Northern Trust

DAILY GLOBAL COMMENTARY

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul Kasriel
plk1@ntrs.com

Diverse Asset Class Correlation and Leverage

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Fund managers and investors have been puzzled why prices across a wide spectrum of assets moved together last week – namely, down. I think it has everything to do with delevering. What is bringing about delevering? When a fund owns assets that are going down in value for some fundamental reason, say mortgage-backed securities whose underlying collateral are defaulting subprime mortgages, and the fund is levered, its creditors start to make margin calls. The fund, then, has to sell assets to raise cash. The fund might end up selling relatively high-quality and liquid assets in order to raise the maximum amount of cash quickly to meet its margin call. This puts downward pressure on the prices of assets not tainted by credit risk.

Now price volatility increases in asset classes unrelated to the originally troubled asset class. Many hedge funds engage in seemingly low-risk strategies that have commensurately low returns. In order to boost investor returns, these low-risk funds incur leverage. Many of these funds measure risk by the price volatility of their asset holdings. When there has been an extended period of low price volatility, risk is considered to be low. Therefore, more leverage can be incurred. But when asset-price volatility starts to increase due to the sale of assets to meet margin calls by funds with tainted assets, funds with seemingly “good” assets are forced to delever because of the increased risk these hitherto low-risk funds now face. So, the low-risk funds end up selling “safe” assets in the process of delevering, thereby putting downward pressure on the prices of these “safe” assets.

Leverage is wonderful when asset prices are rising. It is a bear when asset prices start to retreat. It creates a vicious cycle. Both the sinners and the sacred get got in the undertow.

Derivatives and Risk: When the Cost Goes Down, More Gets “Produced”

In recent years there has been exponential growth in the financial derivatives markets. Financial engineers have been hard at work designing and introducing derivatives that will *shift* the risk of almost anything you can think of. Today (or perhaps more accurately, a couple of weeks ago) the cost of *shifting* risk through the use of derivatives is (was) considerably less expensive than it was twenty years ago. Econ 101 says that when the cost of production of something goes down, the quantity demanded of that something goes up and more of that something gets produced. So, if the cost of risk-*shifting* goes down, more *overall* risk gets created in the global financial system. So, yes, the growth in financial derivatives has enabled investors (?) to shift risk. It also has encouraged an increase in overall risk to be taken in the financial system.

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Can the PBOC Wait Until August 25, 2008 to Rein In Inflation?

The Chinese government reported today that Chinese consumer inflation in July reached 5.6% on a year-over-year basis – its highest rate since February 1997. As the chart below shows, Chinese consumer inflation has been trending higher throughout 2007. The People's Bank of China (PBOC) and the Chinese central government has implemented a series of measures this year in an attempt to rein in consumer price as well as asset price inflation. As I argued in the July 20th commentary (How Do You Say "Rube Goldberg" in Chinese?), these acts will prove to be futile until the Chinese decide to stop supporting a fundamentally weak currency – the U.S. dollar. The PBOC supports the U.S. dollar by purchasing dollars in the foreign exchange market. It pays for these dollars with Chinese yuan, which it creates, figuratively, out of thin air – the way all central banks create their respective currencies under this global anchorless fiat money system that we have had since 1971. The yuan the PBOC creates as a consequence of its U.S. dollar support operations is causing Chinese consumer and asset prices to rise at faster rates. The Chinese central government may be loathe to stop supporting the U.S. dollar until after the upcoming summer Olympics, which are to be held in Beijing on August 8 through August 24, 2008, for fear of creating an economically-destabilizing financial market reaction. But if the U.S. dollar remains under downward pressure and the PBOC continues to support it through August 24, 2008, Chinese consumer and asset prices are likely to continue rising at undesirable rates, which, themselves, may be economically destabilizing. The volatility the global financial markets have experienced in the past week is nothing compared to what they will experience when the PBOC stops supporting the U.S. dollar.

