



## Perspective on the Latest Market Events

### Message from Jim McDonald, Chief Investment Strategist

March 9, 2009

The buyers' strike continues in the stock market, with the S&P 500 now down 24% year-to-date. As we will discuss later, the decline has improved the relative valuation of the U.S. stock market. Recent corporate developments highlight the actions companies are taking to adjust their balance sheets and cost structures to the global recession. To protect their capital positions and weather further potential difficulties, dividend stalwarts General Electric, Wells Fargo and U.S. Bancorp all cut their dividends substantially this past week. This corporate caution also continues to drive employee layoffs, with February job losses of 651,000 leading to a jump in the unemployment rate to a cycle-high 8.1%. Current surveys of corporate business activity, however, contained no major new bad news. U.S. manufacturing activity, which had bottomed at a 32.9 reading in December, crept up to 35.8 in February (accepting that a score below 50 still indicates contraction in growth). U.S. non-manufacturing (service) activity, which bottomed at a level of 37.4 in November, has moved up to 41.6. Evidence may be building to indicate that the U.S. economy will be one of the first major economies to emerge from recession and potentially resume growth later this year.

Significant investor attention has been focused on the Obama administration's budget proposal, which served as a reminder to Wall Street of the budget challenges our nation faces (including a blueprint for national investment in education, energy, healthcare and infrastructure). The budget clearly seeks to reduce the deficit picture over the forecast horizon, partially through tax increases, to pre-Bush levels, for higher income tax payers. The budget also includes a "placeholder" for funding for increased financial system assistance, recognizing the current efforts need further ammunition. Additionally, the budget makes significant proposals to implement election planks such as increased healthcare spending and for environmental initiatives (such as cap-and-trade emissions plan for utilities).

As mentioned earlier, the significant sell-off year-to-date in global stock markets has reduced market valuations substantially. Stocks are currently trading at a price/earnings (p/e) ratio of 10, using market-cap based earnings (a notion recently advanced by Wharton professor Jeremy Siegel). Another method to "normalize" earnings for unusual events is to look at the p/e ratio of the median stock in the S&P 500 – this excludes both very highly and very lowly valued companies. That p/e ratio currently stands at 11 times, compared to a median of 16.5 over the last 37 years. As a measure of the defensiveness of U.S. investors, the ratio of money market mutual fund assets to the value of the stock market currently stands at 42%, a record high and well above prior peaks of 24% reached in both 1982 and 2003. While these valuation statistics do give us some comfort about the long run return potential from equities, especially with the 10-year Treasury yielding less than 3.00%, near-term risks remain due to the fragile nature of the credit markets.

So when will these improved valuation metrics lead to some stabilization in stock prices? Most importantly, the nation's banks must see a return of confidence – from their investors, their regulators, even their own management teams. For this to occur, the challenged assets on their balance sheets must become liquid, either through improvement in collateral values (e.g. housing prices) or restructuring (selling assets, creating



**Northern Trust**

a bad bank). This is why the Treasury and Federal Reserve are so focused on liquidity facilities and mortgage programs. Evidence of improvement in these areas would go a long way towards reducing the need for defensive positioning in investment portfolios.

---

**Important Information**

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. This material is for information purposes only. The views expressed are those of the author(s) as of the date noted and not necessarily of the Corporation and are subject to change based on market or other conditions without notice. The information should not be construed as investment advice or a recommendation to buy or sell any security or investment product. It does not take into account an investor's particular objectives, risk tolerance, tax status, investment horizon, or other potential limitations. All material has been obtained from sources believed to be reliable, but the accuracy cannot be guaranteed.



**Northern Trust**