Perspective on the Latest Market Events

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The winning streak for global equity markets rolled on into May. In the United States, NASDAQ-listed shares recorded their eighth consecutive weekly advance, while the New York Stock Exchange composite and Standard & Poor's 500 stock index have now scored gains in seven of the last eight weeks. Investment returns on small- and mid-capitalization stocks are back in positive territory on a year-to-date basis, and large company stocks both here and abroad are near break-even for 2009 after surging as much as 14% in some G20 countries last month. Equity markets in emerging economies pushed higher in April too, widening their commanding lead in this year's performance derby with surprising year-to-date returns approaching 20%.

Global equity markets are rallying in anticipation that economic growth may resume by year's end. While still far from uniformly positive, current data suggests that the severe economic contraction that began last fall may finally be receding. In the statement following its regularly scheduled Board of Governors meeting last week, the Federal Reserve indicated that "household spending has shown signs of stabilizing" and "the economic outlook has improved modestly since the March meeting." Last week's initial government estimate of 2009's first quarter Gross Domestic Product was considerably weaker than the consensus forecast, but other, more recent data such as unemployment claims, manufacturing activity, factory orders and consumer confidence all improved in April.

Bond markets also provide evidence that better economic and financial conditions may be unfolding. The yield on 10-year U.S. Treasury bonds has risen steadily over the past several weeks to close last Friday at 3.17%, the highest level so far in 2009. Instead of predicting stronger economic growth and building inflationary pressures, elevated long-term Treasury rates presently reflect higher financing costs associated with the federal government's expanding budget deficit and various fiscal stimulus programs.

Simultaneously, however, credit spreads in both investment-grade and high-yield bond markets are falling. After reaching an all-time "wide" of 5.45% above the yield on similar maturity U.S. Treasury securities, the spread on an index of investment grade corporate bonds has fallen to 3.95% over corresponding Treasury bonds. This same "tightening" is also underway in the high-yield bond market, where credit spreads on below-investment-grade bonds have fallen from an all-time wide of 19.4% over similar maturity U.S. Treasury securities to 12.2%.

This compression in both investment-grade and high-yield bond spreads is a welcome signal that investors appear to be moving beyond the "preservation-of-capital-at-any-cost" sentiment that drove returns on short-term, risk-free Treasury securities near zero. Indeed, investors have begun to crawl out of their money market and bank deposit bunkers in search of the premium yields generated by longer-maturity, higher-risk corporate bonds. Increased demand for investment-grade and high-yield corporate bonds has also encouraged new issuance, particularly among financial services firms for which access to corporate credit markets had been essentially closed since last September's Lehman Brothers bankruptcy filing. Last week, several financial services firms, including Northern Trust, successfully issued new bonds at attractive terms and without government guarantees.

Falling credit spreads and rising new issuance volume are important indications that financial markets have begun discounting a rebound in global economic activity. Anticipating this rebound was the rationale we used to support recent changes to our asset allocation guidelines which included reducing cash balances in favor of selective additions to positions in emerging market equities, high-yield bonds and commodities. So far these changes have proved timely and accretive, and we remain confident in their tactical merits. We are still cautious, however, on broader increases to portfolio risk believing that current signs of economic stabilization are both fragile and highly contingent on the success and durability of the government's many fiscal and monetary programs. More time is required, in our opinion, to properly assess the effectiveness of these programs and the contours of the economic recovery that, we believe, should begin later this year.
