

# Weekly Perspectives

Website: [www.lomam.com](http://www.lomam.com)

Email: [info@lomam.com](mailto:info@lomam.com)

[iraj.pouyandeh@lom.com](mailto:iraj.pouyandeh@lom.com)



## A Weekly View of Global Economies

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### North America

By and large, leading economic indicators are pointing to a pickup in global activity in the second half of the year. It looks quite positive except that a number of risk factors are lurking about, with the potential to upset a smooth transition to the desired outcome.

We should also note that one or two of the indicators have turned up rather earlier than they have normally done in the past. In comparison with historical experience stretching over the past several decades, the recent global slowdown has been rather too brief and shallow. Normally, a robust upturn is preceded by a deeper downturn. This is sufficient reason for us to be only cautiously optimistic.

One of the major risk factors is, of course, the twin deficit problem in the United States, being the federal government's budget shortfall and the current account gap. Unfortunately, they aren't showing any tendency to shrink. Positive sentiment regarding deficit reduction, that infused markets last month, appears to have dissipated.

Instead, investors will have to face up to the cold, hard, fact that the task will be a challenging one. The Bush administration is ideologically inclined to slim down the deficit via spending cuts rather than tax increases. But it is obvious to any political observer that getting those expenditure reduction plans through Congress - - even one dominated by Republicans - - is going to be very tough.

Meanwhile, defence spending shows signs of overshooting initial estimates. Iraq and Afghanistan are a drain on resources and the problem will be exacerbated if the administration opens up another front in the Middle East.

It is not just money that the Americans need, but troops too. Essentially, Asians are supplying the money and Europeans are prime candidates to provide military backing. This explains, in part, the recent warm overtures towards Europe. Pejorative adjectives about Europeans have been replaced with kinder words.

But behind all the diplomatic language and public show of reconciliation resides the real issue of geopolitical strategy and rivalry. Needless to say, other big players are involved too, including Russia and China. Fundamentally, there are forces at play that will gradually shape a new world order.

Unlike the cold-war period, there is no substantial reason for Europe to submit to US leadership. It is difficult to identify a serious external threat for which the Europeans need American protection. True, the EU is still somewhat unconvincing as a cohesive political entity that can project a unified view and extend military power beyond its borders. But there is a trend in that direction and some European leaders are explicitly expounding a multi-polar view of the global geopolitical system.

American strategists are well aware of these tendencies and would like to block them. But, at the same time, as resource constraints become tighter, they are gaining a better appreciation of the limits of unilateralism. Their ideological convictions may be intact but they may lack the means to achieve their ends, forcing a degree of cooperation and compromise with allies. The road towards a more equal distribution of global power may involve a good deal of friction but not necessarily of conflict, though history teaches us that the latter possibility can't be ruled out.

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It takes many years before shifts in global power become apparent, but we are already inching our way towards a multi-polar world. Long run, this has obvious implications for the formation of currency blocs, but also for the primary orientation of geographical economic activity. In particular, the large Asian land mass, which includes the Middle East, Russia, India and China, is ripe for significant transformation.

It is likely that inter-Asian trade will grow substantially in the future and, the importance of the US export market will diminish as a consequence. These changes will occur gradually and will reduce the incentive to hold large dollar reserves. In the short run, though, Asian central banks will continue to fund American deficits because it remains advantageous for them to do so.

But there are preliminary indications that diversification of reserves is already on their mind. In this game, first-mover advantage is particularly important. Those who shift out of US dollars slowly and quietly bear the least cost. That said; total Asian holdings of dollar-denominated assets are so large that any missteps could lead to severe disruption of the global economy. So it is likely that risk-averse authorities will play their cards very carefully in this dangerous game.

### Europe

European stock markets have largely weathered the challenges of higher oil prices and stronger currencies. Meanwhile, inflation in the Eurozone is well-behaved in terms of the European Central Bank's target rate, increasing the chances that interest rate increases will be on hold for a longer period.

### Asia/Pacific

Investor optimism perked up after Japanese industrial production in January came in better than expected. They have already forgotten the fact that Japan had a recession last year, its fourth since 1991. It appears that foreign money is flowing into the equity market and the general shift is from domestic demand and finance stocks into export-oriented stocks. In the past, betting on domestic plays relative to exporters has only paid off short term, and hasn't been a winning strategy over the longer run.

### Bonds

Last month, Greenspan was puzzled why long yields remained so low. Well, the ten-year Treasury note yield has risen substantially, since it dipped below four percent on February 9<sup>th</sup>. However, it is still at a historically low rate for this stage of the cycle.

### Currencies

The euro has held up quite well relative to the US dollar despite data releases generally favouring the latter. US GDP growth numbers were quite strong while German unemployment worsened and low Eurozone inflation indicated that interest rates are unlikely to be hiked.

*Iraj Pouyandeh*

*Strategist / Senior Portfolio Manager*

*Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company. Mr. Pouyandeh manages the LOM Equity Growth Fund.*



LOM Asset Management Limited  
27 Reid Street  
Hamilton, HM 11  
Bermuda  
441-295-6999

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