

The Week

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Is it better to lead or follow?

This economic cycle is different from previous cycles in many ways. However, one of the biggest differences is the United States is not leading the global economic recovery; Asia is. Stronger growth overseas helps lift the American economy out of recession, but it also makes the U.S. recovery more dependent on the performance of other economies.

A week ago, my wife and I participated in a ride for the breast cancer awareness, a fundraising event sponsored in part by the local Trek bicycle store. We were riding near the front of the group when we got separated from the rest of the riders at a stop light. The leader of our group decided to go ahead and told us the others would catch up. However, we soon learned that we had gone the wrong way. We turned around and started back towards the rest of the group which was well ahead of us. Our misadventure reminded me that following a leader can be beneficial provided the leader does not falter or take a wrong turn.

In the current economic cycle, China is leading the economic recovery. Many countries are selling resources and machinery to China, earning themselves income which can be used to buy goods from other countries, not just China. As a result, the recovery in the Chinese economy is boosting global economic growth.

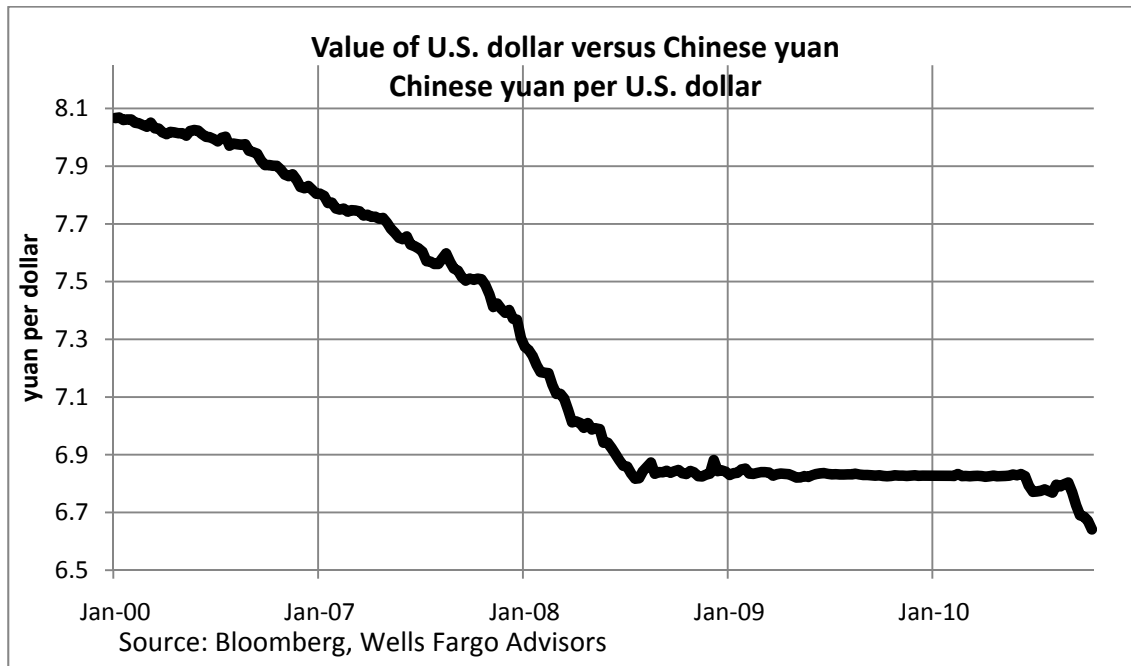
In the previous two U.S. recoveries, in 1991-92 and again in 2002-03, the United States was the global leader. As the U.S. economy recovered from recession, we bought goods and services from other countries, supporting economic activity in those countries. However, in the previous two cycles, these other countries were lagging behind the United States, and were a drag on the U.S. economic activity. Consequently, the U.S. recovery was slow and uneven.

So is it better to lead or follow? When the United States is leading the global recovery, other countries are not doing as well as the United States. This hurts U.S. exports, dampening the U.S. recovery. Now that the United States is following the stronger growth in Asia, U.S. exports

are growing faster than normal, helping to boost the U.S. recovery. This suggests that when the American economy is healthy and recovering from recession, being the leader is better. However, when the American economy is still dealing with many problems, especially weak housing as it is today, it is probably better to follow and benefit from the strong growth of other countries leading the global recovery.

Following the leadership of other countries, forces investors to monitor how other countries are performing. If the leading countries get off track or begin to falter, the United States could suffer too. This is why we closely watch what is happening in foreign markets. Two weeks ago in this report, we showed that 16 of 24 global stock markets that we analyze performed better than the U.S. market during the previous six months. This better performance of foreign markets appeared to be supporting the U.S. market during periods of weakness.

We are also closely monitoring the Chinese economy and the Chinese stock market for any sign that this important engine of growth is slowing down or running into difficulty. So far, the economic statistics on China still look good. However, the internals of the Chinese stock market are starting to suggest that caution may be warranted. In particular, the defensive utility sector of the Shanghai composite index has increased during the past couple of weeks, at the same time that the more cyclical commercial sector has weakened. This could be related to the recent decision by Chinese policymakers to let the Chinese currency appreciate in value, which may be turning investors more cautious on Chinese economic prospects.



Past performance is not a guarantee of future results.

This week's chart shows the value of the U.S. dollar versus the Chinese yuan. As the line on the chart declines, the U.S. dollar declines in value, and the Chinese yuan increases in value. The United States is pressuring China to let its currency increase in value in order to reduce the U.S. trade deficit with China. During the past month, the line on the chart has begun to drop after holding steady throughout the global financial crisis. The outperformance of the defensive sector of the Chinese stock market could be a signal that the increase in the value of the yuan, along with tighter Chinese monetary policy, could hurt the Chinese economy. Investors should watch China closely. After all, if the leader of the global economic recovery slows too much, other countries could suffer too.

In summary, the United States is benefiting from the leadership of strong growth in China. However,

relative performance of the cyclical and defensive sectors of the Chinese stock market may be signaling that investors are concerned that the Chinese economic recovery may slow down. This could slow the economic recoveries of other countries. We remain long-term positive on the U.S. economy and U.S. stock market but near term cautious. We believe the next couple of months could be an important time of testing for the U.S. market. The U.S. stock market may have already discounted perceived favorable mid-term election results and additional monetary stimulus by the Federal Reserve. If this good news is already factored into current prices, the U.S. market could be vulnerable to weakness during the next couple of months as investors take profits or re-evaluate global economic prospects, including Chinese economic growth. As long as the United States is following the lead of other countries, it is important for the leading countries to stay on course.

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