



Perspective on the Latest Market Events

Message from Bob Browne, Chief Investment Officer

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It was yet another daunting week rife with disappointing news. We learned that the economy contracted by an annualized 6.2% in the fourth quarter 2008; General Electric cut its dividend for the first time since 1938; the U.S. government became the proud owner of 36% of Citigroup stock; and global equity markets fell yet again. The Dow Jones Industrial Index is now 50% below its peak reached in October 2007. Amidst all this, President Obama announced one of the most ambitious budgetary and political agendas in recent memory, reaffirming that aggressive government intervention likely will be a staple for some time. Rather than focus on the most recent news, however, it is worthwhile to review the longer term key investment theme which we think will drive asset markets over the next year or so.

We continue to believe that a properly functioning credit market is essential to a properly functioning economy. Until we see evidence that credit is starting to flow through both the financial markets and the real economy in a normal and sustained fashion, we will remain cautious about most risk assets. For credit to flow freely, financial institutions need to feel comfortable that the assets on their balance sheets will be worth more money – not less – a year from now. Right now, few hold that conviction. Housing prices, as noted by many, are the foundation upon which all other collateral values rest. Resting right above housing is commercial real estate. Therefore, it's all about real estate. Until real estate prices stabilize, credit will not flow normally. There is, of course, a "Catch-22" moment here: real estate prices cannot stabilize without credit flowing. This is the dilemma facing financial institutions worldwide, as well as Washington policymakers.

While uncertainty about the credit markets persists, the dilemma for investors is how to protect capital in the short run and yet grow capital in the long run. In the short run, we believe it makes sense to remain cautious and focus on capital preservation and income. The near-term risk of further dividend cuts by major companies; additional significant job losses; earnings disappointments; and de facto bank nationalizations likely will be high either in reality or expectation. Either way, that risk will weigh on equities and other risk assets. We are not yet at the point where one can say comfortably that the market has discounted all the bad news. Things definitely can get worse. For this reason, we maintain a high cash position for liquidity and capital preservation.

We remain particularly guarded about developed equity markets overseas. As bad as the situation is in the United States, it is worse in Japan and much of Western Europe. The United States is further into its recessionary cycle and is benefiting from strongly coordinated monetary and fiscal policies. But Europe's troubles seem to be just beginning, while Japan's economy ground almost to a full stop at the end of 2008. Limited monetary tools in Japan – the country has spent years fighting disinflation



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with near-zero interest rates – and the inability to coordinate fiscal policy across Europe put these economies in a disadvantageous position.

So when does it make sense to take some risk in the short run, and what should we look for longer term? In the short run, the municipal bond market continues to find support from investors seeking attractive after-tax yields relative to U.S. Treasuries. It's pretty clear that income taxes are headed in only one direction from here, and the tax haven provided by municipal bonds likely will be more attractive than ever. Fundamentally, the fiscal policies of the Obama administration will be very friendly toward municipalities, and we believe that talk of default risk in municipals is exaggerated.

It appears to us that taxable high-yield bonds also are increasingly attractive over a range of market scenarios. Should things get worse before they get better, the very high yields offered by non-investment grade bonds should provide a cushion against the inevitable increase in losses from defaults, which are increasingly discounted in market prices. In a very weak economic scenario, high yield likely will outperform equities since they still provide better protection within the capital structure of companies. Should the economy stabilize – let alone improve faster than expected – high-yield bonds tend to offer very strong absolute returns even if they underperform equities. They are thus a good way to dip the proverbial toe into the turbulent waters.

And so what does our key theme – housing and commercial real estate prices must stabilize and credit markets must flow again – say about longer-term value in the equity markets? At some point, valuation actually will trump our key theme. While stability in real estate prices would offer equity investors a more solid foundation from which to start buying, there are valuation triggers that make us feel comfortable that we are getting paid for the risk of being too early. We believe that this value range where equity market values discount a very ugly economic scenario of sustained low economic growth, continued weak real estate markets and dysfunctional credit markets stands between 625 and 675 for the Standard & Poor's 500 versus the 735 level of Friday's close.

The near term risks in the equity market remain high, and we continue to be cautious and disciplined as long as real estate prices are falling and banks' balance sheets are under pressure.

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