



Insights from Northern Trust

Commentary from Bob Browne, Chief Investment Officer

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The Dow Jones Industrial Average just finished its best five-month streak since 1938, according to Reuters¹. The broader market, as measured by the Standard & Poor's (S&P) 500, returned 7.4% in July alone and is now up more than 10% year-to-date on a total return basis. In fact, returns for many key risk assets are now comfortably in positive territory for the year: corporate investment grade bonds, high yield bonds, and developed equities markets. The standout for 2009 thus far – emerging market equities – have now racked up 40% returns and are back to their pre-Lehman-collapse levels.

One of our favorite investment themes, commodities, is also catching up nicely. The broad based Dow Jones-UBS (formerly AIG) Commodity Index is up nearly 9% for the year. Oil is back to \$70 per barrel on the back of stronger-than-expected global economic data and a weaker U.S. dollar. The latter played a key part in giving a late-week surge to gold as well. In fact, the dollar is just about the only asset that has not rallied during the past few months. That's no wonder, though, because our government is making more and more of them every day.

There are several pundits stating that it is not plausible for commodities or the broader economy to stage a sustained turnaround as long as U.S. unemployment is high and heading in the wrong direction. This observation usually coincides with the statement that inflation is not a threat for the same reason. This is despite many instances of "jobless" recoveries in the United States and stagflation in multiple countries around the world. Our Chief Economist Paul Kasriel has pointed out that the correlation between the output gap and inflation is positive, if anything. One need only look at Spain and Italy before the euro, and Latin America for much of the post-war period, to find historic examples showing that structurally high unemployment usually goes hand-in-hand with inflation.

While we are not predicting this type of inflation – in fact, we think it will be subdued in the near term – we do think many investors are predicting the risk of much stronger-than-expected inflation in the long run. It's for this reason that we look for ways to hedge this potential "tail" risk; buying insurance against inflation is a key theme of a recent paper, "*Don't Hang Up on the Inflation Insurance Salesman,*" written by my colleagues, Jim McDonald and Dan Phillips.

The markets once again will be focusing on the July non-farm payroll data due this Friday. As usual, the market will likely exaggerate the importance of a single data point and de-emphasize the underlying significance. Let me save you the trouble of predicting what will happen on Friday: we expect the data to show that more people lost their jobs last month. It is likely that the economy is shedding jobs at a slower pace, but that will be small solace for those actually losing their jobs. Here is the key point: as terrible as it is for the people losing their jobs, what we need to focus on is the confidence level and spending patterns of those 90% of the work force who still have their jobs. Here's why: the usual cause



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of a recession is not the spending habits of the people who actually lost their jobs, but the *fear* among everybody else still working that they could lose their jobs as well. When 10% of the potential work force find themselves unemployed, they rein in spending sharply, potentially default on debt, and increase the federal deficit as they receive temporary government benefits. What really hurts the economy, however, is when the people who still are working start worrying about their jobs. They slow their spending, deferring large expenditures, such as buying a car, to save more and pay down debt. This is not such a bad thing – except when everyone decides to do it the same time.

Jobless recoveries happen when this 90% start to feel better about the world and, more importantly, their own situations. Confidence about their jobs is critical. Companies may take months to start hiring again, but as long as more office cubicles are not popping up empty every Monday morning, people start to think their jobs are safer. As they accumulate more savings and see improvement in their investment portfolios, they start thinking they can spend again.

The bottom line is that while there will be much media coverage of Friday's non-farm payrolls data, it truly is a lagging indicator. Instead, we should pay attention to more forward-leaning statistics: industrial production, the Institute for Supply Management survey and perhaps the most future-oriented (if not volatile) gauges of them all: stock and commodity markets. These markets are telling us things are getting better, not worse. At some point, they may extrapolate the recent trend too far (they have a bad habit of doing that) and possibly make the mistake of pricing in several years of above-trend growth that simply is not going to happen.

With regard to commodities, it is worth reiterating that the number of unemployed in the United States, and even the attitude of those still working, is increasingly *less* important in a global market. U.S. consumers are not the only ones who want and need oil, copper and iron ore; so does the rest of the world. Also, as large holders of U.S. treasuries, overseas consumers are more concerned about the value of the dollar than we are. And so the other problem with the focus on the U.S. non-farm payroll data is that it is a U.S.-centric data point in a very global capital market.

We encourage clients to pay as much attention to global economies as they do to the U.S. economy. In addition to reading daily reports about non-U.S. markets, I have always found it helpful to get true local color from the daily press. For instance, besides reading *The Wall Street Journal*, consider taking an on-line subscription to the *South China Morning Post* (go to scmp.com), the leading newspaper in Hong Kong. If you really want to see how China is doing, just keep track of the SCMP's real estate section. In the long run, that data point is just as important as the U.S. non-farm payrolls.

¹ Source: Reuters stock market summary - July 31, 2009

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