

Weekly Perspectives

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A Weekly View of Global Economies

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As expected, inflation in the United States is edging up. For one thing, it is registering in the prices-paid index of the Institute of Supply Management. Also, according to surveys, we are seeing an increased tendency for small businesses to raise prices. And, normally, this is a sector of the economy that has relatively low pricing power.

Such price trends may eventually reveal themselves in a broad measure such as the PCE (personal consumption expenditure) deflator. This isn't a perfect indicator of inflationary pressures -- nothing is perfect. But it is one of the Fed's favourites, and that makes it important. Of course, the Fed folk concentrate on the core PCE deflator, which excludes food and energy.

In passing, let's note that many people are unhappy with the way that the consumer price index is calculated. They think that hedonic adjustments introduce a downward bias in reported inflation. Hedonism, in this context, does not refer to the secretly extravagant lifestyle of dour statisticians but to their methodology, which dictates that they lower prices to compensate for higher quality. The idea is to get a better fix on the quality-adjusted price of goods. Although quality improvements aren't easy to measure, it is, nevertheless, difficult for the critics to argue that the bias is continuing to increase.

One can go on grouching about other aspects of how the CPI is calculated but instead of delving into those issues, let's look at the labour market. The payroll and unemployment-rate figures, released last week, were stronger than what the Wall Street crowd was expecting, and they promptly marked stocks down for the day.

While the recent payroll data is obviously subject to the usual monthly revision in May, the ongoing trend bespeaks of a robust economy. Wages, as measured by hourly earnings, have been rising at a strong rate. But price rises are eating into take-home pay.

Core CPI may be well behaved, but it is overall inflation -- including food and energy -- that hits you in the wallet. And headline CPI has been rising, and simultaneously diverging from the core number. If labour-market strength keeps up, there will be increasing pressure for acceleration in nominal wages.

So the US stock market is facing the headwind of higher interest rates. But investors still retain the hope that robust earnings growth will offset the drag of rising rates. Expectations are lofty, and as the year wears on, the risks of being wrong are likely to increase. The profit share of GDP is at a historically high level. Only in the mid 1960's -- a period of exceptionally high productivity growth -- did it go higher.

Over in France, the government has caved in to the demands of demonstrators and dropped the recently-proposed legislation that was designed to introduce some flexibility into the labour market for entry-level workers. In the process, President Jacques Chirac has allowed Prime Minister Villepin to be humiliated in order to appease the crowd.

It was a minor piece of reformist legislation aimed at reducing the high rate of unemployment among the young. Normally, new labour-market entrants

constitute a relatively high-risk group for companies that hire them. Such employees are inexperienced and untried.

So a hiring firm may be wary about taking a chance on workers that could turn out to be a financial burden. Allowing companies to fire unsuitable employees and switch workers introduces flexibility into the system. This isn't complicated economic analysis. It is just common sense.

Well, the students and unionists came out in force to protect their privileges, and the government backed down. But the labour market in France needs even more radical reforms, at many levels, in order to make the country more competitive internationally. The defeat suffered by the government doesn't bode well for France's future economic performance. Observers are asking the obvious question whether it is now possible to introduce badly-needed reforms.

It is very difficult to transform a culture of entitlement to one of competitiveness. Whenever there are distortions in an economy, it is always the case that there are privileged groups who benefit from the inefficiencies. What's more, they will either obfuscate the issue or seek to present their privileges as being in the general interest. But of course the reality is that others in the economy pay for the high cost and the inefficiencies created by the protected groups.

The incentive system in the French economy isn't working properly to compensate people according to their actual contribution -- as it is valued in the market. As a result, the achievers end up subsidising those who are protected and privileged. And the taxation system becomes a mechanism for transferring income from the hard-working to the slovenly. So it comes as no surprise that the economy continues to under-perform.

An entitlement culture may be foreign to the makeup of non-unionised companies in Anglo-Saxon economies, but there are still perennial problems of efficiency, compensation and slack. The former CEO at Morgan Stanley once said that, in his firm, twenty percent of the employees did eighty percent of the work. He didn't say how he came up with that precise formula, or whether he considered himself to be part of the high-performing group.

You guessed right that his statement did not endear him to the Morgan Stanley workforce. Besides, there is a question whether the enormous compensation packages enjoyed by the top executives of American firms are well deserved. It looks very much the case that market forces are weak and old-boy networks are strong. The ideology propagated in the media that these "rare talents" are worth it, simply isn't credible.

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