



## MARKET COMMENTARY • SEPTEMBER 2009

### OUTLOOK

Developments in the global economy and financial markets last month demonstrate that repair is occurring more quickly than expected. Global industrial production is gaining steam as managers compare their new orders against depleted inventories — 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 show, the economic recovery will not be boring — but we do think a sustainable recovery is starting to be built. Improvements in the functioning of the credit markets, alongside this economic improvement, help support the recovery case. The Federal Reserve has done a commendable job executing its current mission of supporting both economic growth and financial market liquidity, while also starting to articulate its exit strategy.

The current bounce in economic growth was a near certainty after the precipitous drop in global production during the last nine months, but the pace of initial recovery is exceeding most forecasts. For the United States, Northern Trust has recently increased its growth forecast for third quarter 2009 from -2.0% to +1.0% due to improved expectations for auto sales and export growth. We have been most impressed by the improvements in the Institute for Supply Management (ISM) Manufacturing Index and the labor markets, as evidenced by the weekly unemployment claims and layoff data. In Europe, second quarter growth was well above expectations as both France and Germany showed positive growth. Asian growth, hit hard by the global downturn, has seen outsized gains with second quarter growth ranging from 4% in Japan to 21% in Singapore.

The significant turmoil in financial markets during the last 18 months created valuation anomalies across many asset classes, which we have 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.

### U.S. EQUITY

- The weak labor markets continue to put pressure on consumer spending.
- Export-oriented industries are best positioned for growth.

Corporate earnings were better than expected for the second quarter, but the improvements are largely a result of cost cutting, not revenue growth. The stock market was up approximately 8% in July, with continuing strength in financials and materials stocks and much less of a rise in defensive sectors, such as consumer staples and utilities.

A bright spot for demand has been the emerging markets, particularly Brazil and China. Concerns about the U.S. recovery's sustainability continue, but fiscal stimulus programs, like "cash for clunkers," seem to be taking the upper hand. We may see a returning focus on higher quality companies during the next few months after a period where they have lagged, as the markets digest the economic crosscurrents.

## **EAFE AND EMERGING MARKETS**

- European economies are recovering sooner than expected.
- Asian growth remains the global leader.

An upturn in global industrial production is leading the economic turnaround. Germany, in particular, is benefiting from a rebound in export orders to Asia — and export growth is expected to boost the entire euro area. Meanwhile, the worst fears of further banking system problems in Europe seem to be fading, leading to an increasing risk appetite.

The improvements in global trade also are helping Japan and the emerging markets. The early and effective Chinese stimulus efforts have bolstered growth throughout Asia and beyond, and all eyes are on the sustainability of China's recent economic surge. The improved economic outlook, in conjunction with a more sanguine view of the financial system, has led us to increase our exposure to Europe, Australasia and the Far East (EAFE) equities this month.

## **COMMODITIES**

- Oil prices are being boosted by financial hedging.
- Improved global growth is needed to replace Chinese commodity pre-buying.

Commodity prices are currently being influenced by both fundamental and financial supply and demand dynamics. This is most apparent in the energy markets, where excess supply and recession-reduced demand have pressured both oil and natural gas prices. But the price of oil, as the ultimate global commodity, has outpaced fundamental supply and demand as investors seek to hedge against dollar weakness, future inflation and emerging markets growth.

Chinese imports underpin current commodity prices, and a reduction would clearly pressure prices. Should China step back from its pre-buying levels of this spring, improved global growth would be needed to supplement demand. We continue to expect global growth, in conjunction with reduced capacity investment, to tighten the supply and demand picture and lead to higher commodity prices over the intermediate- to long-term.

## **CONCLUSION**

Improving near-term growth trends alongside normalizing valuations have recently led us to make further changes in our tactical asset allocation policy. We have reduced recommended allocations to Treasury Inflation-Protected Securities (TIPS) and short-duration fixed income, for

example, because these assets have become more expensive. We have increased our allocation to EAFE equities, as evidence of credit market repair and economic improvement has strengthened the outlook for stocks. We continue to overweight emerging market equities and commodities, as their growth outlook continues to stand out.

The strength and durability of the recovery after the current inventory-led bounce remains unclear, because consumers in the United States are 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 leads to significant export growth from developed countries, likely will be required for a positive surprise to current global growth expectations.

*Commentary provided by Jim McDonald*