



TRILOGY  
GLOBAL  
ADVISORS



## Two Key Issues for 2010

“The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant.”

– Arthur C. Pigou (1920)

Looking back at global financial markets in 2009, it is probably fair to say that most investors are both astonished and relieved that global stock markets – and the economies they reflect – have mostly surprised to the upside over the course of the year. Compared to widespread fears of Great Depression 2.0 that prevailed earlier in 2009, the recovery in economic data in most major industrial nations and evidence of boom-like conditions in key developing nations like China has been welcome news indeed.

After a period as tumultuous as the one we have just been through, we suspect that many economists and market

pundits may still be too cautious about the economic outlook. As the above quote from the renowned Cambridge University economist Arthur Pigou indicates, economic crises have historically contributed to “errors of pessimism” just as the preceding booms may have been rooted in misplaced optimism. With more than 770 stimulus measures having been announced around the world since the 2008 crisis, we are more inclined to look for further upside surprises to global growth for 2010 than to be concerned about a renewed slump. That said, we realize that our optimism about growth dynamics may point to a trickier financial market environment, as investors fret about the

potential for higher interest rates and tighter liquidity conditions with the progression of the global recovery.

Rather than review prospects for every major nation, we will instead highlight two issues that we believe will be key to the outlook for financial markets in 2010: One is whether the U.S. economy is headed toward another jobless recovery, as in the past two business cycles. The other is whether China will experience a significant acceleration of inflation in response to the recent surge in money growth.

### **Issue #1: Another jobless recovery for the U.S.?**

Several decades ago, U.S. employment patterns were characterized by large-scale layoffs during recessions followed by large-scale recalls of laid-off employees during recoveries. This layoff-recall pattern was most pronounced in manufacturing industries, where labour unions developed elaborate protocols with management for who would be laid off and who would be recalled based on job function, length of service, etc.

Things changed radically in the last 20 years as millions of manufacturing jobs disappeared and union membership dipped to around 10% of the total U.S. workforce. As massive waves of structural change altered the economy in the aftermath of the savings and loan crisis of the late 1980s and the “tech wreck” of the early 2000s, the layoff-recall pattern seemed to disappear for good. In the early 1990s, the unemployment rate continued to rise for 15 months after the recession was over as signalled by a peak in initial jobless claims. With the recession of 2001, it took 20 months for the unemployment rate to begin to decline following a peak in initial jobless claims.

If the past two cycles offer any guidance, the unemployment rate will not begin to decline until sometime in the second half of 2010, since initial jobless claims peaked in March 2009. That degree of persistently high unemployment would most likely keep the Federal Reserve on hold through much of the year. Likewise, it would point to an extended period of dollar weakness and rising commodity prices. A key

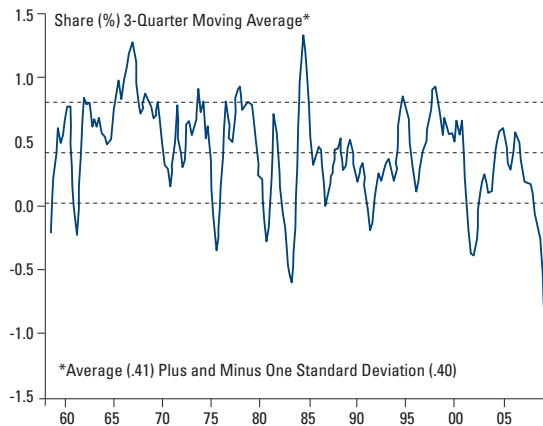
concern under this scenario would be the emergence of financial bubbles in emerging market nations that continue to tie themselves to U.S. monetary policy, even though the current low level of interest rates may be inappropriate to their own domestic circumstances (think China).

Here's what the jobless recovery story misses: (1) the enormous inventory liquidation in the U.S. that was a major driver of “the Great Recession” and (2) how inventory dynamics interacted with overall financial conditions, which have improved dramatically. As we show in Chart 1, the inventory drawdown in the U.S. during this cycle has been unprecedented in the modern era, with the real change in inventories as a percentage of GDP averaging 1% in the three quarters through September 2009. With inventories at such a lean level and final demand having picked up, the stage is set for a multi-quarter rebound in inventories. Such a rebound could provide a strong positive impetus to annualized GDP growth of perhaps two percentage points in each of the following four quarters. Historically, a move toward rebuilding inventories leads to gains for hiring, wage income, and real consumer spending, creating the basis for a “virtuous circle” and a sustainable economic recovery.

