



Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Last week was a continuation on a theme, albeit with a short-term but important twist. Risk markets – equity, credit, commodities – around the world continued their seemingly coordinated rallies. As if on cue, the U.S. dollar continued its slide as global investors sold dollars to fund purchases in the aforementioned risk assets. The singular exception to this trend was on Thursday, when the dollar rallied unexpectedly, sending risk assets around the globe lower on the day. That being said, global markets posted a weekly gain for the most part, with the U.S. markets broadly higher and European markets closing at the best levels in several weeks. Asian markets participated in the global risk rally, with the exception of the Nikkei 225 index, which posted a marginal loss on the week. Consistent with the persistent dollar weakness, gold continued its climb, closing at \$1,116 per ounce for the week. Commodities have benefited from extremely high levels of investor interest and strong cash flows into commodity-based index and exchange-traded funds.

The dollar weakness on Thursday was precipitated by some speculation that People's Bank of China was setting the stage for the Chinese currency, the renminbi, to strengthen against the dollar. This would be welcome news on a variety of fronts, and we will be watching this closely. This is an area of some renewed controversy, and major developed European and Asian economies are rattling sabers against the continued dollar peg of the Chinese currency.

As President Barack Obama continues his Asian road show with a visit to China, a key topic of conversation will be the renminbi policy. The Chinese economy benefited, perhaps like no other, from the U.S. excesses of the past several years. U.S.-led export demand, built in no small part by an insatiable consumer-led demand cycle, provided ample fuel to China's \$4.4 trillion economy. As we are well aware, this has led to both current account and fiscal surpluses that have continued to support the Chinese economy in the wake of the global recession, and the dramatic fall-off in global demand. The bursting of the U.S. housing bubble was felt around the world, and the knock-on effect of the steep decline in global demand and production was stark. However, the Chinese economy had avoided the brunt of the financial meltdown by limiting participation in the balance sheet aspects of the bubble. China's financial system remained healthy, and its economy continued to function relatively well, with gross domestic product growth bottoming at a still-healthy level of 6.1% in the first quarter of 2009, never getting close to recessionary territory.

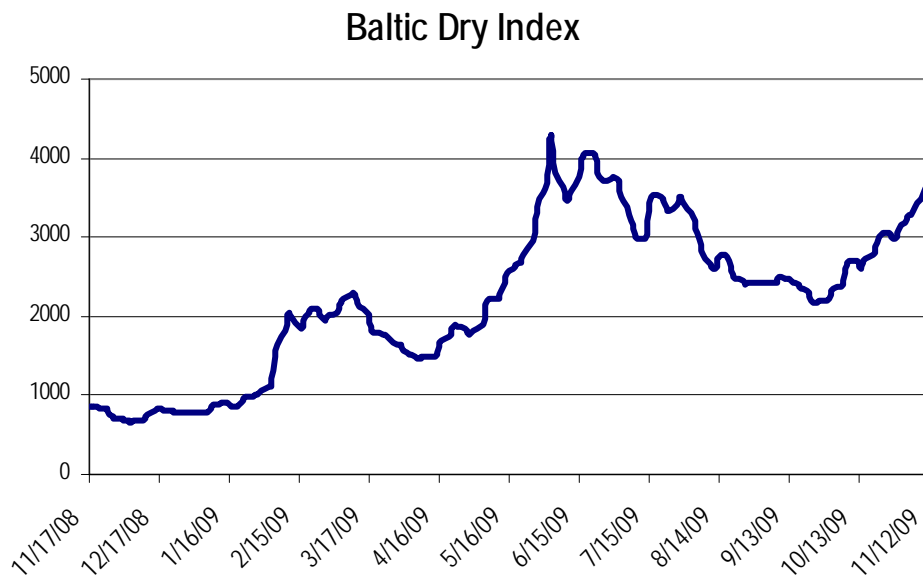
It is clear that the central banks of major developed countries enacted collaborative fiscal and monetary efforts, reflecting a proactive game plan that was set forth in the midst of the global financial crisis. They wanted to wield the "one-two" punch of monetary and fiscal tools to knock out the enemy of asset price deflation and potential global economic depression, and to sequence a



recovery. The plan: first, recapitalize the banking system and mitigate systematic risk; second, maintain easy policy – using whatever tools necessary – to stabilize the economy and avert a depression, and third, re-inflate the economy to avert continued deflation. As we are beginning to see, however, there may be some unintended consequences to this prolonged easy money policy.

