



Insights from Northern Trust

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Shaking off nearly two straight weeks of declines and building negative sentiment, U.S. and global stock markets rebounded sharply last week. Investors overcame their fear of a recessionary double-dip and European debt travails and looked forward to this week's start to corporate earnings reports for the second quarter of 2010 bringing potentially good news.

In a holiday-shortened week, the four-day rally saw the Dow Jones Industrial Average advance by more than 500 points. The 5.28% rally saw the index break above the psychologically important 10,000 level to end the week at 10,198. The rally was the strongest surge in the index since July 2009. Much of the relief seen in equity indexes stemmed not just from the prospect of positive earnings news but also from a much-needed decline in weekly U.S. initial jobless claims.

In contrast to the last several sub-par jobs numbers, the new claims for unemployment report released last Thursday reversed recent modest unemployment increases. Claims declined by 21,000 in the week ended July 3, to a seasonally adjusted 454,000 as reported by the Labor Department. Accordingly, the four-week average also fell to 466,000, which along with recent increases in productivity and hours worked gave investors confidence the economic recovery could continue moving forward.

However, with U.S. unemployment still over 9% and businesses reticent to hire, it appears to us that while we may experience some near-term employment improvements (given prospects for strong corporate earnings), it's more likely that higher-than-usual unemployment could become a structural norm and not an anomaly. This is predicated on the prospect for slow economic growth and austerity programs being implemented throughout the developed world. As developed nations tackle surging long-range deficits with budget cuts and higher taxes, a negative feedback loop on corporate and small-business prospects and hiring may well persist.

Investor sentiment heading into this week continues to be negatively skewed as well. According to the weekly survey by the *American Association of Individual Investors (AAII)*, bearish sentiment has risen to 57.1%. This is the highest level since March 2009, surpassing the peaks of even last November and July. Individual investor sentiment is as negative as it has been in more than a year. Stock market breadth also remains pervasively weak, notwithstanding the broad-based rally over the past week. As we start this new week, only 28% of stocks in the Standard & Poor's 500 index are trading above their short-term 50-day moving averages. While this is significantly higher than the 4% low reading only days ago, it is still well below the lows reached during prior pullbacks.



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Bearish advisor and individual investor sentiment combined with negative breadth may be just the ingredients to keep the recent market advance going in the near-term if corporate earnings deliver.

On that note, second-quarter earnings are set to commence July 12, with Alcoa's report after the market close heralding the start of reporting season. Wall Street is calling for consensus earnings growth of 27% which, while down slightly from several weeks ago, is much higher than was expected when the year began. While strong earnings are certainly not assured, given the current environment, the current cyclical earnings recovery should help allay fears of a double-dip recession, as companies are expected to report strong results over the coming quarters. Wall Street currently expects the next few quarters to deliver well over 20% growth; in fact, analysts are targeting growth that would produce \$82 of earnings this year and \$96 in 2011. If correct, these estimates put large-cap stock valuations at a reasonable 12 times expected earnings, well below the average over the past few years.

The global financial sector continues to garner its fair share of headlines as European bank stress tests loom and the Obama administration's attempt at financial regulation remains unresolved. In an attempt to soothe fears of a fall back into recession in Europe, European Central Bank President Jean-Claude Trichet recently commented on the eurozone's recovery, saying planned budget cuts and bank stress tests would help restore confidence in the region. There is a growing sense that Europe's biggest banks will be able to navigate the upcoming stress test exercise adequately, similar to how U.S. banks fared. Results are due to be released on July 23. As an aside, for those who question our (taxpayer) investment in the bank bailout program, a recent report found the U.S. Treasury has earned a positive return on its initial investment. The bank portion of TARP is expected to remain profitable even in a slower growth environment. Finally, it appears that some of the more onerous banking regulations and fees will not survive through to legislation.

Investors face a complex investment landscape. The positive cyclical forces stemming from global stimulus support programs and strong earnings from a lean, productive corporate sector are clashing with the structural forces of endless deficits, increased government involvement in the private sector and higher taxes. While the upcoming earnings season may be positive, we see a sub-par long-term recovery occurring, highlighted by slower U.S. economic growth than expected, higher U.S. unemployment than in the past, constrained credit, shorter business cycles and increased volatility.

On that note, our Chief Economist Paul Kasriel recently downgraded his U.S. gross domestic product (GDP) forecast for the second half of 2010 to 1.8% from the 2.5% expectation he had earlier this year. The drivers for his decreased GDP expectation include a malfunctioning transmission mechanism between abundant federal credit availability and constrained credit for the private nonfinancial sector. According to Paul, the broken mechanism is the banking sector, which is hoarding capital as it eyes problematic commercial real estate books, and pending domestic and international bank regulator capital requirement ratios. Until the banking sector starts providing credit, economic activity is likely to be sub-par. Secondary effects will be lower Fed rates for longer, with Northern Trust not expecting any rate increases until mid-2011 at the earliest.

After a yearlong rally in risk assets, we are now seeing increased volatility and growth prospects that may be positive but more modest than expected.



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