Insights from Northern Trust

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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With the shift in investor focus away from recent corporate earnings reports and back to the macroeconomic story, economic data released last week ratified what the equity markets have been forecasting during the powerful rally off the March lows. That is: economic activity likely bottomed in the first quarter 2009, and the global economic recovery appears to be taking hold in earnest. Interestingly, market reaction to the good news inherent in the data was relatively muted, with broad markets registering marginal gains on the week. Summer doldrums and data fatigue are cited as two likely culprits, but is something else going on as well? As we know, markets move on expectations, so what are investors expecting?

Looking at the numbers, it is clear that the now-consensus expectation of economic recovery in the third quarter 2009 is becoming reality, and the only outstanding question is the strength of this recovery. With U.S. gross domestic product growth estimates generally ranging from 1% to 4% – our own Paul Kasriel is in the 1% camp – there remains only a question of magnitude. Last week, we received several important data points confirming improvement in some critical areas of our economy. In housing, new home sales for July surged 9.6% from June, and housing inventory, a widely watched statistic improved substantially to 7.5 months down from 8.5 months. Home prices as measured by the Standard & Poor's Case-Shiller index also rose 1.4% in June, the second straight monthly rise and the first quarter-to-quarter gain since 2006.

This improvement in housing is clearly one force behind a resurgence in consumer confidence. As reported by the Conference Board, consumer confidence rallied to 54.7 in August from the July reading of 47.4. We also received some positive news from our manufacturing base, with the Department of Commerce reporting that durable goods orders rose 4.9% in July. But core durable goods, which exclude transportation and defense, edged down slightly to -0.3%. Still, certain trends in the report suggest that the inventory-led rebound we have been discussing may be underway.

Globally, the story is consistent. Sentiment in Europe as reflected in a European Commission survey for August showed a surge in optimism. The survey's summary statistic, the economic sentiment indicator, surged 4.6 points to 80.6, driven by gains in service and industrial sectors. In addition to sentiment, real activity has improved, with global trade advancing 2.5% in the latest quarterly report.

Interest rate policy looks to be stable, with short rates anchored near zero for an extended period of time. Federal Reserve Chairman Ben Bernanke has been re-appointed for another term by President Obama, a show of confidence as well as an attempt to provide the market with a sense of stability in that crucial post.

So, economies are improving at a faster pace than expected, global growth is recovering broadly, and we are seeing stability in interest rate policy. With data like that, one might have expected a market rally over the past seven days. However, and as we have discussed many times in recent past, the market is a forward looking mechanism. The data released last week is already reflected in the market, and expectations around this data fueled the rally we have experienced over the past six months. At this point, investors are looking forward to the next six months, and it remains unclear what will drive the market during that period. There are many questions to answer:

- Will the recovery be sustainable in the absence of the global accommodative fiscal and monetary stimulus?
- Will global economies continue to grow should the Chinese stimulus become muted? With fears of overheating and inflation, China's central bank is attempting to apply brakes as year-to-date loan growth tops US$1 trillion. The Shanghai market is reflecting that concern and fell another 7% over night, extending a four-week losing streak that has erased more than 20% of this year's gains.
- Will US consumer spending recover?, Given the stubbornly high unemployment rate – it is as high as 16.5% when discouraged workers are taken into account – and in an environment of flat wage gains this is an important question. Recent data suggest that there could be an uptrend, however many pundits suggest that activity encouraged by programs like cash-for-clunkers and incentives for first time home buyers simply pull demand forward from future years, and don't stimulate a real increase in demand.
- How do we assess the health of the banking sector as we face the contradiction of successful recapitalization of major financial institutions alongside an increase in the momentum of small bank failures. U.S. bank failures now stand at 83 in 2009. The FDIC recently added 111 lenders to its list of endangered banks, bringing the 2009 total to 416, a 15-year high. At the same time, FDIC insurance funds available to protect deposits have fallen to their lowest level since 1993. What implications might this have for business credit availability for small and medium size businesses, key customers for local banks?

Global markets clearly are looking for the next catalyst to fuel a further move upward. With continued stimulus from various fiscal and monetary programs alongside the long expected inventory restocking, we expect that the data may surprise on the upside. This expectation has informed our decision to bring our tactical equity exposure up to a neutral stance. We remain mindful of the more intermediate-term challenges and will continue to assess our risk posture in light of these issues.

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

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