

WEALTH

THE SEEDS OF RECOVERY

After the economic tumult of 2008, many investors likely have been dreaming of a quiet new year, if not a more positive one. Wealth talked to Orië L. Dudley, Jr., Northern Trust's chief investment officer, about his expectations for the coming year.

We are in the midst of a global recession, and things are likely to get worse before they get better. The major underlying cause of this severe global contraction is the price, availability and the terms of credit.

This credit crisis has had far-reaching effects, causing everything from increased unemployment and corporate bankruptcies, to a drop in spending as consumers and businesses alike retrench and struggle to rebuild their balance sheets. Countries, such as emerging markets, previously thought to be insulated from the economic situation in the developed markets, are suffering as well.

Fortunately, some seeds of recovery already have been sown. With careful tending, the recovery is likely to take root and begin to grow.

STIMULUS PACKAGE WILL PRIME THE PUMP

We're starting the new year with a new administration in the White House, and strong support in Congress for government stimulus to address the situation. We expect, during this first quarter, to see the government

focusing its attention on priming the pump for recovery with a variety of stimulus packages.

"What's important is policymakers have clearly acknowledged that the risk today is a lack of boldness, of not being as aggressive as possible to get the economy turned around," explains Orië L. Dudley, Jr., Northern Trust's chief investment officer.

"President Obama has indicated that he plans to make a significant investment in infrastructure as part of his stimulus package," Dudley continues. "This should have the short-term benefit of providing employment and the long-term benefit of making the country more competitive globally and perhaps to narrow the trade gap between the United States and the rest of the world."

Nor is the Obama administration alone in its efforts to stimulate the economy. "The Federal Reserve is continuing to indicate that it is prepared to do whatever is necessary to get the country moving again," Dudley adds. "We expect that the Fed's aggressive behavior – particularly in its efforts to help the consumer and mortgage markets – will increasingly have a positive outcome."

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HOUSING PRICES WILL FIND BOTTOM

The housing bubble is at the root of this economic crisis, and we won't see a recovery get underway until housing prices stabilize and begin to rebound. While many forecasters are seeing the potential for another 10% to 15% decline in home prices, the combined effects of the efforts to slow foreclosures and lower mortgages rates should begin to stabilize prices.

Unfortunately, the recovery of the housing market will be hampered somewhat by higher unemployment.

"Unemployment is a lagging indicator, and we expect that it will continue to go up," Dudley explains. "We won't see a strong rebound in the housing markets because of the higher unemployment. But corrective forces and underlying fundamentals, such as household formation, should bring about the bottom."

We are seeing signs that we may be approaching the bottom of the housing market cycle. "We're already seeing some stability in prices in some markets," says Dudley. "The efforts to drive down borrowing costs and to slow foreclosures should help that stability spread."

"The Treasury Department's dramatic efforts to drive down borrowing costs – to at least 4.5% – should begin to bring borrowers back into the real estate market," Dudley continues. "When you couple this with the continued creation of new households, we should see the bottom of the housing market reached by the middle of the year."

ECONOMIC GROWTH CONTRACTS, THEN EXPANDS

Recently, U.S. economic growth has been very dependent on consumer spending, as households drew on the increasing value of their homes to finance the purchase of everything from the mundane to the luxurious. "We likely will see subdued consumer spending for at least a year," Dudley explains, "as consumers work to build savings and adjust to the slower appreciation – or even depreciation in some cases – of the value of their homes." This means that U.S. economic growth will increasingly depend on international growth and exporters' ability to meet the growing demand from developing nations.

"We believe the economy will continue to grow below its potential for an extended period," says Dudley. "The de-leveraging that's happening both at the consumer level and at the financial sector level, will make this recovery, from a historical cycle perspective, more moderate and drawn out."

Dudley expects the economy to continue to contract in the first half of 2009, as consumers struggle to rebuild savings and corporations rebuild their balance sheets. "If we do see the kind of stimulus and economic policies we expect, we're likely to see recovery begin in the second half of the year," he predicts. "The underlying confidence is already starting to increase as a result of the boldness and aggressiveness of the economic stimulus programs."

STOCK MARKET BECOMES LESS VOLATILE

Volatility was the defining word for the stock market during the second half of 2008. The S&P 500 rocketed up and down by hundreds of points, sometimes within a single day, giving many observers a feeling of whiplash.

Because market behavior is controlled in large part by investor sentiment, a key question when looking at how the markets may behave in 2009 is, "Have we reached the point of maximum pessimism?"

"By the end of 2008, we already were seeing some signs of resilience in riskier asset prices," Dudley says. "The end of the fourth quarter saw an outpouring of negative news about unemployment and disappointing corporate earnings reports, but the S&P 500 remained above its November 20 low."

Dudley attributes this resilience to some of the economic "silver linings" he sees. "High on the list are attractive valuations, lowered investor expectations and increasing anticipation of meaningful new monetary and fiscal policies. Valuations are now much more realistic, and the S&P 500 may even be undervalued," Dudley explains.

"Investor expectations have adjusted as people are beginning to correctly anticipate the damage from the problems we're experiencing, and are starting to focus (with confidence) on what could go right."

INFLATION NOT LIKELY TO BE A WORRY

With interest rates at an all-time low and stimulus flowing, it's not unreasonable to keep an eye on the potential for inflation. However, Dudley does not expect inflation to be a threat in 2009.

"We will be operating below our economic potential in 2009," Dudley explains. "As a result, inflationary pressures at the unit cost level, which is the key to inflation trends, likely will be contained. Likewise, the projected increase in unemployment means the realization of higher wages is going to be difficult. For this reason, I don't expect we'll face the threat of inflation until after this year, and likely not until later in 2010."

RECOVERY TAKING ROOT

While the economy certainly remains in the midst of a global recession, there are signs that the recovery will begin to take root this year. With housing prices beginning to stabilize in some areas, the strong policy response by lawmakers in Washington, as well as the aggressive and creative Fed and Treasury actions, should prime the pump for recovery. And as companies complete retooling and prepare themselves to meet the growing demand for products and services in emerging markets, they should be able to begin hiring again and reverse the trend in unemployment.

Economically, investor expectations seem to be adjusting, leaving the equity markets less vulnerable to negative news. However, the markets are still looking for a better definition of the economic cycle and prospects for earnings recovery before they can have a sustainable rally.

"The good news about this recession is that the abruptness of the fall has encouraged the kind of aggressive policy responses that will bring about a recovery," Dudley concludes. "But while we're starting to see signs of the bottom, we're not there yet."

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