



Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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The global economy swung strongly into growth mode in the third quarter, with worldwide manufacturing output growing greater than 10% and gross domestic product (GDP) estimated to have grown around 3.5% after growing just 1.3% in the second quarter. Emerging markets, particularly China, are leading the way, with growth estimated to be twice as fast as that experienced in the developed markets. There is building investor concern about the sustainability of this Chinese recovery, owing to the significant amount of stimulus Chinese policy-makers have delivered this year. Can the Chinese economy sustain growth near its target rate of 8% as these stimulus measures fade? And how dependent is the current Chinese economy on the growth of the United States and other developed economies?

Emerging market growth may actually have peaked in the *second* quarter of this year at an annualized rate of 7.5%, as these economies were the first to start to turn around. China, in particular, was very aggressive in implementing fiscal and monetary plans to stimulate growth. Maybe the best way to illustrate this is to examine the growth in their money supply, which has grown 29% over the last year on a 34% increase in loans outstanding. This government-led boost in lending, enabled by a relatively strong financial system and central economic planning, means that China's annual GDP growth from 2007 through 2009 will show only a modest blip on the downside. While there has been considerable skepticism about the validity of the Chinese growth statistics, private electricity is currently running 10% higher than last year, corroborating this surge in industrial activity.

The growth in China's economy has been significantly boosted by fixed asset investment, but trends in retail sales and industrial production indicate breadth in economic activity. Fixed asset investment looks to expand by over 30% in the third quarter of 2009, compared to growth rates in the mid-20% range entering the year. But industrial production growth has jumped back up to low double-digit rates after a serious slowdown in the first quarter, while nominal retail sales look to be up at a pace of around 15%. Reflecting the strength of domestic demand and to some extent commodity pre-buying, imports have been growing more strongly than exports. In the third quarter, imports look to have grown at a 36% rate (annualized), compared with annualized export growth of 24%. The dependence of the Chinese economy on exports is a matter subject to misinterpretation. Official World Bank figures from 2007 would peg exports at 37% of GDP – but this is based on the gross value of exports, which includes items imported into China with the final assembled product being exported. According to calculations by Anil Gupta of the University of Maryland, the value-



added portion of the Chinese export market is about 33%, leaving the real impact of exports on Chinese growth at about 12%. While this is clearly a significant level, it isn't of such a magnitude that a moderately growing developed world will derail Chinese growth.

Import data from developed economies does suggest a modestly improving export picture for emerging economies like China. Imports into the United States very clearly track the trends in the Institute for Supply Management's manufacturing Purchasing Managers' Index, which bottomed earlier this year and is now clearly in expansion mode. To some extent, the areas of the U.S. economy that have received the most focused stimulus (housing and autos) are least tied to Chinese exports, but overall improvement in economic growth and stability in consumer spending will lead to increasing imports. We also expect a multi-year trek to a higher U.S. personal savings rate to mute demand for imported goods. But this trend is no surprise to the Chinese, who understand that the global growth dynamic of the next 20 years likely will be much more dependent on domestic consumption within the developing economies. Thankfully, the aggregate consumption in emerging market economies is already comparable to U.S. consumption, so this transition is not a pipe dream.

So the Chinese rebound, while likely to see some twists and turns, looks sustainable. This viewpoint is starting to be espoused by senior Chinese government officials, who are now talking about the need for a shift in policy from a growth focus to one of preparing for the risk of rising inflation. Meanwhile, the less-robust recoveries in the developed economies may lead those policy-makers to maintain a growth focus longer than their emerging market counterparts, which could continue to pressure currency markets. We think this continues to support a focus on emerging market equities and commodities, which are very sensitive to emerging market growth trends.

I feel compelled to comment on two market developments of the last week that received considerable press coverage. In the first instance, the founder of hedge fund Galleon Group LLC and five outside business executives were charged with insider trading. This is a reminder about the importance of manager due diligence, not only at hedge funds but at investment managers more broadly. While Galleon was a very large and successful firm, they had a previous run-in with the Securities and Exchange Commission (SEC). In 2005, they settled allegations with the SEC that they "shorted" the stock of 17 different companies ahead of an impending public offering – an illegal trade. This is the type of red flag that is uncovered during a serious due diligence process. The second issue regards the administration's efforts to govern compensation at U.S. financial firms and others that have received aid, like General Motors. While there is great political theater in cutting executive compensation, the more important reforms like discussing the separation of commercial and investment banking (the former Glass-Steagall Act) and required capital ratios will generate little public interest. Yet it is these types of action that must be discussed to improve the long-term stability of the financial system. While there is clear merit in making sure compensation plans don't stimulate excessive risk taking, the biggest consequence of capping executive pay at the troubled firms is to make it harder for them to compete, as their healthier competitors don't have comparable restraints.

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