



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Consistent with the major theme of 2009, the focus last week remained on the banking system. However, attention is now squarely on the European banks as the European Central Bank's (ECB) recent comments reflect concern that eurozone banks will face further write-offs before 2011, with the culprits being deteriorating credit quality in commercial real estate as well as exposure to the troubled economies of Eastern Europe. Eurozone banks already have written off €366 billion (US\$525 billion), and the updated ECB estimate calls for an additional write-off of €187 billion (US\$267 billion) next year. Of course, the knock-on effect of continued pressure on banks likely will be tighter credit conditions, which will affect sustainable economic growth in that important region. At the investment policy level, we have become more concerned about the growth forecasts in the eurozone, particularly relative to the positive trends we see in the United States. Clearly the risk has been heightened by the continued fiscal problems with some of the eurozone members – specifically Portugal, Spain, Greece and Ireland – and the possibility that some sort of ECB support may be required in the near future to offset the growing sovereign credit concerns.

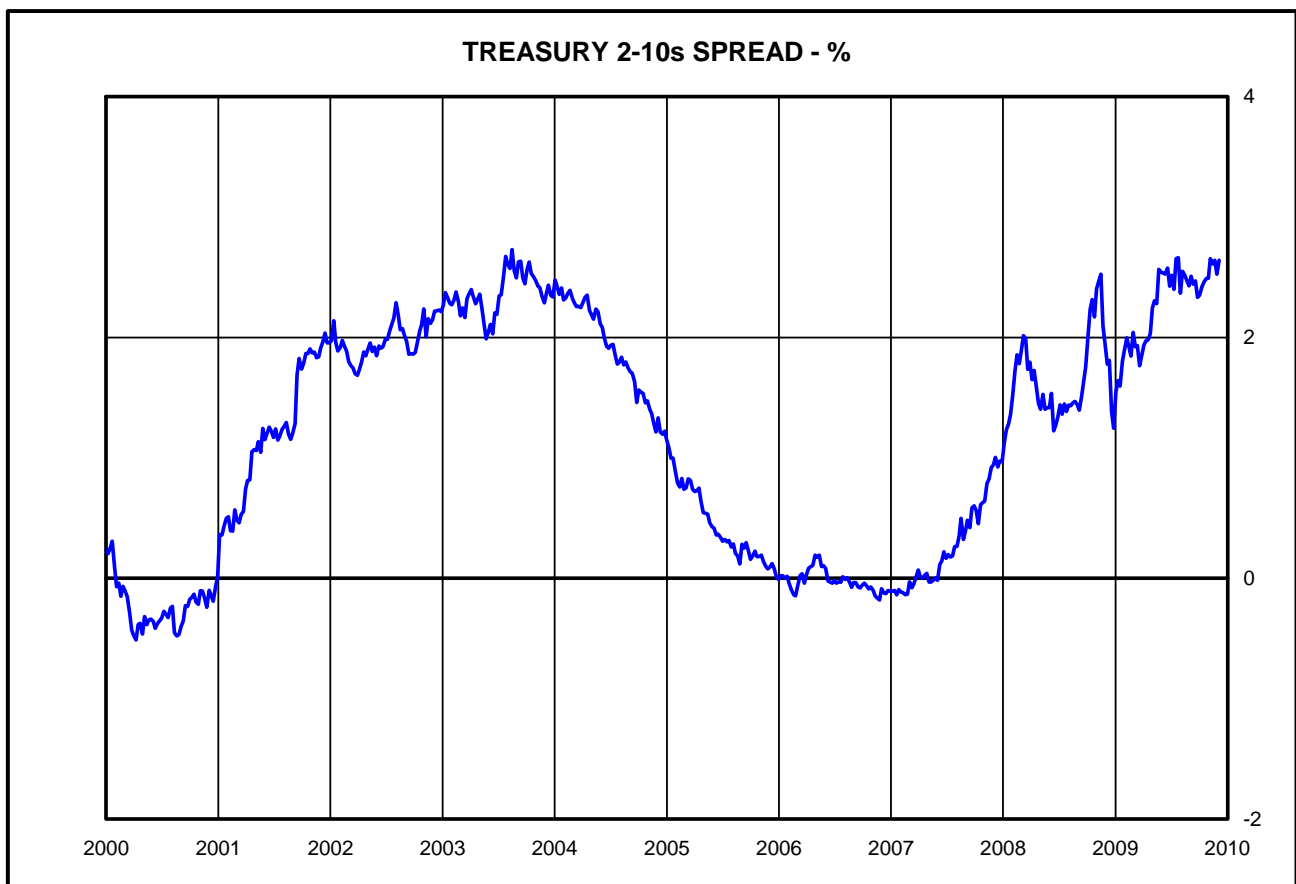
The banking system in the United States appears to have been successful in its attempts to recapitalize, and even Citigroup is now focused on repaying \$20 billion of government-owned TARP trust preferred securities and terminating the loss sharing agreement with the government. On the heels of a very successful capital raise by Bank of America, officials at Citi likely assumed that the market environment was ripe; however, the offer proved to be disappointing. The common stock was priced at \$3.15, which was 20% below the price before the announcement. Had the offer been more successful, it was expected that the government would divest up to \$5 billion of its equity stake. However, it simply was not palatable to divest of the shares at a price below the \$3.25 purchase price that U.S. taxpayers paid for the stake earlier this year, hence this overhang remains. The government has instituted a 12-month window within which to divest itself of Citigroup shares; however, the dependent variable will be the stability of Citigroup's capital structure.

