

# Weekly Perspectives

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## A Weekly View of Global Economies

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### North America

The year has gotten off to a rocky start for the US stock market, with major indices down sharply year-to-date. And, the biggest falls have occurred in technology and small-caps. So it appears that after overlooking looming risk factors in the fourth quarter, investors are having second thoughts about the outlook. But sentiment may not remain consistently negative and, going forward, there is the likelihood of many upswings and downswings in the stock market.

As we mentioned previously, there is a growth slowdown in the works for the US economy. Policy stimulus, which had been a big factor in juicing up economic performance in the past, has been withdrawn. The Fed is in tightening mode, and while it is going to proceed in baby steps, any signs of strength in the economy will likely elicit another turn of the monetary screw.

As for earnings growth, after a good performance in 2004, it should slow down substantially this year. The current consensus expectation is for S&P 500 companies to clock in 10.5 percent earnings growth in 2005. This estimate appears to be too optimistic, given the headwinds, and is likely to be revised lower as the year progresses. What we'll get is deceleration of profits as the economy loses momentum.

Essentially, the US is the main engine of growth for the world economy. There is not much domestically-generated power in Europe and Japan to lead global activity while, in Beijing, authorities are applying the brakes to the Chinese economic express to prevent it careening out of control. If there is a slip-up in US growth, the repercussions will be felt globally.

The biggest danger to a modest upside for stocks in the United States is the Fed interest rate cycle. If policymakers become more aggressive in fighting incipient inflation, then equity valuations will be hurt as a consequence. We could get a nasty case of multiples being compressed, as investors choose to pay less generously for prospective earnings.

Stocks are cheap relative to bonds because bonds are still expensive in historical terms. The Fed, aided by Asian central banks, was instrumental in generating this happy state of affairs but is now in the process of gradually normalising interest rates. Needless to say, higher interest rates diminish the comparative attractiveness of stocks.

Decelerating earnings growth and rising interest rates are likely to encourage a flight to quality. Firms with higher credit ratings, healthy finances and stable earnings will be favoured at the expense of those with dodgier specifications. Notably, many of the quality names are in the large-cap category. So it didn't come as a surprise that in the sell-off during the first week of January, small-cap indices registered some of the steepest declines.

Another category that suffers badly in a deteriorating profits cycle is technology. An analysis of the sector reveals that productive capacity has increased ahead of demand, valuations are on the rich side and pricing power is relatively weak. There is the presumed promise of rapid growth but little cash is actually returned to shareholders. The sector is vulnerable if we get disappointing news.

Base metal prices have experienced a correction year-to-date. This is not unrelated to the rally in the US dollar and it is too early to say if it is the beginning of a significant downward correction. There are still a lot of

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investors who are betting on a multi-year boom in commodities, based largely on China's growth prospects.

In the past few months, sharp falls in the LME's (London Metal Exchange) metals index have been followed by a rebound. Speculative long positions in commodities are still substantial and any unwinding will depend on how the China slowdown story plays out.

### Europe

Oil prices are down substantially from the peaks reached last year and the euro has weakened quite a bit relative to the US dollar. This is good news for the Eurozone economy, including the important export sector. Meanwhile, money supply and credit growth are strong and inflation is tending above target. The European Central Bank has hawkish credentials and would like to start normalising interest rates. But, overall, economic conditions remain relatively weak so that any tightening move is delayed until the latter part of the year.

### Asia/Pacific

Data quality problems aside, China's economic growth does not appear to have slowed down sufficiently to satisfy the authorities. Investment spending is growing at a fast clip and needs to be reigned in. This will require monetary tightening in addition to administrative controls. The consensus bet is that they will pull it off without causing a hard landing. However, if the economy does not respond in the near term then the chances of a less agreeable outcome will rise.

### Bonds

The release of the minutes of the Fed's last meeting primed the bond market to expect more aggressive action from policymakers than they had previously pencilled in. Inflation isn't about to accelerate sharply, but there are upside risks and the Fed doesn't want to appear as being behind the curve.

### Currencies

Market sentiment was dollar friendly at the beginning of the year. More recently, there are signs that the USD rally may have run out of steam. Earlier, the Fed's hawkish tone on inflation appeared to promise a widening of the interest-rate differential in favour of the US.

Also, last week, John Snow the Treasury Secretary, reiterated the administration's strong dollar policy for the umpteenth time, saying that they would become religious on bringing the fiscal deficit down. Snow forgot to mention that they were also in favour of exchange rates being set by the market. He said it this week and the greenback promptly lost ground.

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