



Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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Investor risk appetite returned in force as earnings season kicked into high gear, leading to an 11% rally in the Standard & Poor's (S&P) 500 over the last two weeks. There has been much focus over the last year on corporate America's efforts to cut costs through inventory reduction, layoffs and furloughs, and discretionary expense controls. These efforts so far are leading to a significant improvement in operating profitability in the June quarter earnings reports, even in the wake of a very poor revenue environment. An estimated 75% of companies have reported earnings better than analyst expectations, which we believe positions them for continued profit growth and the eventual improvement in global demand. The markets have also digested the news of CIT Group's financing problems over the last two weeks. While credit markets are concerned about inconsistent government involvement and the future of the wholesale financing model, the equity markets view the government's disengagement as a sign pointing toward normalization of the financial markets.

IBM's earnings are an excellent example of global demand trends and corporate cost-control initiatives. Revenue for the quarter fell 7% (in constant currency), about 2% worse than expectations. Sales from developed markets like the United States and Europe were down 8%, while the BRIC (Brazil, Russia, India and China) market's revenues were down 1%, and the remaining developing markets were up 1%. Services bookings, a sign of corporate confidence, were down 7%, due to delays in discretionary projects and weak consulting bookings. Yet IBM's focus on cost cutting led to a 4% increase in its pre-tax profit margins, helping the company offset the weaker revenue and outperform analyst earnings expectations. IBM's shares handily outperformed the market during the recent rally.

Investors are also focused on the health care debate in Washington, as Congress prepares to leave for the August recess without a bill ready for vote. This isn't too surprising, given the complexity of the issue and considering the nearly impossible twin goals of containing costs while expanding coverage. The "Blue Dog" Democrats are demanding a focus on the fiscal impact of the health care bill, and with a coalition representing 20% of the House, they have substantial power. While this will remain subject to negotiation, it seems likely that we will see increased taxes on higher-earning taxpayers if a bill passes. The potential health care surtax on higher-income earners has generated significant resistance from the Senate, such that the initial House proposal to focus on taxpayers with income greater than \$350,000 may eventually lessen the impact on those earning between \$350,000 and \$1 million annually.



During his semi-annual Humphrey Hawkins testimony to Congress this past week, Federal Reserve Chairman Ben Bernanke received both praise and criticism from legislators as he defended the Fed's moves to date, discussed the Fed's plans to eventually remove its stimulative policy (the "exit strategy"), and worked to influence current efforts to increase oversight of the Fed. He emerged from the two days of hearings relatively unscathed and gets good grades from most economists for his performance during the worst financial crisis since the Great Depression. The focus of the Fed has now moved toward its exit strategy – how and at what pace will the Fed shrink its balance sheet and raise short-term interest rates without either endangering the recovery or stoking inflation expectations. We think the Fed will be very measured in its pace of tightening, with the initial focus on winding down liquidity facilities before turning to potential changes in the fed funds rate. With respect to Congressional oversight initiatives, we think fixed income investors would take an increased Congressional role negatively, given the potential for increased inflation expectations and higher interest rates longer-term.

The stronger-than-expected margin performance of corporate America puts us in potentially better shape to grow earnings once demand trends improve. Signs of improvement in the domestic economy continue to grow, but at a measured pace, while emerging markets are bouncing back hard. One only has to contrast second-quarter growth estimates for Singapore and China (up 24% and 16%, respectively) with Europe and the United States (down 4% and 2%, respectively) to understand the magnitude of these developments. These growth differentials continue to support a focus on emerging market equities longer-term and those assets, such as commodities, that tend to benefit from this growth. We believe a broader move toward assets dependent on growth in developed markets awaits conviction about the sustainability of growth in 2010 and beyond, as well as the successful removal of the Fed facilities that are so important to current stability in the credit markets.

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