



Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

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Movements in financial markets this year have been fast and furious, swinging from fears of systemic meltdown and deflation to the expectation of a year-end economic recovery. Some asset prices, such as equities, have “round-tripped” during this period, while others have been on a one-way ride (think high-yield bonds). The U.S. equity market, down 24% after the first week in March, has rallied to a now-positive 3% year-to-date return. During this period, valuation on U.S. equities as measured by the median price/earnings ratio of the Russell 1000 index has gone from 14 times earnings to 11 and back to 14 times. So despite a clearer outlook for the financial markets and the economy, stocks have essentially treaded water. Conversely, high-yield bonds have enjoyed a one-way ride of strong returns bolstered by spread-tightening. The spread on high-yield bonds has tightened from 16.5% at the start of the year to 9.5% presently, generating a nearly 31% return. So the valuation of high-yield bonds, very attractive at the start of the year, is less so today. These two assets classes are illustrative of the markets we are navigating, and this volatility has been reflected in an unusually large number of tactical asset allocation policy changes of late.

Driving these returns, especially in the credit markets, have been increasing signs of normalization in financial markets and, to a lesser extent, prospects for the economic recovery. The improvement in overall financial conditions (including money market, bond market and equity market indicators) has been broad-based and has bolstered confidence for risk-taking and in the growth picture. Data flow on the economic growth front has been supportive of a gradual economic recovery. With companies seeing a return to growth in new orders, while inventories have been slashed, production looks set to improve nicely in the latter part of the year. Cleaner bankruptcy processes for both Chrysler and General Motors (partially due to the involuntary sacrifice of bond holders) should prove less disruptive to growth than expected. The housing market, while not near price stabilization, does appear to be close in achieving balance at least between new home sales and production. We are progressing one step at a time. Finally, a continued reduction in the number of workers losing their jobs is evidence that we may be on the verge of exiting the recession.

So how do we think about these developments in both asset prices and the market outlook? We recently advised several changes to our tactical asset allocation policy to reposition the portfolios. First, the dramatic tightening of high-yield spreads takes away some of our “margin of safety” for this asset class, so we have reduced this policy position back to its strategic weighting. Similarly, earlier in the year we moved to an overweight on short/intermediate bonds in recognition of the historically high ratio of municipal bond yields to treasuries. With this ratio having normalized, we have also returned this asset class to its strategic norm level. With the proceeds from these moves,



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we have again increased our exposure to commodities. We continue to see this asset class as a beneficiary of the emerging market growth rebound and think long-term supply constraints will lead to a higher price outlook. We also increased our exposure to U.S. equities to its strategic norm, recognizing its attractive valuation, especially compared with fixed-income alternatives. Overall, we have continued to selectively add to risk positions this year, getting closer to our normal portfolio risk position.

A final word is in order after this week's proposal from the Obama administration on financial regulatory reform. This will undoubtedly be a long legislative process, as the topic is tricky and the law of unintended consequences looms large. Congress is also facing major legislative work surrounding health care reform and climate change legislation. While there were many expected provisions in the proposal (increased regulation of derivatives, registration of hedge funds, modification of securitizations), there are also elements that are lightning rods for debate (for example, increasing responsibilities for the Federal Reserve). One element of this whole debate is clear – regulation without proper enforcement is ineffective. The largest Ponzi scheme in history recently occurred directly under the nose of regulators who had been repeatedly told that it was happening.

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