Our own Federal Reserve's Open Market Committee continued with the "exceptionally low" for "an extended period" language intact and some relatively upbeat comments on the U.S. economic environment in the official statement released last week. It is clear that the wheels are very much in motion to begin to reduce the extraordinary stimulus provided to the system, beginning with the expected expiration of several important short-term liquidity programs early next year. This will provide us with an important first look at how the markets will react to a reduction in stimulus and support. More immediate reaction to Federal Reserve policies is visible in the bond market, where we see a historic steepness to the yield curve – the difference between short-term rates and longer-



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term rates. The gap between the two-year Treasury and the 10-year rose to 276 basis points last week, slightly higher than the prior record set in August 2003 at 274 basis points, a level reached after a three-year easing cycle drove the Fed funds rate from 6.5% in 2000 down to 1% in 2003.



(Source: Bloomberg)

The curve stayed fairly steep from August 2003 until the Fed began to tighten policy in June 2004, and certainly this delayed tightening. The long cycle of low rates has been credited with fuelling the speculative boom in credit that ensued.

This spread can reflect a number of things – most often expectations of buoyant economic growth or worries about rising inflation. With the increase in the Fed funds rate pushed off into 2010, economists and strategists alike are beginning to worry about the inflationary effect of prolonged easy money, and this will continue to pressure longer-term rates. At the same time, there is a growing chorus speculating that economic growth may indeed surprise on the upside based on continued strength in corporate earnings, banks easing up on overly stringent credit standards, and potential improvements on the employment front.

