Weekly Perspectives

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A Weekly View of Global Economies

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North America

US productivity growth is expected to enter a slowdown phase, in keeping with this stage of the business cycle. Unit labour costs are trending higher and this means that corporate profits will be losing momentum. Cash flows are still plentiful and, in managing the money, firms have a choice between stock repurchases, dividend distribution, acquisitions and capital spending. So far this year, they haven't shown a great inclination to increase capex despite the fact that they have the means to do so. This indicates a cautious approach that is not expected to reverse course given the outlook for slower economic growth.

We have entered the earnings season for second-quarter reports. Earlier on, there was a rise in negative preannouncements, which isn't a good portent of things to come. At the same time, consensus estimates have been reduced, in line with an expected slowdown in earnings momentum. The potential for negative surprises is higher in cyclical sectors such as industrials, technology, materials and consumer discretionary.

Europe

The reprehensible terrorist attack in London, last week, is unlikely to have much of an impact on the UK and, still less, the global economy. Investors quickly came up with the right assessment of the likely effect of the event, and this was reflected in market moves. A one-day sharp sell-off on European equity markets reversed course and safe-haven buying of government bonds has also been unwound.

The sort of terrorism that London experienced has the ability to cause short-term shock and distress, but there is no indication that the groups perpetrating these crimes are able to carry out repeated attacks to cause major disruption. Only in Iraq, where the government is weak, the local defence forces are poorly organised and sections of the Sunni population provide a measure of support to militants have they been able to cause serious problems.

Such terrorist attacks are unlikely to precipitate a pullout from Iraq. Tony Blair is no closer to leaning in that direction than he was before the bombings. The leadership of al- Qaeda may be miscalculating if they believe that Western resolve will be shaken. It is unrealistic to think that the world will allow extremist Islamic governments to take power in countries that control major oil and gas reserves on which the global economy depends.

Asia/Pacific

China's economic growth is still very robust, if the data are to be believed. Retail sales and industrial production have been picking up and exports are outpacing imports. This translates into a hefty trade and current account surplus that is sure to bring more outside pressure for renminbi revaluation. As for inflation, it has been stable. Despite high raw material and labour costs firms face plenty of competitive pressure preventing them from implementing price increases. This is good for consumers but not so good for corporate earnings.

One feature of the problem of global imbalances is the wide current account deficit in the United States, contrasting with big surpluses in Asia. In part this has to do with inflexible currency regimes maintained in the emerging countries of Asia. As for Japan, the yen is a floating currency. However, in the past, authorities have often intervened heavily to move the exchange rate in a desired direction.

A more important reason for the imbalances is the high saving rate in Asia and the very low one in the United States. The result is that Asian savings are funnelled to the US to finance spending. If the objective is to correct the imbalances then shifts in the saving rate will have a bigger impact on the current account than changes in the exchange rate.

But policymakers find it easier to focus on currencies than on measures to alter saving and consumption rates. China attracts attention because of its size and growth performance. One consequence of China's greater competitiveness in export markets is the growth of trade frictions with both the EU and the US. There have been a number of disputes, most recently with regard to the textile industry.

We are seeing a drift towards greater protectionism in developed markets. However, it is not yet a serious problem but needs monitoring because of its potential impact on inflationary pressures. Markets that are protected from international competition face a higher risk of inflationary tendencies taking hold.

Another ongoing trend is the pressure put on China by Europe and America to revalue the renminbi. Chinese authorities have resisted the calls for revaluation. This has partly to do with their goal of having a financial system that is robust enough to withstand such a change. A bigger policy issue is the choice between the domestic and the external sector as the main driver of growth. A significant revaluation would effectively put the emphasis on domestic demand at the expense of exports as the main engine to drive the economy.

The most likely outcome is that Chinese policymakers will widen the bands within which the currency trades relative to the US dollar, but they will start off modestly. Once begun, there will be cautious incremental steps towards further band widening. Unfortunately, this isn't going to do much to solve the problem of current account imbalances.

Bonds

US non-farm payrolls for June were lower than expected but fairly decent, nevertheless. April and May numbers were revised upwards, and this made up for the June shortfall. The trend increase in job creation is enough to keep consumers spending at a respectable rate. As a result Treasury yields have been edging higher.

Currencies

The euro found some support against the greenback after comments by a European Central Bank council member poured cold water over expectations of a possible rate cut by the ECB. US trade data, to be released this week, may also be weighing on the dollar. However, it is too early to say whether a reversal is taking place in the dollar's bull run.

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