



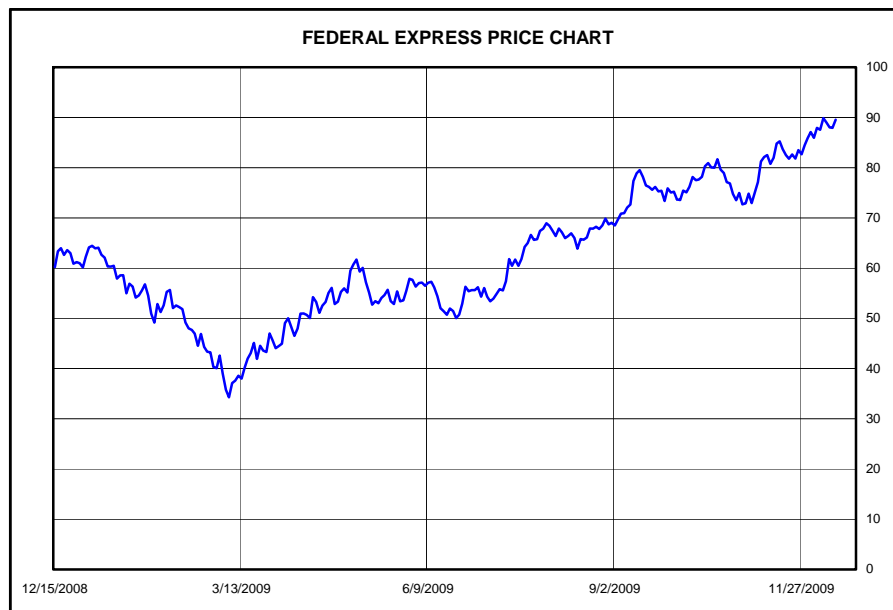
Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

December 14, 2009

As we get set to leave this awful decade behind (labeling this decade the “Naughts” is high on my list), our thoughts are on the state of the global economic rebound and the mood of policy-makers. During our recent asset allocation committee discussions, much time was spent on the relative growth trajectories of the major developed economies (the United States, Europe and Japan) as early signs are emerging that the United States may be outperforming. We also spent considerable time on the issue of sovereign credit in the wake of the difficulties in Greece, Ireland, Spain and Dubai – to name a few.

We have upgraded our view of the prospects of the U.S. economy – a stance we first hinted at last month. The highest profile development over the last month was the November non-farm payroll report – indicating that the economy lost 11,000 jobs over the month and the unemployment rate fell from 10.2% to 10.0%. Along with an increasing work week and four consecutive months of increasing temporary help, the worst is likely behind the labor markets. Evidence from the transportation sector, including a more upbeat outlook from Federal Express and increases in railcar loadings, indicate continued improvement.



Source: Bloomberg

(In U.S. dollars)

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This was also present in the government's estimate of November retail sales announced last week, which rose a much more robust than expected 1.3%. To be fair, not all the economic data has been a positive surprise – the headline Institute for Supply Management surveys for manufacturing and services were disappointing and the private sectors estimate of November chain-store sales were soft – but on balance we think the outlook has improved.

In contrast to this near-term improvement in the U.S. economic data, recent data from Japan and Europe have been less inspiring. Japanese gross domestic product growth for the third quarter has been revised from an initial report of 4.8% annualized growth to just 1.3%, and with falling prices the Japanese economy actually registered negative nominal growth in the quarter. A significant reduction in corporate capital spending was the major culprit for the negative revision, while consumer spending and exports met expectations. In Europe, weak industrial production data for the Eurozone and soft German order and output data for October give slight pause to the generally improving growth outlook. With exports having only recovered around one-third of their losses from the recession, there still does appear to be room to run but the journey may be more eventful than previously expected. The European Union is also finding itself increasingly dragged into discussions of member-country fiscal problems. On balance, the potential of a moderating growth outlook and sovereign credit problems should mean somewhat easier monetary policy.

As we move further from the nadir of the global stock markets, we are increasingly focused on the financial repair bill that has been left for the public. This sovereign budget issue has been heightened by the recent travails of Dubai and Greece, but is also of great discussion in the United Kingdom, United States, Spain and Ireland. With both Dubai and Greece, there has been some market expectation that “Big Brother” would reduce the credit risk – Abu Dhabi in Dubai's case, and the European Union in Greece's situation. Just as investors reached the conclusion that they shouldn't rely on any assistance, Abu Dhabi has interceded by supplying emergency funds to Dubai, and the related Dubai bonds have leapt in price. Global fixed income investors would do well to forget this particular case and focus on underlying sovereign credit worthiness going forward. We think the path to repair will start with governmental budget restraint à la Ireland's “tough love” plan, and potentially improve with continued global economic growth.

So as we get ready to leave the “Naughts” behind, we expect the combination of broadly accommodative central banks and improving global growth to continue well into 2010. Emerging market growth continues to impress, with Chinese industrial production up 19% in November. Constructively for global growth, Chinese imports in November were up 54%, while exports were up 22%. We do think we'll see shifting opportunities among the various asset classes, such as the current growth differential that may be developing between the United States and its developed cousins in Japan and Europe. The risk to our moderate overweight to risk remains an early tightening by central bankers – we'll hear from the Federal Reserve this Wednesday and expect any modification to the “low for long” interest rate policy to be modest. We continue to think a portfolio overweighted toward emerging markets, including equities and commodities, may best position investors for not only the near term but also the major shifts in the global economy that we expect to be talking about for years to come.

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