



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

March 15, 2010

Seemingly in celebration of the important anniversary of the market trough in March 2009, markets around the world posted positive returns for the week ending March 11, 2010, with many hitting 17-month highs. This was despite contrasting economic and fundamental news that came out of the different regions: The U.S., European and developing markets released various economic data last week, reflecting very different outlooks on growth and inflation. Despite the differences, the Standard & Poor's (S&P) 500 gained 0.99%; the MSCI Europe, Australasia, Far East (EAFE) gained 2.3% (in U.S. dollars); and the Dow Jones Asia/Pacific gained 2.24%. Gains since the market bottom one year ago have been nothing less than extraordinary across the risky global asset classes, although it is important to note that the returns for the decade ended December 31, 2009 represented the worst decade since the 1830s. Even the decade of the 1930s compounded by -0.3% which, unfortunately, looks relatively robust compared to the -1.0% return in the S&P 500 for the aughts.

Here in the United States, it was a case of actions speaking louder than words as the unexpected strength in consumer spending flew in the face of the still weak consumer sentiment data. Sentiment data as measured by the University of Michigan survey actually fell to 72.5, a decline from the February reading of 73.6 and below consensus of an improvement to 74.0. Despite predictions to the contrary (disastrous news from Toyota in terms of a major product recall and challenging weather), consumers actually hit the stores in February and the U.S. Commerce Department reported retail sales climbed 0.3%, 0.8% excluding autos. The strength was fairly widespread and pronounced in the discretionary spending areas. It is apparent that there is indeed pent-up demand on the consumer side of the economy despite the stubbornly high unemployment rate.

On March 16, we will hear from the Federal Open Market Committee regarding the progress and plans around exit strategies, including the much-watched Federal funds rate. While we are not expecting any change to either strategy or language, and believe that the "exceptionally low" language will remain in force, Northern Trust will be examining the statement carefully for any change to the assessment of the pace of our economic recovery. Many who favor a continuation of the zero interest rate policy currently in place heaved a sigh of relief over the weekend on the rumor of the potential appointment of Janet Yellen, the San Francisco Fed president, to replace Don Kohn as vice chair of the Federal Reserve. The appointment of Yellen would bring an additional authoritative dovish voice to the fore, countering the growing hawkish chatter. Northern Trust economist Paul Kasriel recently pushed off his forecast of a Federal funds rate hike into early 2011, which is later than consensus estimates of the fourth quarter this year.

