Global Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com

16 April 2007

Risk appetite has perked up and many asset classes that were shunned over a month ago are once again creeping back into favour. However, risk factors haven't melted away and sooner or later we are going to get another spate of risk aversion and market volatility.

The global economy is still expanding at a good clip, but there are signs of a slowdown. Aggregate industrial production, covering major economies in both the developed and developing world, is growing at a slower pace. Also, the OECD leading economic indicator (LEI) is still heading lower, signalling more weakness ahead. Though we should point out that the LEI for many non-OECD countries, which are principally emerging economies, are still gaining momentum.

An encouraging feature of recent trends is a degree of de-synchronisation in global growth. This convoluted word seems a better choice than "decoupling", which connotes eliminating interrelationships - - something that is unlikely, given globalisation trends. Anyway, the idea is that there is some evidence of divergent economic prospects for major regions.

Last year, it looked improbable that European economies would be strong enough to counterbalance an expected slowdown in the United States. But, now, we are witnessing fairly robust domestic demand in Europe, as well as greater reliance on booming economies in Asia as a destination for exports rather than the US.

Meanwhile, Asian exports to China are growing at an accelerating pace, a trend that is likely to continue in the future. As for China itself, the composition of domestic demand has shifted from capital spending to consumption expenditure. This shift should make growth more stable and sustainable.

So, America, as the consumer of last resort, is no longer an essential factor in keeping the global economy afloat. But the US isn't irrelevant either, as a force in determining how fast the world economy can grow. The GDP in the United States constitutes about twenty percent of global output, on a purchasing power basis. So it continues to be a large part of the world economy.

The latest data on US economic activity still point to slowing growth and sticky inflation. This mix is problematic for the Fed, which would prefer to have easier policy options. Unfortunately, that is how the cards are being dealt and policymakers will have to do the best they can in balancing the risks.

The March payroll numbers were expected to be strong because of weather-related factors that had kept employees out of work when the previous report was issued. Even so, it surprised a little on the upside. But the signals on the labour market aren't uniformly upbeat. The employment indices of both the manufacturing and non-manufacturing reports, issued by the Institute of Supply Management, are losing momentum.

Apart from the housing market, a more troubling issue is the slowdown in business capital spending. Firms do not appear to have sufficient conviction in the economic outlook to boost expenditure. The problem is that capex is normally closely correlated with employment growth and corporate profitability.

Meanwhile, productivity growth is slower than expected, even as costs are rising. If these trends continue, the consequences for corporate profitability aren't particularly pleasant. Firms that face pressure on their margins are likely to reduce employment in order to maintain profit levels. So the expectation that a strong job market will sustain household spending may be too optimistic.

The stock market has generally been reacting positively to good news and ignoring bad news. At the same time, mergers-and-acquisitions activity continues to be strong, acting as a significant driver of the market as a whole.

We are at the start of the earnings reporting period, for first-quarter results. And, analysts have substantially reduced their year-on-year growth estimates, over the past three months. So the question is whether corporations will be able to meet the lowered expectations. But even if they manage to do it in Q1, they will face tougher challenges going forward.

Generally speaking, with regard to analysts' consensus forward earnings estimates, momentum is falling in the United States, while it is still rising in Europe. In other words they are revising their estimates downward in the US and upward in Europe. Over in Japan, it is broadly flat. As for China, enterprise profits are rising strongly.

It appears that short positions in small-cap stocks have risen substantially in the US. Valuations are indeed more stretched for this category than for large caps. And, the not unreasonable expectation is that the smaller fish will fare less well than their bigger brethren in a challenging economic environment. The big ones have a much greater exposure to export markets and generally better credit ratings and financial resources.

On the other side of the pond, German mid-caps are outperforming the biggies. The former are more exposed to a domestic economy that is doing quite well. However, there are also a good number of mid-caps that are strong exporters and face relatively inelastic demand for their products abroad. In other words, they aren't going to be hammered by a rising euro. The German stock market, as a whole, has outperformed the world index, year-to-date. Even so, it remains relatively cheap compared with the global market, on a PE basis.

Broad commodity indices such as the CRB and Rogers, which include a wide range of commodities, have moves gently higher since the beginning of the year. But this does not constitute strong momentum. The metals are a different matter, though, and they have been putting in a robust performance, as indicated by the London Metal Exchange Index. Some of this strength is caused by a spate of stocking-up by Chinese importers. As for the forward outlook, commodity prices are highly correlated with global industrial production, and if growth slips there is reason for softer prices.

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. He manages the LOM Global Equity Fund.

The information in this newsletter is for general use only; it is not intended as specific investment, financial, accounting, legal or tax advice for any individual and should not be relied on as such. LOM makes every effort to ensure that the contents herein have been compiled or derived from sources believed reliable, however LOM does not warrant the accuracy, timeliness, or completeness of this information and material and expressly disclaims liability for errors or omissions in this information.

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

Licensed to conduct Investment Business by the Bermuda Monetary Authority

The material herein may not be reprinted, in part or in full, without prior expressed consent in writing from LOM Asset Management Limited