



Insights from Northern Trust

Commentary from Jim McDonald, Chief Investment Strategist

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A question on the minds of many investors is, “Has the stock market come too far, too fast – and is it too late to get in?” While it is tempting to listen to confident prognostications about short-term market action, the intellectually honest answer is that no one knows over the short term where the market is going. You must assess the economic outlook and study asset class valuations, and then marry that result with the objectives of your investment portfolio. The primary driver of the strong market rally since March has been the better-than-expected pace of repair in both the economy and the credit markets. This has resulted in a significant normalization of valuations across most asset classes. Let’s review the key determinants of the outlook for risk assets to determine if it is “too late to get in.”

The equity market has a long history of economic forecasting, and like all forecasters, sometimes gets it wrong. But there is a strong enough track record of discounting recoveries that equity prices are included as one component of the leading economic indicators. Historically, the stock markets have bottomed and begun advancing around six months ahead of the start of an economic recovery. Global markets bottomed in March this year, and many important economies (including China, Japan, Germany and France) actually reported growth in the June quarter. It is our forecast that the U.S. economy will report gross domestic product growth of around 1% in the September quarter, and some of the more bullish forecasters see growth of nearly 4%. We find the data coming out of the Institute for Supply Management’s Purchasing Manager Index, along with the reduced pace of layoffs showing in labor market data, to be supportive of continued economic recovery. U.S.-based investors need to get used to the fact that many international economies are growing faster than the United States economy, and that you risk underestimating the strength of the global economy if you are too U.S.-centric.

Central bankers gathered at the Kansas City Federal Reserve Bank-sponsored annual conference in Jackson Hole are confirming the view that the global economy is set to emerge from recession. The overwhelming force used to combat the collapse of the credit markets has had some success, leading to a normalization of interbank lending rates and improved functioning of the secondary markets. Spread levels, while still elevated by historical levels, are down significantly from peak levels realized earlier in the year. Because of the vast scope of the credit crisis, and the fragility of the recovery, central bankers are still espousing their plan to keep short-rates “low for long” to support growth. But they are also laying the groundwork for their exit strategy to remove the unprecedented level of liquidity support without tanking growth or stoking inflation.



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What has the advance in most risk assets done to valuations? In many cases, it has just brought them back toward normal. High-yield bonds, which have returned 40% year-to-date based on the Barclays Capital 2% Issuer Constrained High-Yield index, have seen spread levels (the interest rate premium over the risk-free U.S. Treasury bond) narrow from nearly 20% at the beginning of the year to 8.3% currently. We still think this valuation level is attractive and supportive of owning high-yield bonds. U.S. equities, as measured by the Russell 1000, have moved from a median price/earnings (p/e) ratio of 11 in February to 15 today. With earnings still depressed by the recession, and interest rates relatively low, this valuation level is still supportive of equity investing. Historically, the stock market has experienced p/e expansion for five quarters subsequent to the bear market bottom as investors discount the economic and earnings recovery. Then p/e ratios tend to fall as earnings increase and stocks “grow into” their valuations. The lesson from history is to not let reasonable increases in valuation dissuade your commitment to the equity markets. Of course, you should consult your adviser to determine the best course for your particular situation.

As evidence has unfolded over the last six months that the credit markets were starting to improve – and that an economic recovery could be forecasted – we have been moving our tactical asset allocation recommendations from a very defensive posture back toward their strategic normal levels. What are the risks that the improvements seen to date won’t be sustained? The principal risk is that the stimulus-led growth in Asia and the United States doesn’t lead to a continuing economic recovery. Our economics team is confident that the economy, once it is on a growth path, will continue to grow until the Fed slams on the interest-rate brakes. There is also risk that we see renewed concern over the liquidity of major financial firms, as the credit markets aren’t completely healed and “toxic” assets remain on many bank balance sheets. We believe this risk seems manageable, as the winners and losers among the systemically important financial firms have been identified. We are also witnessing improvement in the underlying collateral of some of the most toxic assets (residential mortgages). But there is also an upside risk scenario to consider – that stronger-than-expected global growth could continue to push the considerable amount of cash now on the sidelines into reasonably priced risk assets. It is this balance between the risk cases that has moved us broadly back toward strategic norms in our tactical asset allocation, and we do that with confidence that valuations are supportive and fairly typical for this stage of an economic recovery.

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