Insights from Northern Trust

Commentary from Bob Browne, Chief Investment Officer

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The resurrection of President Obama's health care reform initiative is without doubt noteworthy and deserving of much analysis, debate and, depending on where you sit on the political spectrum, either great praise or severe condemnation. One thing is for sure, however, the real scope, cost and benefit of the health care package will not be known for decades. Anyone telling you otherwise should simply look at the relatively modest origins of Social Security and Medicare. One needs to have some humility – and a lot of imagination – about how big these things can really become in the long run. We are headed for years of amendments, modifications and – if you believe the Republicans – perhaps even outright repeal someday. From where I sit as an investor in US Treasury bonds, my main take-away is that the US government is continuing its habit of offering my fellow citizens benefits we can no longer afford as a country.

I will leave such long-run ruminations for another time. At the moment, I prefer to focus on the other side of the world: China. As important as major health care reform in the United States will be for the economy in the long run, it is just that, a long-run factor. Sure, it may cause some to question the United States' ability to get serious about its deficit, it may or may not increase the access and quality of medical care for millions of Americans, but I don't think it will drive market prices much beyond the next week or two. What's going on in China, however, is something very worthy of our short-term attention.

We have been recommending to our clients overweight positions in risk assets since the second quarter of 2009. In particular, we have favored both emerging market equities and commodities for nearly a year now, and much of our confidence in these two sectors has been a result of our confidence in China. China, as we like to say, has been *unleashed*, and there is no going back. In less than two decades, it has become the world's largest exporter, the largest consumer of coal, iron ore and copper, and last year it surpassed the United States to become the world's largest automobile market. China recently announced that 2.87 million vehicles were sold in January and February of this year, putting it on track to once again top the United States in total vehicles sold. Annualized real gross domestic product (GDP) growth will easily exceed 10% in the first quarter and most sectors of the Chinese economy are very strong, but there are signs of stress that are getting our attention.

Every action has a reaction, and the Chinese government is doing all it can to create conditions of sustainable growth so that it can avoid painful booms and busts. For good reason, the Chinese are proud for having mostly missed out on the pain suffered by the developed world over the past two years. While investors have focused on the government's overt efforts to control property speculation, the real target is broad, generalized price inflation. With annualized inflation in China running at 2.70% in February, inflation definitely is heading in the wrong direction and it is getting there quickly. The Shanghai Stock Exchange Composite Index has been range-bound since the summer of 2009, and some investors are pointing to this sluggish equity performance as a precursor to a broader economic slowdown. Aggressive monetary policy is rarely good for equity markets and the Chinese authorities may only be in the very early stages of their tightening process. The government already has raised rates modestly and it is using a variety of administrative actions to stem loan growth (mostly targeting property development). A currency revaluation is another form of tightening and so any appreciation of the Chinese yuan later this year will likely also have an impact, especially on the important export sector.

For now, we remain overweight in emerging market equities because we believe the valuations and economic background remain attractive compared with developed markets. Additionally, the long-term positive secular trends of productivity growth, work force growth, high savings rates and growing consumption also should bode well for equity investors. China is the locomotive of the emerging market train, but even good long rides have some bumpy spots along the way. We are watching the inflationary signals very carefully. A sharper than expected tightening leading to a severe downturn is now one of our major risk scenarios. We are always thinking about the downside of our investment positions, and we prefer to miss out on the very bumpy spots. While our base case scenario is that China will manage to a glide path of sustainable economic growth of 7% to 9%, there is a growing risk that further tightening will choke off growth completely and cause the very bust the authorities are trying so hard to avoid. We remain long but vigilant. If we need to get off the train for a while, we will.