



Perspective on the Latest Market Events

Commentary from Jim McDonald, Chief Investment Strategist

June 8, 2009

Are we seeing evidence of the start to an inflationary cycle that could prove problematic for consumers, investors and central bankers? Due to the historic magnitude of the current global economic downturn, U.S. consumer prices are currently falling. It is our expectation that the consumer price index will fall by 0.7% for the full year of 2009. But this disguises the fact that much of this deflation occurred in the latter part of 2008 and early 2009, and prices are expected to begin increasing again in the second half of this year. Financial markets are showing signs that are consistent with rising inflation expectations. For example, the 10-year U.S. government bond yield has risen from 2.20% at year-end 2008 to its current yield of 3.85%, while the inflation breakeven level built in to 10-year Treasury Inflation-Protected Securities (TIPS) has risen to 2.00% during the same period. The challenging part of this analysis is deciding whether these increases are the result of a normal cyclical rebound in the economy, or are a precursor of upcoming inflationary problems. We are currently in the cyclical rebound camp, but with a lookout seeking inflationary signals.

Two of the most prominent themes of our current investment policy – emerging markets leading the global economic recovery and government intervention preventing a repeat financial meltdown – are generating inflationary concerns. The early turnaround in emerging market economies, led by China's stimulus-led recovery, has led to significant jumps in broad commodity prices. While oil's rise to its recent price of \$68 a barrel is a highly visible signpost of this, the broad-based Dow Jones/AIG commodity index has jumped 21% since the first week in March. Strategic commodity buying by the Chinese, and investor enthusiasm for the asset class, has clearly exacerbated what to date has only been a modest improvement in global economic activity.

The markets are also worried about how the United States and other large, indebted nations will handle their expected surge in sovereign debt over the coming decade. Monetizing the debt (which involves the Federal Reserve creating new bank reserves to purchase outstanding debt) would result in a direct increase in the money supply, unrelated to any overall change in growth in the economy. This is an easy way to get too much money chasing too few goods, especially as the banks can lend out these reserves at leverage of 10 to 12 times! Investors – including those from our largest creditor, China – are already raising serious concerns about this possibility. So the sunlight is focused on this potentiality, somewhat reducing its eventual likelihood.

Our economics team presented its views on the inflation question in its June 1, 2009 issue of the "Econtrarian" (www.northerntrust.com/ouexperts) and concluded that there is a greater risk of inflation, not deflation, over the next five years. The analysis focuses on the beneficial impact to



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inflation over the last 15 to 20 years from strong productivity growth, imported deflation from emerging economies and reduced defense spending. The team concluded that we are at the risk of inflation being, at the least, comparable to levels of recent years. For reference, the Personal Consumption Expenditure Price Index has averaged 2.54% annually over the last five years.

As we deliberate the investing outlook at the Investment Policy Committee, our base case scenario is that inflation will remain contained over the next five years, but increasing as the time period progresses. There is considerable upward pressure currently on commodity prices, but we don't see commensurate pressure on manufacturing or services prices, as spare capacity in these areas has built considerably over the last year. The Fed does face a considerable challenge over the next 12 to 18 months as it implements its exit strategy – how quickly can it retract various liquidity programs and tighten financial conditions without risking the economic recovery? And will the government be able to resist the temptation to ease the looming debt/gross domestic product ratio problem (see our May 26, 2009, Market Commentary) through debt monetization and inflation?

At the end of the day, we don't see economic growth being sustained at a level that will lead to problematic inflation levels over the next several years. While we are likely to get a growth bounce at the end of this year due to inventory restocking, we see the growth outlook muted thereafter due primarily to the need for consumers to rebuild their balance sheets. With the unemployment rate hitting 9.4% in May, labor seems unlikely to have much bargaining power for the foreseeable future. And with corporations coming off dramatic falls in demand, they seem unlikely to seek price increases from their fragile customer bases. Some of our current tactical asset allocation recommendations – emerging market equities, commodities, gold, and TIPS – are assets that typically benefit from the current flight to reflationary assets. But a more serious degradation to the inflation outlook would require a more vigorous realignment, including re-examining our fixed income exposures and possibly expanding our investments in real assets.

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