

- Significant investor uncertainty continues to be the rule, not the exception. Volatility in stock prices, as measured by the VIX index, has plateaued at 40%, down from the highs set in the late fall but well above long-term levels.
- Investors have reacted to this volatility by continuing to increase their cash holdings — data from Ned Davis Research found that money market mutual fund assets recently reached a record 42% of total stock market value, compared to the prior peak of 24% reached in 1982 and again in 2003. Corporations are acting in similar fashion. Their lack of confidence in future demand — new orders for durable goods fell 26% in the most recent period — has led to job losses totaling 4.4 million
- This downward spiral likely will continue until investors and corporations regain confidence, which will require stabilizing the major banks, clarifying government's ongoing role in the economy and being able to forecast a durable economic recovery.
- The recent financial sector rally, in which a 39% jump in bank stocks led to an 11% increase in the S&P 500, is a clear indicator of how important stabilizing the banks is to the overall stock market. The primary catalyst for this rally was positive commentary from certain leading bank executives about the profitability of their operations at the beginning of this year. (To a lesser degree, talk of regulatory action on short-selling rules and mark-to-market accounting may have helped.) Good news from the banking sector is important not only to show that the U.S. economy may be moving beyond the worst of the financial losses, but also that banks may be in a position to begin increasing their risk taking.
- The banking system is changing, and the market is working to understand how. The new system likely will be smaller and more risk averse, but more stable. Although a more stable financial system should boost confidence, its increased risk aversion and reduced leverage may lead to slower growth. The massive engines of credit creation that drove growth during the last two decades likely won't be replaced.
- A newer concern weighing on investor confidence involves the role of government, both in the financial rescue process and the ongoing management of the economy. Since the unexpected bankruptcy of Lehman Brothers in September 2008, investors have been unsure that the existing rules of the capital markets will prevail. Until investors feel confident the existing rules, including the sanctity of contract law and the seniority of claims, will prevail, risk-based capital will stay on the sidelines and recovery will be delayed.
- The only silver lining in the rapid pace of the current economic downturn is that the pace at which the economy reaches maximum contraction potentially also is accelerating. The cyclical slowdown in consumer and business spending seen during a typical recession has been multiplied this cycle by the contraction in credit — but this can reverse with improvement in the credit markets.
- Retail sales in January fell nearly 10%, reflecting both a lack of consumer confidence and scarce credit. Even though there seems little doubt that a sustained increase in the national savings rate will prove a longer-term headwind to consumer spending growth, a cyclical bounce back seems likely with some improvement in credit creation.
- Of course the stock market is, at the end of the day, a discounting mechanism. We feel that many, but maybe not all, of these problems are reflected in current stock prices. The high level of losses from the financial and auto companies complicates the analysis, but a couple of measures do provide good insight.



- In terms of the S&P 500 as a percentage of the overall economy, the index has declined from a valuation peak of 135% of gross domestic product in 2000 to approximately 50% today. On a longer-term basis, it has returned to levels last seen in the late 1980s, when 10-year bonds were yielding 8%. Looking at price/earnings (P/E) multiples, the median P/E ratio for the S&P 500 has dropped to 12, compared to a median level of 16.5 during the last 37 years. This reflects the significant risk premium investors are demanding today.
  - So how will the confidence game play out? Stabilizing the banks remains the first order of business. The \$787 billion stimulus plan is unlikely to generate a sustained recovery if it doesn't restore the flow of credit to the economy. During the intermediate term, U.S. economic growth will have to become less dependent on consumer spending. Developing countries will need to boost their domestic consumption, expanding U.S. export market opportunities, for a more balanced global economy. Lastly, the government will have to restore confidence about its role in the markets and plans for economic growth before investors regain their appetite for risk.
  - The government is implementing additional plans to stabilize the banking system, including the recent quantitative easing program, and is just starting to implement the stimulus program. As these events unfold and their effectiveness becomes clearer, we will continue to assess whether our defensive portfolio recommendations remain warranted.
- *Jim McDonald, Chief Investment Strategist of Northern Trust Global Investments.*
- The Canadian financial system seems to have avoided the worst of the global credit crisis due to the conservative lending policies practiced at the major banks and prudent oversight by bank regulators. However, the economic downturn continues to take its toll on Main street as layoffs mount in the traditional cyclical industries of manufacturing, construction, and natural resources. With the unemployment rate hitting 8.0% in March, it seems optimistic to expect a near-term recovery in economic growth. Much of prior years' excess – both debt and consumption – will need to be worked off before growth can restart anew.
  - Despite the barrage of gloomy news, Canadian markets should be well-positioned to benefit from the eventual recovery of the global economy. While energy and materials prices have fallen significantly from record highs, we have seen some recovery of late as investors came to realize that the world still needs our resources. A great deal of patience may be required before economic growth begins to stabilize, but when that does occur, Canadian equities should benefit strongly from renewed trade and investment.

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