Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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The last several weeks brought evidence of accelerated near-term improvements in both the real economy and financial markets. A potent combination of depleted inventories, fiscal and monetary stimulus and improving confidence is leading to better economic data not only in the United States and Asia, but surprisingly, also in Europe. As recent soft U.S. retail sales figures demonstrate, the path to economic recovery will not be uneventful, but we do believe the recovery is taking root and will continue to gain steam into 2010. And while the evidence of stock market gains is highly visible, the less-apparent improvements in the credit markets are just as important.

The significant turmoil in financial markets over the last 18 months created valuation anomalies across many asset classes that we sought to take advantage of through tactical asset allocation policy moves. But as the credit markets have improved and the economy has proceeded on its path toward a near-term recovery, these anomalies have been significantly reduced, and asset allocation should move closer to strategic norms.

The combined monetary and fiscal policy response to the financial crisis, especially in the United States, was scaled to minimize the risk of falling into a deleveraging-led deflationary spiral. And while recent data showed U.S. consumer prices fell 2.1% over the last year, the core inflation rate (stripping out food and energy) was a positive 1.5%. We do have strong conviction that the deflationary risk has been minimized, and the risk case is now toward higher inflation. While the credit creation mechanism is not yet fully functioning – as evidenced, for example, by challenges in the securitization markets – enough improvement has been realized that the focus has moved to the Federal Reserve's exit strategy. The government will continue its focus on stimulus spending in this environment, as the success of the "cash for clunkers" program demonstrates the efficacy of a targeted, and politically popular, initiative.

While the pace of global economic recovery has accelerated in the near term, the long-term drivers of sustainable growth remain less clear. A bounce in economic growth this year was a near certainty after the precipitous drop in global production over the last nine months, but the pace of initial recovery is exceeding most forecasts. In the United States, we have recently increased our forecast for third-quarter 2009 growth from -2.0% to +1.0% due to improved expectations for auto sales and export growth. We have been most impressed by improvements in the manufacturing Institute for Supply Management index and the steady improvement in the labor markets, as evidenced by the weekly unemployment claims. In Europe, second-quarter growth was well above expectations, as both France and Germany showed positive growth. Asian growth, hardest hit by the global downturn, has seen outsized gains, with second-quarter growth ranging from 4% in Japan to 21% in Singapore.

As the real economy and financial markets have moved further away from last September's brink, valuations in most asset classes have also become more normal. The increased risk premium was a function of both increased economic uncertainty and decreased liquidity. As these have improved, risk premiums have dropped and prices have increased. Whether it was in Treasury Inflation Protected Securities (TIPS), where deflation fears created attractively low inflation breakeven levels; or high-yield bonds, where fears of mushrooming defaults and reduced liquidity caused a blowout in spreads; or the equity markets, where concerns about economic growth and financial stability combined with a very liquid market to lead to severe selling pressures, previously elevated risk premiums have become much more normalized.

As these anomalies have faded, and the growth outlook has improved, we have been steadily "normalizing" our tactical asset allocation recommendations. Early moves to overweight TIPS and high yield, for example, have been reversed as these markets are now discounting more realistic outcomes. We have been steadily increasing our tactical allocations to the equity markets, including a recent increase to EAFE (Europe, Australasia and the Far East), as evidence of credit market repair and economic improvement have strengthened the outlook for stocks. Our first move to increase portfolio risk earlier this year related to our conviction about the early and sustainable recovery in emerging markets – hence an overweight to both emerging market equities and commodities. We continue to support this view, and are also tilting our U.S. equity portfolios toward those sectors best positioned for international growth.

In summary, a combination of improving near-term growth trends and normalizing valuations has recently led us to further increase the tactical risk profile of the portfolio toward its strategic levels. The economic growth picture into 2010 has clearly improved, as production plans need to increase to match the growing order trends. The strength and durability of the recovery post this inventory-led bounce remains less clear, as the U.S. consumer appears to be in a multi-year retrenchment and global growth must transition to a more balanced origin. Evidence of progress toward this transition, where domestic consumption in developing countries starts to support significant export growth in developed countries, has shown its first evidence in Germany's recent export data. Further evidence will likely be required for a positive surprise to current global growth expectations.