

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Taking into account the data distortions introduced by earlier hurricanes, the US employment release, last week, still managed to beat expectations, indicating a fairly robust economy. But this did not prevent the stock markets from being pummelled. Indeed, the prospect of stronger growth also raised the spectre of even tighter monetary policy.

Worries about mounting inflation pressures were exacerbated by speeches from a number of Fed notables. They focused on the need to take effective action and stop the problem from taking root. This sent shivers down the spine of an equity market that has fed at the trough of easy liquidity for a number of years. The primary fear is that the nasty medicine of higher interest rates may not just cure the disease of inflation in its early stages but also weaken the economy.

The heightened concerns are not about near-term growth but about what happens later in 2006 when interest-rate hikes begin to bite. For now, monetary policy is still stimulative, even as hurricane-related rebuilding efforts are going to boost the US economy.

As for the global economy, the general picture is one of strength rather than weakness. We are witnessing strong growth in China and India, recovery in Japan, and even Europe is managing to grow at a gingerly pace rather than stagnate.

As the saying goes, those analysts who still think that inflation is a non-problem need to wake up and smell the coffee. The evidence of a pickup in inflation has been mounting for some time. That said, there is no indication that we are facing anything other than a containable problem, as long as authorities show some resolve in tackling it.

Apart from monetary policy, another factor to monitor is the possible rise in protectionism. It is well known, from past experience, that jacking-up trade barriers dampens growth and promotes higher inflation. Recently, there have been some scuffles among the major trading blocs but nothing too serious yet.

And the hope is that differences over global economic imbalances can be resolved amicably. There is now a greater degree of interdependence in the world economy than in the past and it requires far-sightedness and a spirit of compromise from policymakers to avoid the damage that would result from adopting a confrontational attitude.

Currently, there is reason to worry about a pickup in inflation and the need for higher global interest rates. In the near term, any crimping of consumer spending in the US is likely to be offset by investment expenditures.

And, it can be argued that the spending on infrastructure and housing will have a higher domestic content than consumer spending, which is proportionately more import intensive. As such, the former will have a larger multiplier effect on activity and a bigger impact on inflation.

The outgoing chairman of the Federal Reserve has, in the past, often warned about the dangers of fiscal profligacy. Well it's almost too late for him to address the issue because he is scheduled to leave his post in January, but the new chief at the helm will have to face the problem of even wider budget deficits. It will be a choice between counteracting or validating fiscal largesse. The likelihood is that monetary policy will be tighter in order to maintain the credibility of the central bank.

And this means that challenging times are ahead for both the bond and equity markets. US stock markets have underperformed those of a number of regions and countries this year, and continue to face more headwinds than tailwinds. Interest rates are expected to rise at a faster pace than elsewhere and there are question marks about the forward outlook for earnings growth.

Third-quarter earnings reporting season is getting underway and a factor that many investors will be focussing on is not so much the recent performance as the outlook for profit growth in 2006. If the Fed manages to slow down the economy, this will weigh on earnings, even as labour and energy cost remain elevated.

We have witnessed a compression of PE multiples for US stock-market indices, on account of the aforementioned factors. But on a short-term basis, the market may be oversold. Some investors are waiting for an opportunity to take advantage of a possible rebound. Others are betting on a fourth-quarter technology rally. Still others are positioning themselves to profit from higher volatility.

Europe

The political logjam in Germany has finally been broken, with the Christian Democrats and the Social Democrats cutting a deal to form a grand coalition government. But the government is not inspiring much confidence in the markets. The new Chancellor, Angela Merkel, was forced to give cabinet posts to the opposition in the key areas of finance, health and labour. All these areas are critical parts of any reform programme. Change will come slowly and the coalition may not last. Merkel is still a long way from being able to bash her colleagues with the famous Thatcherite handbag.

Asia/Pacific

Despite a somewhat disappointing Tankan business confidence report, output and employment data point to a sustainable path of recovery for the Japanese economy. The latest sharp rise in machinery orders confirms the positive trend. Meanwhile, consumer prices continue to fall, with both core and headline prices down in August. But there are indications that inflation is getting closer to moving into positive territory soon.

Bonds

Hawkish talk from the Fed, last week, was supportive of higher yields. But investors are still uncertain about the outlook, with divided views about whether we are going to get a steepening or flattening of the yield curve. Under the circumstances, conditions are likely to remain volatile.

Currencies

The greenback is looking stronger against sterling, the euro, and the yen, on the back of expectations for further Fed tightening. Hawkish rhetoric from the European Central Bank on inflation risks may have helped to soften the euro's fall, which was weighed down by disappointment over the composition of the new German government.

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