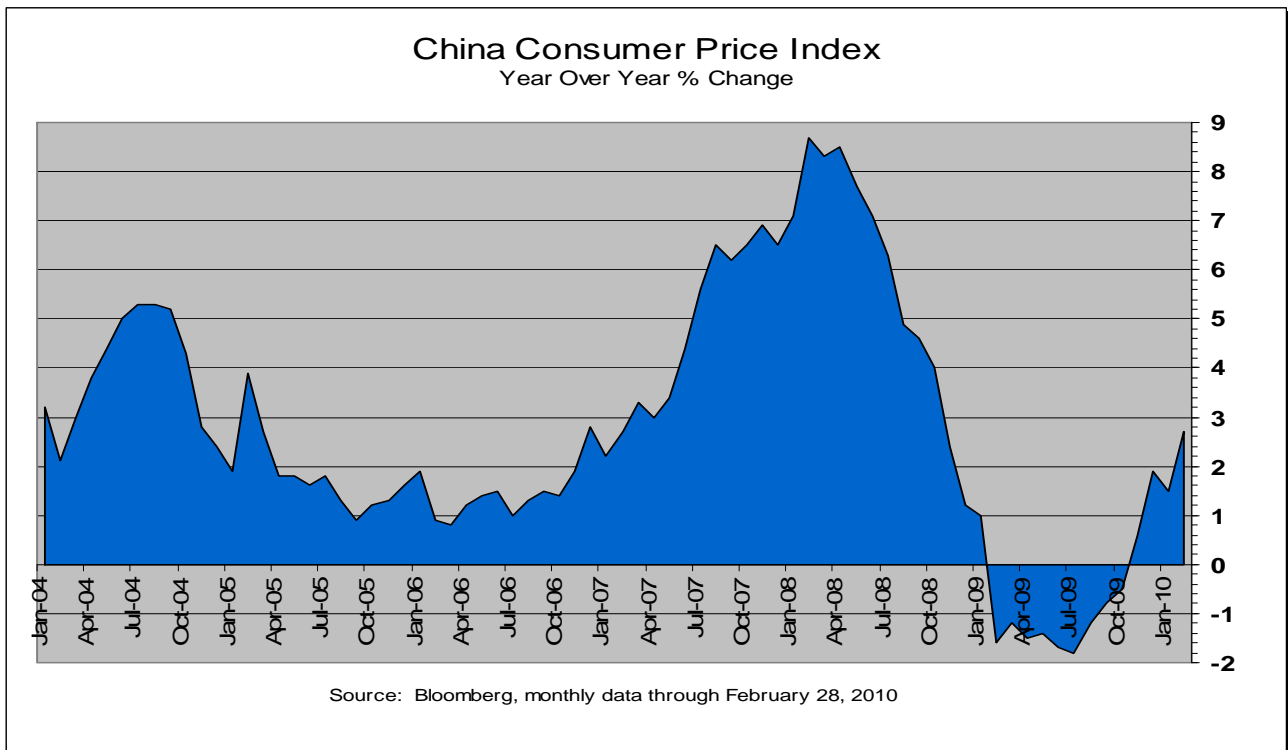


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Economic news out of Europe was less encouraging: both the United Kingdom and Germany announced weak economic numbers centering on manufacturing activity and exports, and the growing crescendo of austerity measures geared toward addressing some of the weakest of the European Union nations will undoubtedly continue to put pressure on the regional economies. Despite the successful bond issuances out of Greece and Portugal, we continue to express concern not only with continued sovereign credit problems but with the tenuous nature of the economic recovery.

Big news out of the developing world centered on China. With the ending of the National People's Congress (NPC) meeting in Beijing, an annual gathering of China's legislature and the Chinese equivalent to the U.S. State of the Union, the world received a view of the economic roadmap for China. With a centrally controlled economy, this roadmap is quite a predictable template for the policies that will be put in place to ensure the intended outcome. The most interesting information to come out of the NPC meetings was the straightforward assessment of the growing risks to economic stability in China, including a global double dip recession, asset bubbles, income inequality and inflation. To the extent that these forces create social unrest, they are intolerable.

Data out of China on inflation reinforced some fears that the massive stimulus package enacted by China during the global financial crisis would ultimately be inflationary. We have all watched with concern potential asset inflation evident in certain property markets, and now we are seeing consumer price index (CPI) inflation in the system as data revealed that Chinese consumer prices rose 2.7% year over year, exceeding analysts' estimates. Both food and service inflation are accelerating, with food prices increasing 6.2% and service inflation increasing 1.7%. Producer prices have risen even faster, with an aggregate gain of 5.4% year over year, potentially signaling the trend to continue. Recent news on the wage front has highlighted what may be more of a secular trend that, although exacerbated by recent stimulus measures, increasing wages may actually be more a function of the evolution toward a more balanced economy and increased reliance on domestic consumption.



It will require a delicate balance indeed to address income inequality and inflationary forces without creating disruption and destabilization, an outcome with extremely adverse consequences for the ruling Communist Party of China. Government programs in 2010 include more spending on creating low-cost housing, the extension of pension benefits and other programs geared toward weaving a more comprehensive social safety net. According to a recent World Bank report, the Gini coefficient for China, a main gauge of income disparity, surged to 0.47 in 2009 as the country expanded to the third biggest economy in the world, exceeding the “security line” of 0.4, indicating unequal income distribution that could arouse social unrest.

Of course, there was much discussion at the end of the NPC session regarding currency policy. Chinese Premier Wen Jiabao articulated clearly that China would not be beholden to others regarding policy, that the yuan was not fundamentally undervalued and that any external political pressure on the exchange rate would be considered to be protectionist. We expect that there will be a de-pegging of the yuan to the U.S. dollar, and that it will be gradual and well controlled. The war of words that may be brewing between the United States and China on this subject may come to more of a head in April when the United States will have the opportunity to formally label China as a “currency manipulator” in the semi-annual Treasury report. Tensions are heightened in the wake of President Obama’s meeting with the Dalai Lama as well as U.S. arms sale to Taiwan.

Finally, Wen reiterated the 8% gross domestic product (GDP) growth target for 2010, with a 3% inflation target. It is widely held that 8% is a bit of a magic number as it is the rate of growth that maintains stable employment, a key policy initiative and a political necessity. It is becoming clearer that it may be difficult to achieve both.

Katherine Ellis Nixon holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.

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