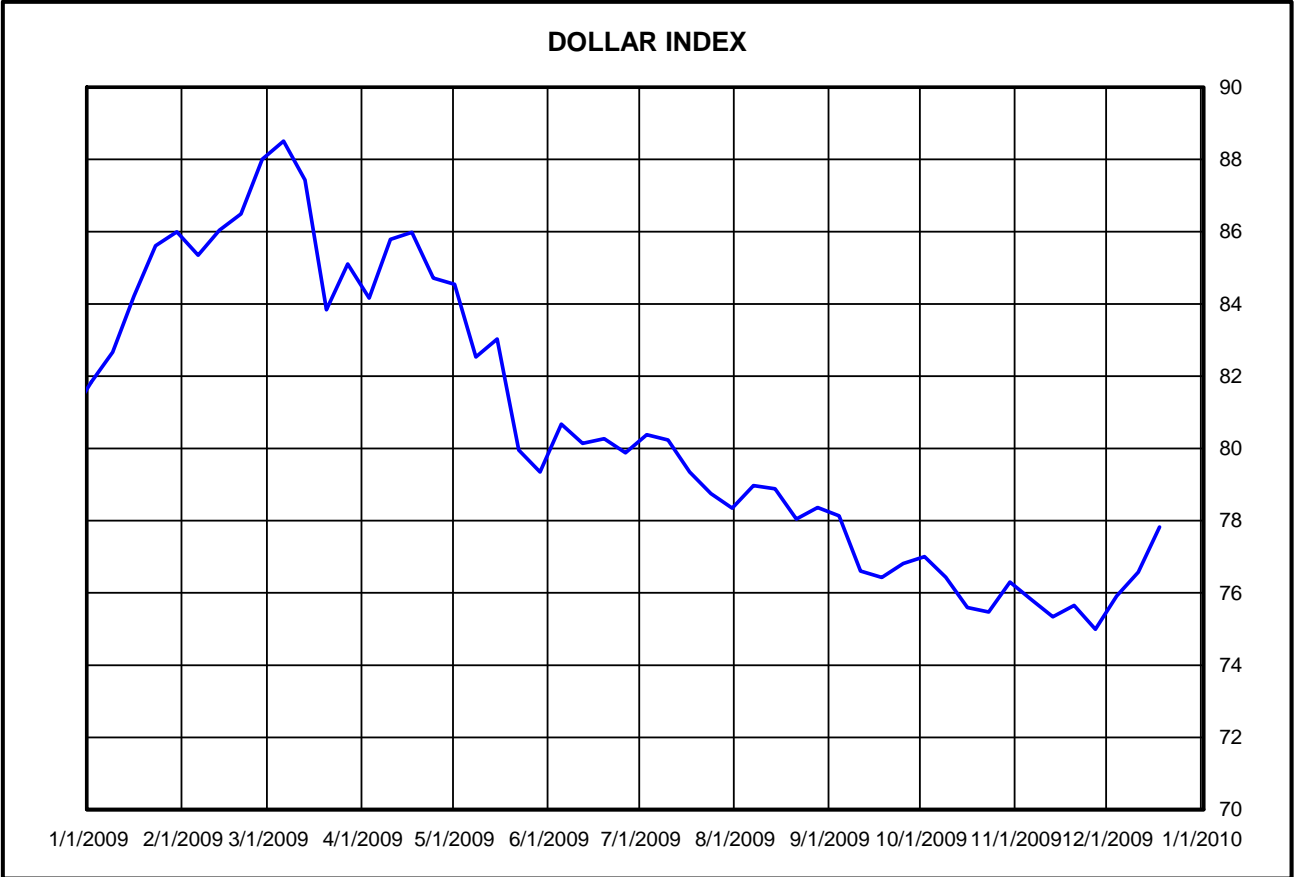
While Europe struggles with potential economic stagnation, and pundits in the United States discuss the “not-if-but-when” inflation debate, the Bank of Japan came out last week with some strong language around its seven-year struggle with deflation. It is clear that deflation is an incredibly tough



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beast to tame (more support for the dramatic and quick reaction of the Federal Reserve to the specter of deflation in this country), and the Bank of Japan will be forced to keep rates at virtually zero as well as to engage in continued quantitative easing measures. The near-term result will be pressure on the yen, and potentially the re-emergence of the yen as the carry trade currency of choice.

Which brings us to the major story of last week: the surprising strength of the U.S. dollar. The dollar spent much of 2009 falling against most major currencies in the face of extreme fiscal and monetary stimulus and worries about deflation and economic malaise. As Jim McDonald, our chief investment strategist, has pointed out many times, however, the dollar is a relative currency. Its value is pegged relative to other global reserve currencies, and certainly relative to the continued issues in Europe and the persistent deflation in Japan, the U.S. dollar appears to have superior fundamentals at this point.



(Source: Bloomberg)

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

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