Weekly Perspectives

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A Weekly View of Global Economies

12 April 2005

North America

Oil prices have moved lower, after rising to another peak at the beginning of the month. This is helpful in maintaining global growth, which was beginning to face greater downside risks due to high energy costs. However, the market remains volatile because of speculative interest and rapidly changing sentiment. So, further short-lived spikes aren't out of the question.

The evidence from the available data is that there are no serious supply shortages, and inventories are rising. At the same time, officials from some OPEC members have issued statements in favour of higher production. It may not be necessary to raise output, but it is an indication that they are concerned about the economic health of consuming countries.

What they would like to avoid is a sharp slowdown in global growth, which would significantly reduce revenue streams for oil-producing countries. This would play havoc with the finances of those who are most dependent on oil income to fund their expenditures. So, essentially, it is in everybody's interest to have global growth chugging along smoothly, along with oil prices that do not undergo boom and bust cycles.

Recently, Greenspan also got into the act of talking energy prices down. As for inflation, the language from Fed notables is that they will continue to exercise vigilance. And, that should be enough to cap any upside to inflation. Cost pressures and labour market conditions aren't such that a self-generating inflationary spiral is in the works. The important thing is that monetary authorities should continue signalling that they won't tolerate and, still less, validate higher inflation. Any signs of backsliding will cause a rapid reaction from the markets.

We have mentioned previously that, because of the forces of globalisation and international outsourcing, the secular trend is broadly deflationary. But there are also cyclical phases of moderate speedup or slowdown in inflation superimposed on the secular trend. Unless there is an increase in impediments to globalisation, in the form of protectionism, inflationary flare-ups are likely to be relatively mild.

However, there is also another basic scenario that has wide circulation in the investment community. This one focuses on a broad repetition of the experience of the sixties and seventies, in which plentiful liquidity and easy US fiscal policy was followed by higher inflation, rising commodity prices and, subsequently, stagflation (a combination of high inflation and slow growth).

The latter scenario is negative for stocks and bonds, while being favourable to commodities and precious metals. This explains, in part, the preference shown by some investors for commodities. The investment rationale is to find asset classes that can act as a hedge against rapid and volatile inflation. One should hasten to add that commodities may also be favoured under the globalisation scenario, not primarily for reasons of inflation protection, but in terms of longer-term rising demand from rapidly-industrialising emerging countries.

In the globalisation and structural change story, there is limited upside to inflation because of the presence of competition - - provided policies are not enacted to unduly hinder market forces. As a result, there is little need to raise interest rates substantially to prevent overheating and an inflationary build-up.

Among the major economic regions, only the US and China have strong growth and a bit of inflationary pressure. The Eurozone, as a whole, is operating below capacity and has only mild inflation, while Japan suffers from weak domestic demand and is still trying to escape the clutches of deflation.

As for trends in the United States, in the absence of substantial liquidity created by the Fed beginning in 2001, the US would have suffered a sharper slowdown than it actually experienced in 2001-2002. Easy policies pumped up the consumer, who has driven the economy until now - - presenting the possibility of a better balance being achieved between consumption and investment, going forward. Certainly, the policy created imbalances, but one can argue that this was a better option than risking recession.

Currently, it looks likely that tighter policy in both China and the United States will rein in their economies and prevent overheating and an inflationary surge. As a result, global growth will slow down and asset markets will adjust accordingly. This will set the stage for a reprise, once the adjustments have worked their way through the system. Given the impact of globalisation and the flexibility of markets, compared with the situation in the seventies, it seems unlikely that we will end up with an extended period of stagflation.

Europe

Economic data released in the Eurozone continue to be disappointing. The decline in the Purchasing Managers Index for March supplemented earlier weak reports on industrial output. Meanwhile, high oil prices are dampening consumer confidence and increasing worries about an uptick in inflation. The risk is that there will be more pass-through of rising energy costs into final goods prices. Despite this risk, the European Central Bank adopted a less hawkish tone on monetary policy, because of the uncertain outlook for growth. Going forward, a stable euro and lower oil prices would be very helpful in keeping growth hopes alive.

Asia/Pacific

The macro picture in Japan isn't very promising. Output, household spending and exports have all disappointed on the downside. At the same time, unemployment is up and business confidence is down. If we can find a positive factor, it is to do with slow improvement at the corporate level.

Bonds

Recent comments from Fed notables appear to confirm that policymakers continue to be vigilant - - and investors haven't forgotten about inflation risk and rising rates. Meanwhile, the benchmark ten-year Treasury note has benefited from a number of factors that have led to a bid-up in prices. In part, this has reflected short-covering, as bets on a decline in price proved too hopeful. Prices were also supported by some safe-haven buying of Treasuries after Ford cut its profit forecast. Still, many investors stayed on the sidelines, regarding the ten-year note's price as being a little rich. They want to see higher yields before they are prepared to buy.

Currencies

Against the key Eurozone currency, the dollar has failed to breach the 1.28 level, which may have resulted in even more downside for the euro. In part, the dollar's rally over the past few weeks has been attributed to liquidation of short-dollar positions, which may have run its course. However, the overall market sentiment remains dollar positive.

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