

Weekly Perspectives

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A Weekly View of Global Economies

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North America

According to preliminary data, third-quarter GDP growth in the US was quite robust. It beat consensus estimates. The impact from the hurricanes was fairly minor, which means that there may be less reason to have a rebound in fourth-quarter growth.

Consumer spending held up, despite soaring energy prices. And higher government expenditure was also a helpful factor. Households leveraged rising home equity to drive consumption, even as the personal saving rate remained negative.

We know that the Fed is targeting the housing market, which it regards as somewhat overextended. As households come to depend less on home equity monetisation they will have to rely on better gains in employment and compensation to power spending. Meanwhile, high energy prices continue to squeeze disposable income for those at the lower end of the income scale.

So it is important that the Fed should achieve a soft landing in the housing market and that employment conditions remain favourable. Otherwise, American consumers may find it difficult to spend as heartily as they have done in the past. The biggest risk to the growth outlook is the household sector's confidence about its future prospects and the wherewithal to spend.

The Federal Reserve has helped to monetise household-sector deficits, through the mortgage market, for the past several years. We may recall that this strategy was originally intended to boost consumer spending as the main engine of growth, and to avert a recession. The policy was obviously successful but it has also resulted in a somewhat bubbly housing market that policymakers are now intent on cooling.

Meanwhile, there is another major deficit unit garnering increasing attention and that is, of course, the public sector. It looks very much like the government's borrowing appetite is set to increase. And the issue for the Fed is whether it is willing to monetise these deficits with the same largesse with which the private sector was treated.

The indications are that the central bank will not indulge the government. Greenspan has more than once warned about the size of public-sector deficits and their long-term impact on lowering the growth potential of the economy. Bernanke is unlikely to view things differently.

Any sign that the Fed is willing to monetise public-sector deficits will be viewed negatively by the markets. There will be concern that the central bank is losing its independence and going down the slippery road of validating inflation. Currently, investor confidence in the independence of major central banks is quite high.

Better-than-expected US economic growth, weaker oil prices, in conjunction with mergers and acquisitions (M&A) activity was enough to fire up the stock market last week. Indices rose from their recent lows. Investors with a bullish bent pounced on what they believed were short-term oversold conditions. But the market has been quite volatile recently and it is not yet clear whether the rebound represents a sustainable upward break.

The S&P 500 is still in a broad trading range and has yet to show year-to-date positive returns, though it came close to doing so in the most recent rally. Valuations aren't unreasonable, putting aside concerns about interest-rate increases. Also, money managers still have excess cash holdings to put to work and boost their fund's performance which, on average, has been lacklustre this year.

We should note that there is less than two more months left to turn things around. In addition, retail investors, who have been standing on the sidelines, may decide to nibble again. Meanwhile, corporate share repurchases continue and there is the prospect of further M&A activity.

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Almost 70 percent of S&P 500 companies have reported their earnings for the quarter and current consensus estimates are for a 16.1 percent rise, which includes forecasts for firms that are yet to report. This is a fairly decent performance but there are also doubts about the forward outlook. The treatment meted out by investors to underperformers as well as overachievers has generally been unkind. Companies failing to meet expectations have received a drubbing, while those that beat estimates have generally been rewarded with only small gains.

There is no obvious sector leadership in the market. The two sectors that had made the biggest gains this year, namely energy and utilities, have now stumbled badly. In the past month, financials have outperformed the market. This may appear a bit surprising, given the relatively flat yield curve and the possibility of deteriorating credit quality.

However, it wasn't the banks that were leading the sector higher, but brokerages. In the current environment, some investors are prone to make only short-term sector bets and rotate rapidly on the basis of momentum and changing sentiment.

Strong global growth may help to shore up earnings and boost near-term risk appetite. But in an environment where there is greater policymaker concern about inflation as well as rising inflation expectations, there may be trouble for the stock market, further ahead.

If growth moderates, of its own accord, over the next few quarters then the need for tough action from central banks will be averted, giving equities a new lease of life. A cool-down period will allow the build-up of additional capacity to meet rising demand and the dissipation of inflationary pressures. Otherwise, the prospect of tighter monetary policy may lead to the waning of risk appetite.

Europe

Consensus forecasts for Eurozone growth have been edging up, following a pickup in leading indicators. Accordingly, expectations of rate increases by the European Central Bank have also been moved to an earlier date, in the first quarter or even in December.

Asia/Pacific

There is growing confidence in the sustainability of Japanese growth. The Bank of Japan has begun to signal the eventual abandonment of its loose monetary policy, over the next year. It will be a gradual process.

Bonds

Interest-rate futures contracts are pricing in an increase in the fed-funds target rate to 4.25 percent by the end of the year. A sharp rise in the Institute of Supply Management's prices-paid index did nothing to alleviate inflation concerns.

Currencies

The greenback reached two-year highs against the yen. Investors expect the Fed to keep on raising rates, while the Bank of Japan has to wait for a sustained inflation trend before it makes a move.

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