So far, the incipient recovery in industrial output has been met with a reduced workforce and a huge increase in productivity and corporate profits. But recent productivity gains have been so outsized – 8% annual growth in the past two quarters – that the odds are high that the labour market will experience a “slingshot effect,” whereby business hiring can outpace GDP growth for a number of quarters. As we have noted in previous reports, financial conditions in the U.S. have experienced a massive improvement as measured by the Bloomberg Financial Conditions Index. As of late December 2009, that index had reverted to its average level of 1992 to mid-2007, after having plummeted to a reading of minus 11.5 standard deviations in the aftermath of the Lehman crisis in October 2008. That means that the index has experienced a huge positive shock over the past year that is without precedent in the U.S. As our previous research has indicated, the Bloomberg Index is a good leading indicator of overall U.S. real GDP growth and has been pointing

### Beware "The Slingshot Effect": U.S inventory drawdown smashes records

Real change in private inventories as a share of real GDP

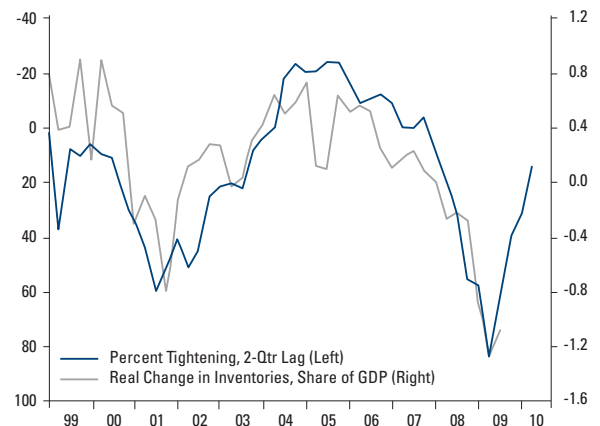


Source: Haver Analytics and ITG Hoening

*Chart 1: U.S. firms slashed inventories dramatically in recent quarters, setting the stage for a "slingshot effect" as inventory levels are normalized over the next year.*

### The Fed's Loan Survey points to inventory rebuilding in 2010

Senior loan officer survey vs real change in private inventories as a share of real GDP



Source: Haver Analytics and ITG Hoening

*Chart 2: Even though bankers remain cautious, the Fed's Senior Loan Officer Survey shows a significant thaw in bank lending conditions in the fourth quarter. That should support inventory rebuilding in 2010.*

consistently to better-than-expected economic outcomes over the past year. It also turns out that the Bloomberg Index is an extremely good indicator of bank lending conditions – especially for commercial and industrial loans – as measured by the Federal Reserve Senior Loan Officer Survey.

As we show in Chart 2, the Fed's Loan Survey has given very strong signals about inventory building in coming quarters. Historically, there has been a strong correlation between the current quarter's lending conditions and inventory changes two quarters in the future. Although the Fed survey shows senior loan officers are still, on balance, tightening lending conditions, the net percentage who are tightening conditions has fallen to only 14% in the fourth quarter. That compares to a record 84% two quarters ago in the aftermath of the Lehman bankruptcy. In our view, the latest Fed survey

reflects an important thaw in lending conditions that should permit a major reversal of firms' inventory policies.

If we are correct, this points toward an early rebound in employment growth and labour income that will be much stronger than generally expected. Assuming that we begin to see job growth exceeding 200,000 per month this year, there are likely to be several implications for financial markets. First, market-based interest rates could rise sharply as market participants begin to rethink the timing and magnitude of the Fed's exit strategy from the zero interest rate policy. Secondly, the dollar could rally further against most major currencies in response to changing expectations for U.S. interest rates and growth. Finally, commodity prices could come under pressure as a rising dollar curbs the rest of the world's purchasing power for dollar-priced commodities.

## Issue #2: Will China's surge in money growth lead to higher inflation?

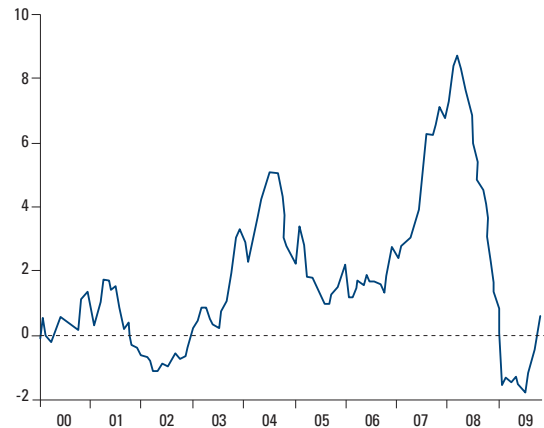
One of the major positive surprises for global equity markets in 2009 was the speed and vigour of China's economic recovery from the global financial crisis. China's aggressive monetary and fiscal stimulus measures not only prompted a rapid recovery in China's economic growth rate, but also gave a considerable boost to global commodity prices and helped the Fed's efforts to prevent Japanese-style deflation expectations from becoming entrenched among economic decision makers.

The key question now is whether China's authorities overreacted in their attempt to insulate their economy from the global economic shock. Addressing this question is also challenging because many economists are concerned that China's official economic data may understate the cyclical ups and downs of China's massive economy. That could make it difficult for both China's policymakers and market participants alike to assess whether the inflation genie is out of the bottle. On current evidence, the jury is still out.

