Insights from Northern Trust

Commentary from Bob Browne, Chief Investment Officer

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U.S. employment data disappointed last Friday, with the report showing 85,000 jobs were lost in December even though some economists were actually forecasting mild growth. The longer term trend does remain positive, however, and we finally should see positive job growth sometime in the first quarter. The headline figures also will get an additional technical boost in the coming quarters as the U.S. Census Bureau starts to hire several hundred thousand temporary workers needed to conduct the census.

While the trend in employment is without doubt improving, the bottom line is this: it will be a long time before we see substantial enough job growth to make a material dent in the unemployment rate. Most sectors are still showing sluggish to negative job growth. One notable exception is health care, which actually has created 631,000 jobs since the recession began. In fact, health care is now the second largest source of employment in the United States, with more than 16 million jobs. The government is No. 1, with 22.5 million jobs. By the way, one way to think about healthcare reform is that if it succeeds, the government will directly or indirectly have a huge influence on 30% of the entire workforce.

The fact that unemployment will remain relatively high for some time brings us back to one of our key market themes: we take the Federal Reserve at its word that it will keep rates low for an extended period of time. The Fed has indicated that it is looking for some combination of improvement in economic slack (read this as job growth), worsening realized inflation trends or deterioration in long-term inflation expectations. While the last one has started to take place with long-term implied inflation rates rising back to 2.5%, it is still a manageable number and close to long-term averages. More importantly, the Fed is unlikely to justify a rate increase, given the high unemployment rate and lack of inflation pass-through in broad price indexes.

The likelihood of low U.S. rates for an extended period of time leads us to another key theme: the unintended beneficiaries of monetary easing – emerging market equities and commodities. Some market observers point to “bubble” conditions in these markets as a reason for the Fed to get ahead of the curve. We find it highly unlikely that the Federal Reserve will hike rates because of robust equity markets in Asia or record copper prices – not while more than 15 million Americans remain unemployed. So the Fed keeps rates low while the emerging world and its demand for commodities continue to emerge.

From a non-U.S.-centric perspective, the recent data out of China are even more important than the U.S. employment figures. Even taking into account the easy year-on-year comparisons when the world was falling apart last year, the December import and export figures out of China were very robust. Imports were up nearly 56% year-on-year in December while exports climbed 17.7%. The full-year figures for 2009 were down for both, but the recent trend is very strong and indicates robust growth in 2010 for China.

There are those who state that China eventually will have to rein in this level of growth. We agree, but this is not the time. Will they rein in bank lending to control speculative property investment? Absolutely. Will the Chinese government rein in fiscal and monetary polices to the extent that it causes gross domestic product (GDP) growth to fall short of the "holy-of-holies" 8% GDP growth for now and forever? Absolutely not. While the United States rightly worries about its 15 million unemployed, here's another figure for context. There are 15 million new entrants into the Chinese workforce every year. Over 6 million college graduates joined the workforce in 2009 alone. The main public policy objective in China is to generate sufficient growth to keep these folks employed. While the Chinese government has more than enough wherewithal at its disposal, it will get additional support from low U.S. rates. Capital, as we like to say, will eventually flow to the place where it receives its largest expected reaction. More capital will find its way to China and everything China consumes.

One thing to keep an eye on is agricultural prices. There was a pretty good scare in the summer of 2008 in the emerging world regarding global agricultural prices. In the wake of the Lehman crisis and the global recession, people have pretty much forgotten about the stress on the global food market which was occurring in 2008. Despite the enormous wealth being created by the emerging economies, they remain very poor countries and substantial increases in the prices of core staples such as rice and sugar cannot be ignored for long by their governments. The only public policy objective which trumps keeping their people working is keeping them fed.

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