Insights From Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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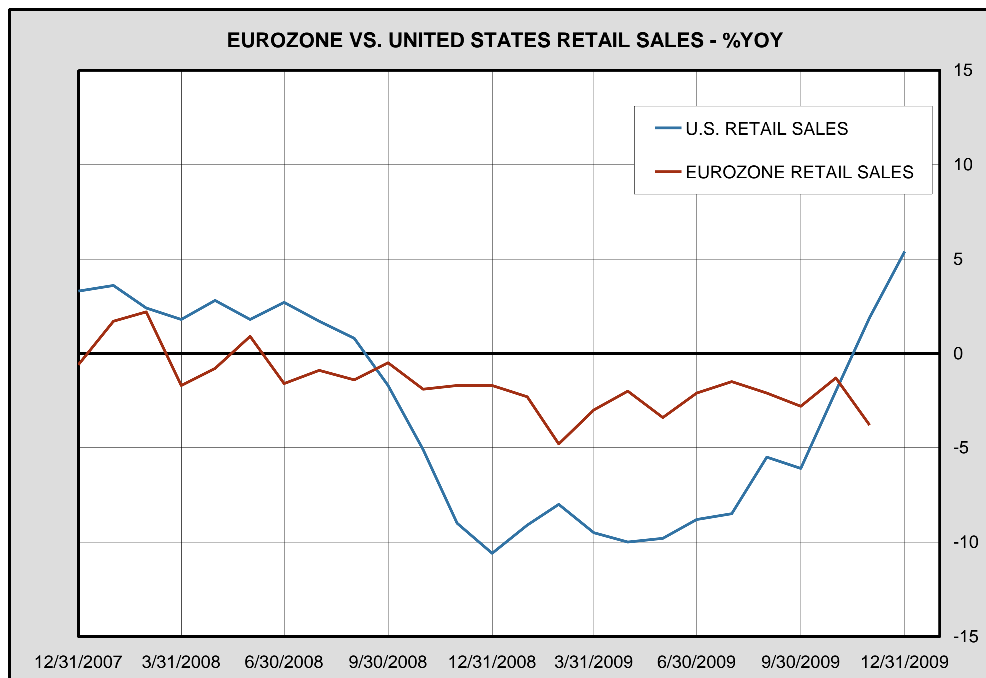
The year 2010 has started off with continued evidence of differentiated global growth – new orders at U.S. industrial companies in December outpaced even the famed "BRIC" countries, while strength in China has led its government to increase the required reserves held by China's banks in an attempt to moderate growth. U.S. retail sales, meanwhile, were also better than expected through the holiday season as improved financial markets led to an increased willingness to spend. Developed markets outside the United States, particularly Europe and Japan, have shown more disappointing economic progress. European consumer spending has slowed after the completion of government stimulus plans, while Japanese officials have restarted quantitative easing to combat deflationary forces. This relative shift in near-term economic strength has led to a firming of the dollar after eight months of nearly unbroken weakness.



Source: Bloomberg

Political leaders globally seem to be struggling to develop economic growth plans as a sequel to the broadly successful financial stabilization efforts. This challenge should force the Obama administration more toward the center politically, as a message of job creation and deficit reduction will be needed for the mid-term elections. This move could be accelerated by the outcome of the

special election today in Massachusetts, where the Democratic candidate to fill Ted Kennedy's Senate seat is behind in some polls. Should the Democrats lose this seat and thus the filibuster-proof majority of 60 seats in the Senate, expect health care and other legislative priorities of the Democrats to become much more challenging to pass. This type of gridlock is typically well-received by the financial markets! European leaders, meanwhile, are struggling with the varied fiscal woes of their member countries, as exemplified by the challenges surrounding Greece's debt problem. The recently elected Democratic Party of Japan, out of power for virtually the entire last 60 years, is trying to restart economic growth after that economy has now experienced six consecutive quarters of contraction in nominal economic growth.

Significant market appreciation in 2009 left some assets fairly valued and still offering good return potential, while others have a reduced return outlook. We are most interested in those assets that we think will generate solid returns or offer protection of principal in our base case scenario, which is measured global growth with accommodative central bank policies. But we are also keen to include assets that we feel will perform acceptably in our primary risk case scenario – that of the Federal Reserve and other central banks tightening policy prematurely. We feel the significant appreciation in the U.S. investment grade bond market, due to a wall of money flooding into it in the wake of improved fundamentals, has left this asset class with a less attractive return profile in the event of such a disruptive market event.

Our base case expectation for 2010 envisions continued improvement in global growth accompanied by relatively easy monetary policy. While inflation expectations have been steadily increasing over the last year (the U.S. 10-year TIPS breakeven currently stands at 2.37%), we don't expect realized inflation to be problematical. As a reminder, the Fed cited three factors it will consider for raising rates: capacity utilization (think the unemployment rate), realized inflation, and inflation expectations. From an economic growth standpoint, we expect emerging markets to continue to lead the recovery, followed by the United States, Europe and then Japan. We view the most likely risk to this somewhat benign scenario as being premature tightening by central banks due to either better than expected growth or a significant increase in inflation. But we think the odds of the Fed raising interest rates without noticeable improvement in the labor markets are remote.

In recognition of the tremendous return realized in investment grade fixed income over the last year, and the resulting reduced attractiveness prospectively, we think investors may benefit from reallocating some exposure to high yield bonds (either corporate or municipal) which tends to provide a larger yield cushion in the event of interest rate increases. Additionally, we think an increased exposure to gold may also make sense today. The metal has pulled back from its recent highs and we think should perform well in a strengthening global economy while also providing diversification benefits in the event that investor concern over sovereign credit reignites.

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