



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Global capital markets continued their ascents last week, with equity and credit markets across the world staging broad rallies in response to mounting evidence of economic stability and, in some cases, recovery. Global advances were synchronous with the U.S. market, as reflected by the Standard & Poor's 500 advancing 2.45%. Developed international markets tracked by the Europe, Australia, Far East Index (EAFE) rose 1.8%, led by strong advances in Australia, France, Norway and Portugal. The emerging markets posted some of the strongest results, with Brazil, Russia and China advancing 5.65%, 4.10% and 2.18%, respectively. Japan, however, diverged from these other global market gains, as the Nikkei fell 0.71%.

For U.S. dollar investors, these global equity market returns are enhanced as dollar weakness persists. The U.S. dollar has continued weakening against most major currencies and has fallen 15% against the euro since the onset of the flight-to-quality trade that resulted from the near global financial meltdown. A function of our zero interest rate monetary policy (ZIRP), the U.S. dollar has become the carry trade currency of choice, with investors borrowing U.S. dollars cheaply to reinvest in higher-yielding currencies. Further, the depth and breadth of the U.S. stimulus has exposed what may be a more secular issue with the currency: the stark realization that unwinding the various fiscal and monetary stimulus programs and dealing with the budgetary aftermath will be difficult. Of course, currency exchange rates are a relative exercise, and there is a growing sense of concern around the European Central Bank's intent to remove its own punch bowl. The dramatic rise in gold, which over the past week breached the \$1,000-per-ounce mark, is evidence that there is concern more broadly regarding fiat currencies.

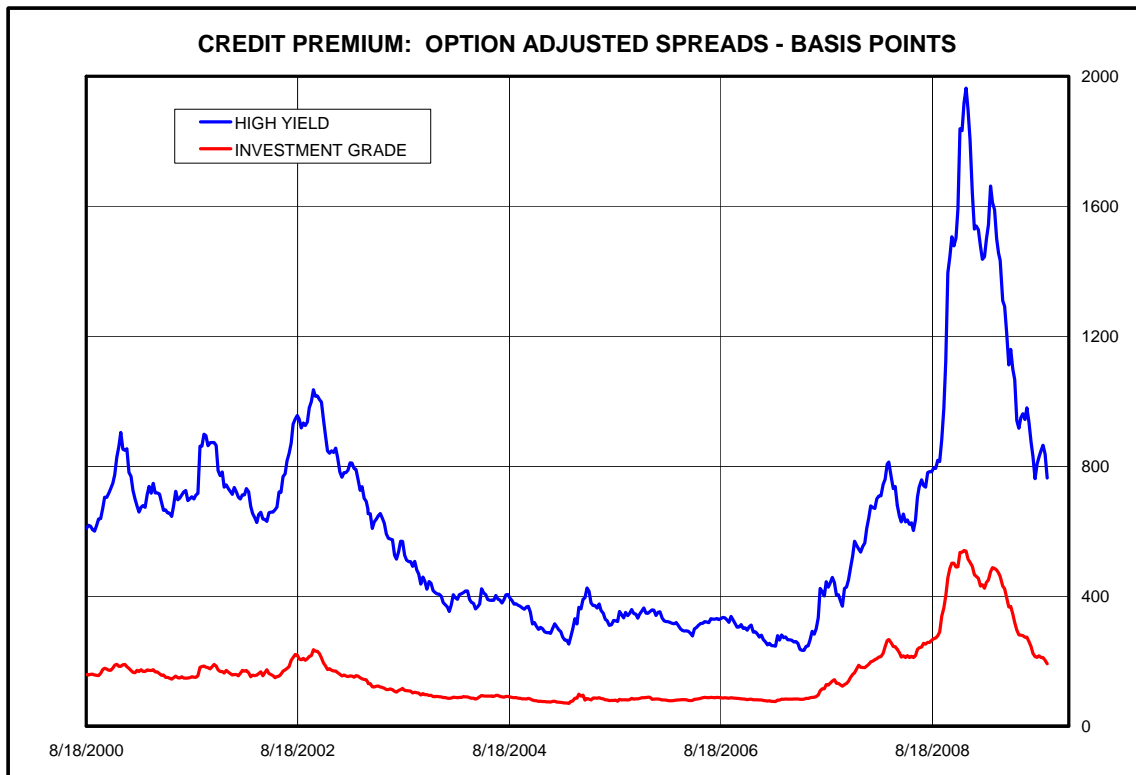
Clearly, potential gains from the carry trade may be fairly marginal, especially with global short-term interest rates anchored near 0%. There also is a growing chorus from central bankers, including the Federal Reserve's Ben Bernanke, that they are keeping vigilant oversight of the still-fragile financial system. And while they note signs of economic and financial market stability, these acknowledgements are coupled with a myriad of qualifiers. One can only imagine their growing sense of anxiety as the "risk trade," or investors extending beyond cash reserves into risky equity and credit asset classes, continues unabated. While asset class bubbles always have seemed clear through the rear view mirror, they often are apparent through the front windshield as well. An example may be the property market in Singapore, where low interest rates coupled with ample credit availability have created an all too familiar boom in housing. There is most certainly a risk inherent with maintaining stimulative policies.

With the extraordinarily low rates available in money market funds, plus expectations that the currently low fed funds rate may be with us for some time, investors have begun to explore opportunities further out on the risk spectrum. Money market funds lost more than \$55 billion last week, according to a recent iMoneyNet report. A clear beneficiary of this trend has been the fixed income market.



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Within fixed income, the surge in flows into taxable fixed income has helped narrow the spreads in investment grade as well as high yield, or “junk,” bonds. At the height last fall of the financial crisis, high yield credit spreads were as wide as 1800 basis points over treasuries. Today, that spread stands at approximately 764 basis points, a marked improvement. Similar spread compression is evident in the investment grade space, and this improvement in cost of funds has encouraged high quality companies to issue bonds at very attractive long-term rates. This is truly a global phenomenon as well, with global fixed income issuance this year topping US\$1 trillion through August, according to Dealogic. This beats the annual record set in 2007 of \$898 billion, and we still have four months left in the year. The funds raised through these underwritings may encourage firms to invest for the future, and specifically provide a catalyst for increased mergers and acquisitions (M&A) activity. We expect that M&A activity will accelerate in this environment, with strategic acquisitions taking center stage. With most economists anticipating that global gross domestic product will grow at a fairly benign pace post-recovery, corporations are assessing the viability of acquisition as a growth engine. With banks still hoarding capital and investors hungry for yield, the private sector has filled an important funding gap.



Source: Bloomberg

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

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