Chart 1

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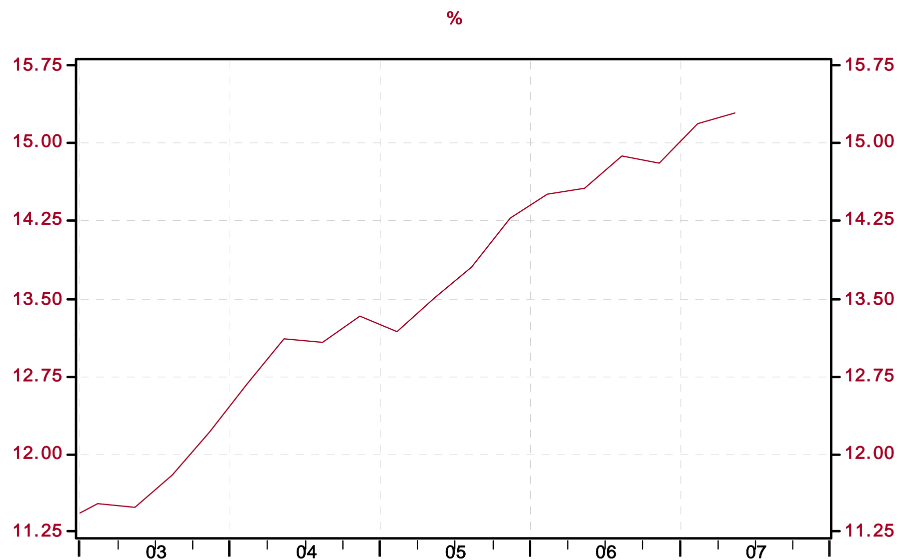
Japanese Q2 Real GDP Growth Downshifts Sharply as Export Growth Slows

After growing at an annualized rate of 3.2% in the first quarter, Japanese real GDP growth slowed to only 0.5% in the second quarter. To be sure, domestic demand growth slowed – from 1.5% to 0.4%. But, as the first chart below shows, a rising percentage of Japanese real GDP is accounted for by its exports. For example, in Q2:2003, real exports accounted for 11.5% of Japanese real GDP. By Q2:2007, this ratio had risen to 15.3%.

Chart 2



In the second quarter, annualized Japanese real export growth slowed to 3.5% from 14.3% in the first quarter. Hmm. U.S. real *imports contracted* at an annual rate of 2.6% in the second quarter after growing 3.9% in the first. As the chart below shows, there is relatively high positive correlation between U.S. real import growth and Japanese real export growth. So, if U.S. domestic demand is slowing, this will retard U.S. import growth. Simultaneously, this will retard export growth in the world's second largest economy – Japan. All of which goes to show that the consensus talk about how the global economic fundamentals are in great shape even if the U.S. economy is going through a bit of a "soft patch" (Alan, how we miss your phrase-making) is just another example of partial-equilibrium analysis. We live in a general equilibrium world. Everything affects everything else. And one important reason non-U.S. real GDP growth has been so strong in recent years is that the U.S. has been a huge importer of the rest of the world's production. Now that U.S. domestic demand is giving up the ghost, the rest of the world will begin to see its export growth slow. On top of that, because many foreign central banks have been tightening their monetary policies, the rest of the world's *domestic* demand will be slowing as well.

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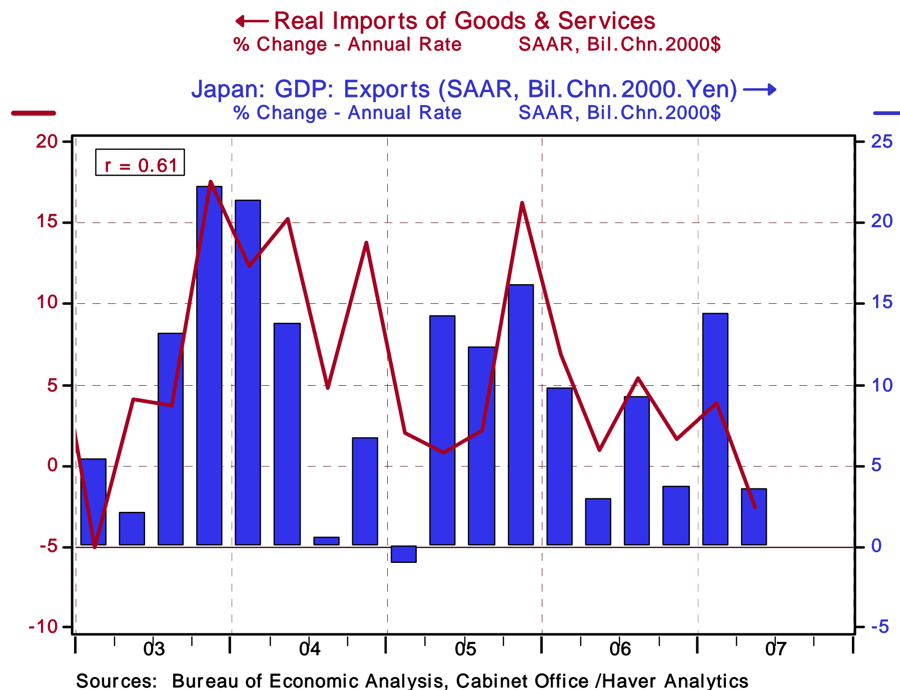
Chart 3



