



Perspective on the Latest Market Events

Message from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Global financial markets ended the week on a sour note after attempting to digest a variety of significant and unprecedented news and events. The combination of weak economic data and a deepening banking crisis pressured already-frail equity markets, sparking a further safe-haven rally in gold and the U.S. dollar. The MSCI Global index fell almost 8%, emerging market equities declined more than 9%, and U.S. benchmarks posted 2009's worst weekly declines thus far. The Dow 30 Industrials fell 6.2% and the Standard and Poor's (S&P) 500 lost 6.9%, resulting in double-digit declines year-to-date for these key indexes. We now are nearing stock price levels not seen since the nadir of the 2000-2002 bear market.

The information-loaded week featured President Barack Obama signing into law the American Recovery and Reinvestment Act (ARRA) of 2009, more disclosure about the administration's mortgage plan, and U.S. auto makers' pleas for additional financial assistance. More evidence of broad economic weakness, ongoing discussions in Washington about potential bank nationalization, and strong signals from Moody's that European banks could be downgraded also punctuated the period. In short: the crisis is not over.

Wall Street, which slid after Treasury Secretary Timothy Geithner offered too few details about the Financial Stability Plan, showed similar displeasure with the more-detailed ARRA. This far-reaching program will cost approximately \$787 billion and has a primary goal of creating jobs. Through the tax cuts and spending, the administration hopes to stem the rise in unemployment, which threatens to replace housing as the public's number-one concern. Questions about the timing of the stimulus package (much of it won't take effect until 2010), the balance between tax cuts and spending, and the ultimate efficacy of the program weigh heavily on the minds of investors. Many fear it is too little, too late.

In addition, this week the government clarified further its housing plan, which aims to cut mortgage payments for more than 9 million borrowers, and thereby stem the rise in the foreclosure rate as well as the pace of decline in housing prices nationwide.

This will be accomplished in two ways. First, the plan provides incentives to lenders to modify loans made to the up to 4 million borrowers who are at risk of foreclosure, providing subsidies to lenders and encouraging loan modification aimed at capping borrowers' debt-to-income expense ratio at 31%. While we believe this is a step in the right direction, we think the economic downturn is having



an increasingly negative impact on the denominator of the debt-to-income equation, particularly for the most fragile borrowers. Hence, this program may be akin to catching sand in a sieve. Further, evidence suggests a high re-default rate among these borrowers, a fact that quells optimism.

Second, the plan will enable the 4 million to 5 million borrowers with negative equity in their homes to refinance with Freddie Mac and Fannie Mae into new 15- or 30-year fixed rate mortgages. Again, this is a step in the right direction; however, this program does not apply to mortgages currently held in securitization pools, which comprise the vast majority of this class of loan. Also, the program is limited to borrowers with loans up to 105% of the value of their properties, effectively limiting participation by borrowers in the hardest-hit areas. We are seeing evidence of a growing populist backlash to this bailout and the implicit moral hazard therein, and that could prove to be a very real obstacle to its success.

There is “nationalization” in the air, and the financial markets are signaling strong distaste for such extreme measures, despite the trial balloons sent by former Federal Reserve Chairman Alan Greenspan and Sen. Christopher Dodd (D-CT) this week suggesting the need for at least a temporary nationalization. Wiping out shareholders? Been there, done that. The real problem is the lack of clarity and the wavering that continues around this important issue. Ironically, it is the very lack of decisive action on this front that may encourage conditions under which nationalization is the only solution. Stock prices for the major banks are plummeting at an alarming pace, and there is waning private appetite for investment in these entities, signaling a vote of no confidence. Ultimately, government may be both lender and investor of last resort.

That being said, there are multiple high-caliber weapons pointed at this crisis, and this tremendous focus will have an impact. To quote Northern Trust’s esteemed economist Paul Kasriel, “...never underestimate the initial positive impact on aggregate demand of that powerful combination of increased federal government spending/tax cuts and a central bank running the monetary printing press at a high speed.” I believe the operative word in that sentence is “initial”. While this stimulus may result in some powerful short-term rallies across the capital market spectrum, we continue to consider carefully both the longer run adverse consequences as well as the real efficacy of these policies. We continue to maintain a risk-averse posture for portfolios at this juncture.

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

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