The Chinese had a game plan as well, with the singular goal being to avert economic malaise brought about by the sharp reduction in U.S. consumption-led export demand. The Chinese central bank had a single mandate: economic growth. Federal Reserve Chairman Ben Bernanke has nothing on the Peoples Bank of China, and this Chinese plan involved tremendous fiscal and monetary stimulus, implemented decisively and early into the financial crisis, and focused on domestic investment and spending. One key difference with their plan vs. the developed world is the success in stimulating bank lending. In contrast to the capital hoarding we have seen here in the United States, banks in China have been prolific in lending: growth in total loans increased 60% in the quarter ended June 2009.

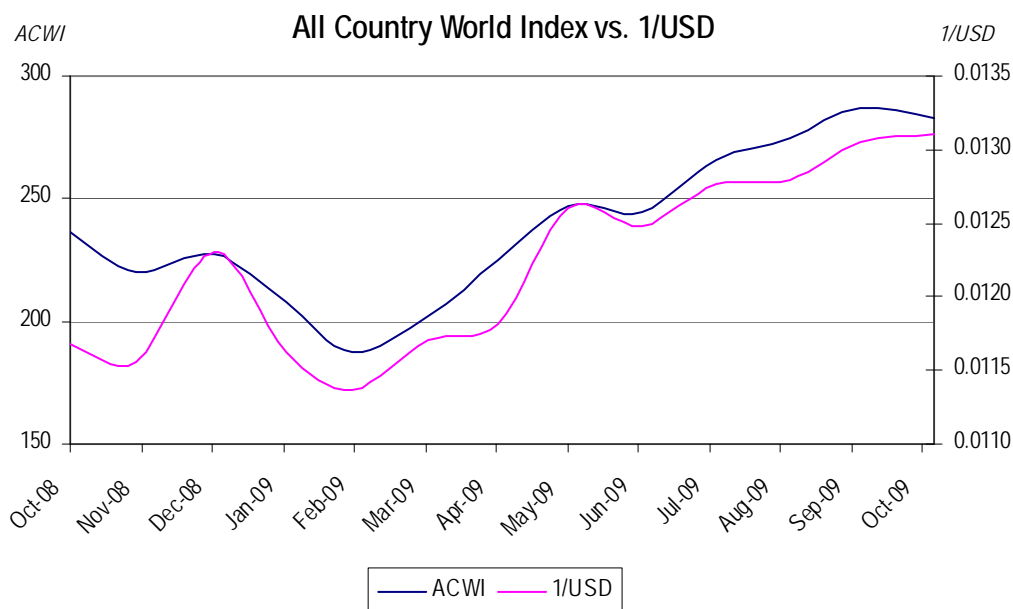
As far as results to date, industrial production jumped 16.1% year-over-year in October, and some of the retail sales data support robust internal consumption expectations. The consumer price index is still negative, so inflation doesn't appear to be a problem. Economic activity in China appears to be accelerating; in fact, the Baltic Dry Index, which measures dry bulk ocean freight rates, has surged since October as a result of record commodity imports to China, a precursor to even more robust industrial output.



Source: balticexchange.com

So, China's plan to stimulate its domestic economy appears to be working. That being said, recent trade data in some ways represented a step backwards – China's trade surplus increased to \$24 billion from under \$13 billion in September. This brings us back to the currency debate. China's dollar peg puts pressure on other currencies, including the euro, and raises the concern that China is overstimulating its own economy and perhaps taking unfair competitive advantage of the United States' policies. Some suggest that China is coat-tailing our own easy policies, benefiting from the dollar weakness as its goods for export continue to be exceedingly competitive on the world market when priced in dollar-pegged currency. Further, there is fear that the weak currency will spur

continued speculation in all asset markets – equities, real estate and commodities specifically, and that the carry trade (e.g., selling dollars to invest in higher-yielding currencies and assets) has become self-fulfilling in an environment where our central bank has expressed the view that rates will stay low for an extended period of time. In the meantime, the inverse correlation between the U.S. dollar and risky assets around the world has continued, as evidenced by the chart below which shows clearly the relationship between the weakening dollar and the global equity markets.



Source: Bloomberg

Lest we forget, however, China has a somewhat vested interest in a stable and strong U.S. dollar as the biggest holder of our debt – China holds almost \$800 billion of Treasuries. It is not in China’s long-term best interest to see the dollar continue to weaken. There has been more rigorous and audible discussion emanating out of Asian economies, and specifically China, urging the U.S. to consider carefully the current stimulative monetary policies, and more broad-based concerns that this easy money will create bubbles in other asset classes. Even Ben Bernanke, at today’s speech before the Economic Club of New York, raised the issue of the U.S. dollar as something the central bank is “attentive to.” There are no easy answers, and the solution is likely a gradual and orderly strengthening of the renminbi concurrent with the continued improvement in the U.S. economy.

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

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