



## Insights from Northern Trust

**Commentary from John D. Skjervem, Chief Investment Officer, Personal Financial Services**

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Following the sweet treat of a better-than-expected U.S. gross domestic product (GDP) report last Thursday, global equity markets ended October with a nasty trick. Setbacks in both consumer spending and consumer sentiment spooked investors, and prices of stocks, oil and other industrial commodities fell sharply in Friday afternoon trading. The Halloween eve sell-off sliced 2% to 3% off the major domestic equity indices, and put a bid back into prices of U.S. Treasury securities. A meaningful uptick in Friday's trading volume also signaled that investors' selling had become increasingly deliberate. Indeed, Friday's stock market decline erased all of the month's earlier gains and pushed most major indices below their 50-day moving averages.

Prior to mid-October, stocks had extended their autumn gains on more indications of improving economic activity and positive corporate earnings announcements. Last week, the U.S. government's initial estimate of third quarter GDP came in higher than most economists had expected. At 3.5%, this advance reading of third quarter GDP beat the 3.2% consensus and marked the economy's first quarterly expansion in over a year. Investors celebrated with a strong equity market rally, believing the advance GDP report represented conclusive evidence that the longest and deepest recession in post-war history has finally ended. Moreover, broad-based strength was evident among the underlying, individual GDP components, although gains in consumer spending and residential investment were clearly boosted by the government's "cash-for-clunkers" program and first-time homebuyers' credit, respectively.

The Federal Reserve's current "low for long" interest rate policy also received support from the advance GDP report. A price index embedded in that report (the "GDP price deflator") showed still subdued inflation in the third quarter. Economists had expected a 1.4% increase in the price deflator, but pervasive excess capacity in both production and labor markets kept the deflator to a more modest 0.8% rise.

As of last Friday, 351 companies or 78% of the Standard & Poor's (S&P) 500 had released third quarter profit reports. The results thus far have been exceptionally strong: 52% of S&P 500 firms have announced upside earnings surprises relative to consensus expectations, a full 10% above the 42% historical average. Revenue trends, however, remain stagnant compared to second quarter levels. Only 33% of S&P 500 firms recorded top-line (i.e., revenue) surprises relative to analysts' estimates, a 7% shortfall from the 40% historical average. Third quarter revenue growth was also concentrated among firms



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engaged in various stages of the production process, while sales at firms most exposed to final demand remained flat to slightly down on average. This bifurcation in revenue trends illustrates that the economic recovery underway in the United States has thus far been dominated by inventory re-stocking, and sales to end users have yet to regain a bona fide growth trajectory.

Unfortunately, the bullish response to positive economic and corporate earnings headlines was short-lived. Early Friday morning, the government reported that personal incomes were flat in September (relative to August) while consumer spending fell back into negative territory following the expiration of the government's cash-for-clunkers program in August. Later that same morning, the University of Michigan's consumer sentiment survey registered no improvement in October (versus September), corroborating a similar mid-month survey from the Conference Board, which recorded a 3-point decline in consumer confidence since September. When combined with the unexpected retreat in September new home sales (announced last Wednesday), the decline in consumer spending and tepid sentiment readings proved more than sufficient to ignite last Friday's selling.

This coming week features more corporate earnings announcements and a plethora of economic reports. Policy statements from the Federal Reserve, Bank of England and European Central Bank are scheduled too. The most important headline will most likely be Friday's October jobs report which will receive intense scrutiny for signs that unemployment has peaked, a necessary condition to propel the U.S. economy from an inventory-led recovery to a final demand-driven expansion.

At this point, we believe the recent price declines in stocks and other risk-based assets represent a correction in the rally that has otherwise been almost uninterrupted since late June. This correction now measures approximately 4% from the recent highs of mid-October and could carry further as the favorable effects of third quarter earnings reports begin to fade. We do not believe, however, that recent selling pressures mark the end of the cyclical, post-recession rally in risk-based asset prices. Low interest rates, improving corporate profitability and benign inflation trends remain supportive to financial market investments.

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