

Weekly Perspectives

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A Weekly View of Global Economies

1 February 2005

North America

January has been a bad month for US stock markets, and last week's pickup was way too small to reverse the earlier downswing. So the returns, year to date, are still stuck in negative territory. Notably, many European indices have done better than US averages. In January, the S&P 500 was down 2.53% while the DJ STOXX 600 (a broad representation of high-capitalisation European stocks) was up 2.32% in local currencies and down only 1.57% in US dollar terms.

Wall Street lore has it that a lousy January bodes ill for the year as a whole. However, the statistical evidence for this view is far from decisive. Turning our attention from a loosely-based belief to fundamentals, we need to continue monitoring earnings growth, the interest rate cycle and economic momentum. As we have noted before, these factors do point to challenges ahead.

Takeover activity in the US has been a positive factor in underpinning equity markets. The past four months have been busier than at any time since 2000. As always, the merger synergies are overestimated by management.

Some investors are highly sceptical about the benefits to shareholders, brought about by mergers and acquisitions. Most studies carried out on this topic find few gains and lots of integration problems.

Really, the onus is on corporate management to demonstrate that they are not simply engaged in empire building but are adding value -- strategic acquisitions that make solid business sense. There is often a good case to be made that if a company cannot grow internally then it should increase the payout to shareholders rather than spend the cash on acquisitions.

But the market likes high takeover activity because it implies greater confidence about the future. And, of course, it is particularly popular among arbitrageurs and investment bankers. Wall Street always cheers up when there is money on the table.

While we are on the topic of synergies, the popularity of conglomerates has declined among investors over the past few years. The supposed synergies are not obvious in practice, and integrating diverse operations is difficult to do. Also, the investing public finds it tough to size them up properly and compare them to alternatives. Furthermore, there are greater opportunities for all manner of accounting sleight of hand.

Often a sum-of-parts analysis of a conglomerate may reveal that it is selling at a discount to its market value. Does it represent good value or is the collective judgement of the market right in refusing to pay more?

So the general view is that conglomerates are better off divesting their peripheral operations and concentrating on core competitiveness. As an example, Citigroup's plan to sell its Travelers insurance business to MetLife was well received by the market.

The elections in Iraq went off better than expected, and this boosted short-term optimism on global stock markets. Well, it was the first genuine exercise in mass democracy that the country has experienced, probably in its entire history. As far as we know, Babylonian monarchs weren't champions of democratic principles. And, after the fall of Babylon, there is no record that successive invaders were particularly keen on holding elections, either.

So, the Americans are the first invaders ever to promote free voting. It was a signal event for Iraq and for many surrounding countries, as well as a black eye for the terrorists. All well and good, except that US policymakers still have a wide credibility gap they need to close, on the issue of promoting democracy in the Middle East.

The record of the past fifty years shows that they repeatedly sided with anti-democratic forces. It's a start that these mistakes were recently recognised by President Bush. But, hey, as Abe Lincoln once said, we have to get a good fix on where we were and where we are before we can figure out where we are heading.

There are no prizes for guessing that the road ahead is going to be tough as hell, in Iraq and the entire Middle East. But given the strategic importance of the region it is also unlikely that we will witness US withdrawal.

Europe

European Central Bank notables are still harping over the issue of the euro's appreciation versus the US dollar, even though the Eurozone currency has lost a good deal of ground relative to the greenback from the highs reached late last year. The policymakers remain concerned about the strength of domestic demand and the robustness of export growth. However, faster normalisation of interest rates in the United States accompanied by a decent pace of growth should help to keep a cap on a sustained rise in the value of the euro against the dollar.

Asia/Pacific

Data releases indicate that, far from slowing, China's growth accelerated as we entered 2005. So the authorities will be on guard to raise interest rates to prevent overheating though, obviously, they don't want to take severe measures that will squelch growth. At the same time, there are still no signs that they are ready to allow a sizeable revaluation of the renminbi.

Bonds

Economic numbers have generally been on the strong side and positive newsflow from Iraq has removed possible safe-haven buying of Treasuries. This has supported yields at the short end of the Treasury curve. Meanwhile, the benchmark ten-year note's price has strengthened recently but remains vulnerable to inflation risk scares. Needless to say, with both a Fed meeting and the employment report on the schedule, there is the potential for large market movements this week.

Currencies

Good news on the Iraq elections was dollar positive, but didn't do much to lift the currency. Lots of market-moving risk events this week, including the FOMC and G7 meetings, and the US payroll report are keeping speculative money on the sidelines for now. These players may be willing to place stronger bets as events unfold.

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