



## Insights from Northern Trust

### Commentary from Jim McDonald, Chief Investment Strategist

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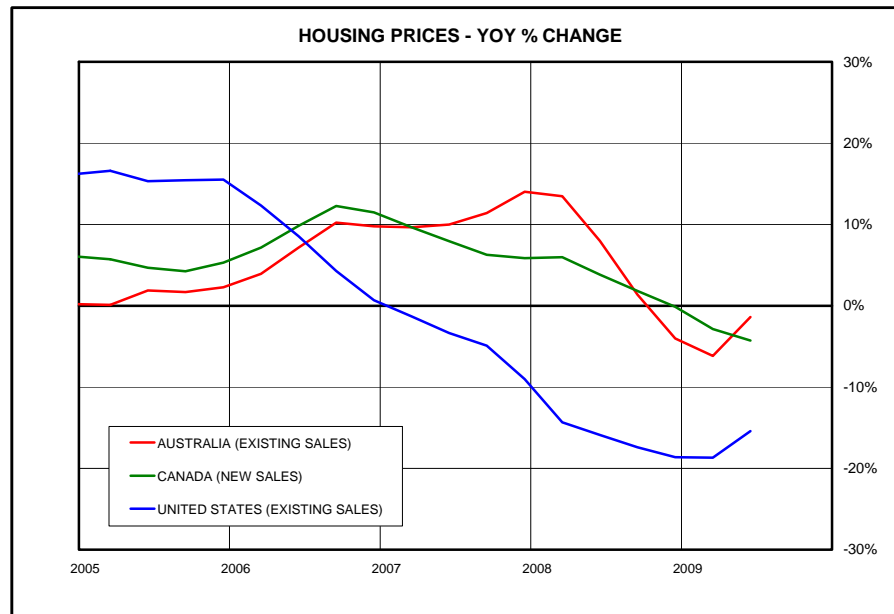
The starter's gun for the global central bank tightening race was shot off last week, but while some central banks are getting comfortable in the blocks others are still looking for the arena. Australia was the first Group of Twenty (G-20) central bank out of the blocks when it raised its benchmark short-rate from 3.00% to 3.25% last week, as it sees evidence of economic upturn in the wake of significant stimulus programs and renewed Asian demand. On the heels of this move, global equity markets rallied and the Australian dollar jumped 4%. On a go-forward basis, just how important is the focus on central bank and governmental policy versus the more traditional focus at this stage of the business cycle on the outlook for growth and inflation? What does the reaction of global markets to the Australian move tell us about the prospects for risk assets as we begin to normalize policy across international financial markets?

Last Thursday, Northern Trust's Tactical Asset Allocation Committee held its monthly review of the outlook for the economy and financial markets. In this discussion, we typically focus on the normal drivers of asset returns: the outlook for growth and inflation, valuation and technical factors such as asset flows and investor risk appetite. But we find ourselves increasingly focused on the impact of government action on financial markets. This includes discussion around the unwind of policy initiatives, regulatory change and geopolitical risks. Our conclusion was that the global economic recovery was going to be heavily impacted by government actions. Government intervention got us through Phase I of this recovery (stabilization of credit markets with an early economic recovery supported by inventory rebuilding) and will heavily influence Phase II (withdrawal of credit market support alongside an economic expansion supported by end-demand). The proportionate impact of the eventual policy moves will be influenced, to a significant degree, by the financial strength of the region being discussed and its exposure to the current drivers of global growth.

This brings us back to Australia. Because the Australian economy was on much sounder footing going into the global crisis, the ability of the authorities to remove their stimulus is that much greater. Despite the global downturn, the Australian economy has avoided falling into recession through this period. One of the reasons for this relative stability is the strength of their banking system and housing markets. In an excellent essay on the U.S. housing crisis, "*The Trojan Horse of U.S.-Style Securitization*," Christopher Joye highlights the fundamental differences between the residential mortgage markets in the United States, Australia and Canada. Over-reliance on securitization in the United States led to poor loan standards, which led to ballooning defaults. Contrast this with the experience in Australia and Canada, where securitization is subordinate to the bank-based credit system. This has led to default rates in Australia and Canada, which are less than 15% of those of the United States – and housing prices in those markets have been much more stable. Another result of this more conservative mortgage culture is that Australia and Canada lay claim to seven of the 11 AA-rated banks in the world.



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Source: Haver Analytics and Bloomberg

While Australia is clearly a developed market with a mature banking system, capital markets and legal system, the dynamics of its economy are more clearly tied to emerging Asia than the developed western world. Due to both proximity and its natural resource-rich geology, Australia has been a major beneficiary of Asian growth – and this should continue. So think of Australia’s move to start raising rates as one of the signs that the developing economies will be the first to normalize monetary policy.

Contrast this situation with the deliberations of the European Central Bank (ECB) and Bank of England (BOE) this past week that left current stimulative policy measures unchanged. In a rather startling (and probably politically motivated) comment, the U.K.’s chancellor of the Exchequer was quoted as justifying the continued accommodative monetary policy by saying, “If we stopped supporting the economy now it would crash.” Even discounting for hyperbole, this is a direct contrast to developments in Australia, where their Senate launched an inquiry last month to examine whether policymakers needed to move more quickly to tighten policy.

So what are the implications for the global markets, and the positioning of portfolios, as central banks are in varied stages of preparing for the tightening race and the global economy seeks to transition from an inventory-led bounce to more sustainable growth? We think that investors need to focus more on policy actions than traditional growth and inflation metrics, as the growth and inflation picture is unusually dependent on governmental action. We see the healthiest economies moving first to normalize policy, with their economies most able to handle higher interest rates. These higher rates will likely lead to continued strength in those countries’ currencies at the expense of the U.S. dollar. This picture supports a focus in portfolios toward emerging markets and the commodities area as the likely beneficiaries of this stronger outlook. However, our focus on the important role of government action in this recovery means that we continue to keep a vigilant eye out for the possibility for policy mistakes and the damage that could result.

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