



## Insights from Northern Trust

**Commentary from John D. Skjervem, Chief Investment Officer, Personal Financial Services**

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Despite a mixed set of economic reports and financial news, global equity markets snapped a month-long losing streak last week. In the United States, measures of large-company stock performance such as the Standard & Poor's (S&P) 500 index rose 1% while international equities also registered gains for the first time since early January. The advance in U.S. stock prices matched a week of mostly positive economic and corporate news, while modest rallies in overseas markets were notable contrasts with clear indications of corresponding policy restraint and weakening economic activity.

Until Friday, the week's most significant story was whether or not Greece would receive a financial backstop commitment from the leading members of its European Union (EU) fraternity. And when the EU did deliver such a commitment following a summit meeting in Brussels on Thursday, markets quickly began to assess its details (or, in this case, the noticeable lack thereof) and whether or not this commitment would prove sufficient in stemming rising sovereign default risk on Greek and other struggling EU member bonds. But international news wires lit up feverishly again early Friday following the announcement in China that authorities there had raised deposit reserve requirements on that country's banks. This move marked the second time in as many months that Beijing policy-makers have responded to China's surging money supply growth and rapid increases in residential property prices. The announcement was released after the close of business in Shanghai on Friday, but it rattled other global markets when trading began later that same day in Europe and North America.

By increasing its banks' reserve requirements, Chinese authorities are trying to moderate their country's booming economy by rationing credit more stringently in order to both temper rising inflation and counter concerns that China's real estate and financial markets represent the world's next big asset bubble. While Beijing's more assertive monetary policy is laudable for its proactive approach to the very real threat that the world's third largest economy may be overheating, the announcement caught many investors by surprise and raised a new set of concerns that too aggressive an approach to China's soaring money supply could put a primary engine of global economic growth at risk.

Indeed, investors were quickly reminded of how unique and significant the Chinese growth engine is when the EU also announced on Friday that economic activity among its member countries had completely stalled in the final quarter of 2009. In sharp contrast with robust fourth-quarter 2009 growth in both the United States and developing market economies, the countries comprising the EU produced combined economic growth of just 0.1% last quarter. This barely positive result was down from the 0.3% increase the EU recorded in 2009's third quarter and fell short of analysts' 0.3% expectation. While the acute fiscal challenges of the EU's "Club Med" members (Greece, Italy, Spain and Portugal) are now widely known, investors were jolted by the news that growth in the EU's



dominant economy, Germany, collapsed in the fourth quarter 2009 from the strong 2.9% rebound that country posted in the third quarter 2009.

Fortunately, last week's economic news in the United States gave investors more to cheer about than China's dampening policy moves and Europe's faltering growth picture. After a few consecutive, troubling increases in first-time unemployment claims so far in 2010, this weekly series registered a meaningful improvement last week which brought its more reliable four-week moving average down for the first time in a month. However, accompanying commentary from the Labor Department offset what would have otherwise been interpreted as good news by suggesting that the substantial 43,000 drop in initial claims for the week of February 6 (weekly unemployment claims are reported one week in arrears) was attributable in large part to the reversal of a New Year holiday claims backlog. Moreover, the past two weeks' "Snowmageddon" episodes will likely reduce the clarity and effectiveness of weekly unemployment claims as a good barometer of domestic economic activity for awhile.

But Friday's release of strong retail sales in January was not compromised by snow or other reporting caveats. Matching analysts' expectations, retail sales rose 0.5% in January while retail sales for December were revised up from an initially reported 0.3% drop to a more moderate 0.1% decline. The January report on retail sales marks the third consecutive month that retail sales have matched or exceeded analysts' expectations, and while the current level of retail sales is still below the average trajectory found in past post-recession recoveries, U.S. consumers do appear to be in better shape than had been previously feared and projected.

One of the upshots from last week's global news milieu was that recent strength in the U.S. dollar continued with the dollar hitting a 9-month high against the euro. Ambiguity around the EU's proposed financial commitment to Greece and the surprisingly weak pace of EU economic activity in the fourth quarter 2009 tipped the foreign exchange scales still further in favor of dollar-based assets and transactions. And despite an increasingly ominous budget outlook (and the complete absence of any credible fiscal policy remedies from either Congress or the Obama administration), the United States and its currency compare reasonably (albeit perversely) well relative to both the possibility of a fracturing EU and an already debt-laden Japan.

In credit markets, the recent backup in corporate spreads validates our concerns earlier this year that 2009's remarkable rally in investment-grade bonds had reached fair and in some cases overvalued levels. However, we continue to believe that the current combination of accommodative monetary policy by the U.S. Federal Reserve and strong economic growth in developing market economies will benefit investment portfolios tilted toward risk-based assets in general and stocks, commodities and high-yield bonds in particular. Finally, our forward-looking attention remains keenly focused on the aggregate and regional contours of global economic growth as well as when and to what extent the past two years' extraordinary stimulus measures will be unwound by their sponsoring governments and central banks.

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