Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.bm

iraj.pouyandeh@lom.bm

A Weekly View of Global Economies

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North America

Inflation moved further into the limelight, right after Greenspan made some comments about his readiness to deal with any inflationary flare-up. Of course, people had already noticed that it was creeping up, way before the Fed chairman cared to acknowledge the risks. What they weren't sure about was how aggressive the central bank would be in tackling the issue.

So, in this context, Greenspan - - who is a seasoned operator - - knew that there was a need to give some assurance that he was on top of the problem and would not let things get out of control. He also gave himself some room for manoeuvre if the scenario takes a more negative turn than previously foreseen. Actually, the Fed doesn't have a grand plan and is adapting to events as they develop. It has almost certainly been surprised by the uptick in inflation.

There is something illusory, but comforting, about the view that the Fed is in charge and capable of fine-tuning the outcome. The evidence for this is rather slim, judging by the record. More often than not, the Fed has lagged the market. Market-set rates generally lead policy-set rates, and policymaker influence is even more tenuous at the longer end of the yield curve.

Wall Street is full of accolades for the central bank's successful policy of implementing extraordinarily low interest rates that helped the economic rebound. But the actual folks to thank for the easy policy are the Asian central banks, because its realisation would have been impossible without their cooperation. The above arguments are not aimed at belittling the Federal Reserve. However, it is necessary to be realistic about their power and purpose, and the favourable or unfavourable circumstances in which they act. It is an error to fall into the trap of ascribing to them capabilities that are beyond their reach.

The occasions when the Fed has made a substantial difference have been instances of impending financial distress and systemic risk. Funnelling liquidity and arranging rescue plans on a timely basis has saved the entire system from greater stress. However, this was also done at the risk of exacerbating the moral hazard problem. In other words, entities would be encouraged to take on more risk in the future than they would normally do, because of the existence of a presumed safety net to rescue them if their bets worked out badly.

As for how things are shaping up in the US economy, there is a downside risk to productivity growth and an upside risk to inflation. Fudgy words like "measured rate increases" have never meant much. They are not absolute, but context dependent. And in this context, the market will force the Fed's hand if it is too lethargic in dealing with inflationary trends. The "measure" talk, however, does express the policymakers' preference for promoting growth at the expense of moderately higher inflation - - provided inflation does not appear to be getting out of hand and thereby destroying their credibility.

As we mentioned previously, unit labour costs are on the rise and firms are flexing some pricing-power muscle. If consumers continue to borrow and spend, relief for any margin pressure may have to come through higher inflation. And this may require a tighter policy to reduce demand and force the household sector to adjust its weak balance sheet - - with downside consequences for economic growth.

Just when investors were getting ready to nibble on some more risk again, the whiff of faster interest rate hikes has spoilt their appetite somewhat. As a result, stock markets have been hurting a little, but not enough to rule out brief rebounds. Fund flows into equity mutual funds were on the positive side, last week - - to the tune of $1.4 billion. However, money market funds attracted a hefty $14.8 billion. Looking forward, as interest rates move higher, so will there be an increase in investors' reluctance about applying high P/E multiples to expected earnings.

Europe

Inflation in the Eurozone is above the target rate set by the European Central Bank. In addition, inflationary expectations are now on the rise. This is likely to increase worries at the ECB that a self-fulfilling cycle may take hold. However, wage-rate increases are contained and there are few indications of a tightening labour market. But the ECB tends to be a hawk on the issue of price stability and it is probably now moving to a position of being on guard to tighten policy, if need be. The probability of a rate increase before the end of the year has now risen.

Asia/Pacific

Japan's first-quarter growth rate was revised up to an impressive 6.1% in real terms, on an annualised basis. Consumer spending is surprising on the upside, on the basis of improving sentiment and a recovering labour market. Business investment is also performing well. While GDP growth is still expected to slow down in the second half, optimism has certainly improved about the Japanese economy.

Bonds

Some strong economic numbers, together with more strident talk from Fed notables on being tough on inflation have helped underpin Treasury yields. Inevitably, there will also be instances of overreaction and subsequent correction. Meanwhile, there is a tendency for the yield curve to flatten, notably in the 2-year to 10-year range. At this point in time, the market is not out of synch with Fed signals. The policymakers' message is that they will do what is necessary to cap inflation by raising short rates - - over which they have influence - - in order to stabilise longer rates.

Currencies

Last week, Greenspan's comments fired up hopes about a stronger US interest-rate- increase cycle and helped the dollar advance against a host of currencies. The unwinding of some carry trades may also have been a factor in the rebound. This week, the April trade deficit poured some cold water over the enthusiasm. It widened to an all-time high, causing the greenback to give back some of the earlier gains. The structural story is still rather dollar-negative, unless the US economy registers some impressive productivity growth numbers.

Iraj Pouyandeh
Strategist / Senior Portfolio Manager

Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company. Mr Pouyandeh sits on the LOM Investment Policy Committee, responsible for determining global asset allocation.

LOM

LOM Asset Management Limited
27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

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