some perilous conditions. At this point, our assessments support the maintenance of our current asset allocation strategies.

Katherine Ellis Nixon holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.



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