Asha Bangalore
agb3@ntrs.com

Retail Sales Strength Partly Due to One-off Events

Retail sales rose 0.3% in July, following a 0.7% drop in June. Estimates for May and June show small upward revisions. The introduction of the iPhone and the new Harry Potter novel gave an extra boost to total retail sales in July. Sales of autos (-0.3%) and gasoline (-0.8%) dropped in July, but purchases of apparel (+1.3%), furniture (+0.5%), general merchandise (+0.9%) and electronics and appliance stores (+1.0) advanced in July. Of these gains, the increase in apparel sales is suspect because the chain store tally published last week showed weak apparel sales with missed expectations at many stores and "declines in customer traffic and falling margins." (see Shoppers Held Back in July)

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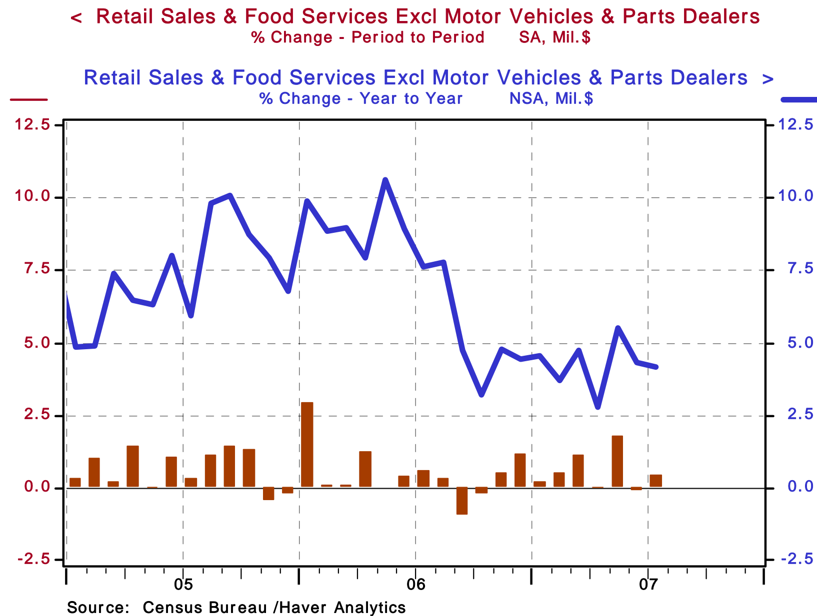
Chart 4



The upward revisions to retail sales of May and June should show up in the preliminary GDP estimates for the second quarter as a larger increase in consumer spending which was estimated to be a 1.3% annualized gain. In the third quarter, consumer spending is again projected to show soft growth, assuming no upside surprises in August and September.

Retail Sales – July 2007

	May	June	July	07:Q2	07:Q3*
				quarterly change SAAR	
Total Retail Sales & Food Service, % m-o-m	**1.6**	**-0.7**	**0.3**	**5.5**	**1.4**
% change y-o-y	5.6	3.5	3.1		
Ex-auto, % m-o-m	**1.7**	**-0.2**	**0.4**	**7.8**	**3.7**
% change y-o-y	5.5	4.3	4.2		
Ex- autos and gas % m-o-m	**1.4**	**0.0**	**0.6**	**5.4**	**4.3**
% change y-o-y	5.6	4.6	5.1		
Exc. Bldg. mat., auto, gas, % m-o-m	**0.9**	**0.3**	**0.6**	**5.4**	**4.7**
% change y-o-y	6.0	5.6	5.4		

* -annualized change based on July data

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