As shown in Chart 3, headline consumer prices in China in November were up only 0.6% from a year earlier, suggesting that inflation is still not an issue despite the booming economy. That said, the seasonally adjusted consumer price index has risen at a 4% annual rate since July and a strong case can be made that the economy is now starting to overheat in response to the massive stimulus efforts that have pushed broad money growth (M2) up by nearly 30% from a year ago in recent months.

Economists at Lombard Street Research estimate that on a seasonally adjusted basis, China's GDP grew at an annual rate of more than 30% in the third quarter. Recent monthly data on industrial production, exports and fixed asset

**China's consumer price inflation turns positive**  
Percentage change, year ago

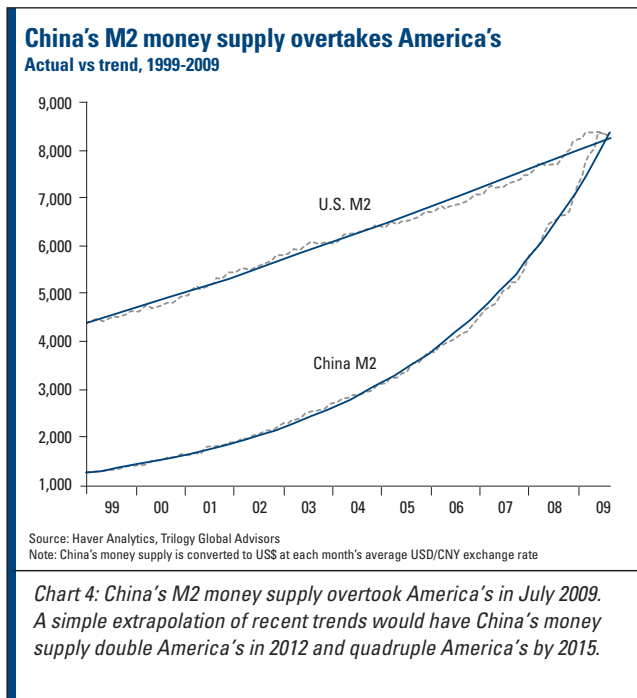


Source: Haver Analytics

*Chart 3: After nearly one year of deflation, China's consumer price inflation turned positive again in November. China's inflation is likely to accelerate in coming months in response to huge money supply growth.*

investment suggest that the economy is on track to expand at an annual rate of nearly 20% in the fourth quarter. These are astounding figures and suggest that the amount of excess capacity in the economy created by the decline in exports in 2008 and early 2009 has been more than offset by the boom in domestic demand and the recent recovery in export growth.

The strength of China's rebound can be traced at least partly to the enormous four trillion yuan (equivalent to more than C\$600 billion) stimulus program announced late in 2008. That amounted to about 13% of GDP, which is probably close to a record for any economy outside of wartime. However, there was an even more impressive surge of credit creation led by China's state-owned banks that added fuel to the fire. In the first half of 2009, bank lending grew by an



astonishing seven trillion yuan, which amounted to nearly half of the nation's GDP over that period. Under a more normal growth rate of 15%, bank lending should have grown by only two trillion yuan over that period, which underscores the extraordinary nature of China's credit surge.

With China's currency tied to the U.S. dollar, the combination of 30% money growth and a 10% effective devaluation of its currency would seem to point strongly toward the probability of an acceleration of inflation in coming months. Although China's Politburo emphasized stability and continuity of economic policy in its recent statement on the economy, the recent movement to shore up bank capital and to put a 5.5% transactions tax on sales of certain properties indicates the authorities' growing concern about the impact of the credit surge.

One way to understand how unsustainable China's monetary dynamics are at the moment is to consider the data in Chart 4, which compares recent trends in China's M2 money supply to the trend in the U.S. Interestingly, China's money supply outstripped that of the U.S. in July 2009 despite the fact that China's nominal GDP is only US\$4.6 trillion, compared to \$14 trillion for the U.S. Based on the trends of the last 10 years, China's money supply would be double America's by the end of 2012 and quadruple America's by the end of 2015. But that is simply not going to happen, since it would imply a degree of inflation in China that would almost certainly be intolerable to China's leaders. Therefore, the key questions are when and how forcefully the Chinese will need to curb their monetary growth.

In short, the very success of economic stimulus measures in the U.S. and China in 2009 may mean that the "sweet spot" for equity markets that has been in place since March may be drawing to a close, along with various "one-way trades" like a weaker dollar and booming commodity prices. However, the good news is that a self-sustaining global economic expansion now seems well entrenched. The challenge for investors will be to avoid overreacting to the occasional bouts of volatility that are likely as policymakers try to orchestrate graceful exits from the extraordinary policies put in place in 2009.

*William Sterling*

William Sterling  
Chief Investment Officer  
Trilogy Global Advisors, LLC