

Weekly Perspectives

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A Weekly View of Global Economies

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It wasn't surprising to see a sharp correction in commodity and oil prices. They had gone up higher than justified by the supply demand balance, driven in part by speculative froth. Furthermore, as we had mentioned earlier, cyclical trends were pointing to somewhat weaker commodity prices.

The global economy is still expanding rapidly, but that is also allowing inflation to edge higher. What's more, inflation expectations are rising. And that means policymakers are going to be put to the test to tighten monetary conditions. The result would be a growth slowdown, which also has the effect of reducing commodity demand.

Emerging-market equities have been particularly hard hit, among a general stock market sell-off. Again, this is hardly a surprise. Equity valuations in the emerging world had been pushed to unusual heights by big external inflows, as foreign investors poured money into mutual funds targeting this area. Hedge funds have also been active participants in driving these markets higher.

Stock markets seem to be sensing, at last, that there is the possibility of relatively tighter monetary policies than they had previously counted on. As higher interest rates bite, and growth slows down, so will earnings be hurt. It isn't that there will be a dramatic rise in rates and a fall in growth. But when forward earnings estimates are optimistic, there is room for downward adjustment. In addition, higher interest rates begin to provide an attractive alternative to being invested in stocks.

Meanwhile, fixed-income investments with relatively long duration have been hurt as yields have climbed. Those who had been betting on a decline in rates have been badly wrong-footed. Yield curves have been steepening as bond investors demand a higher inflation premium.

Gold has corrected, along with base metals, after its impressive rise over the past month. It may decline further but there are a number of supporting factors that haven't yet dissipated, and may still attract buyers. There are worries about inflation. The greenback's structural problems provide an incentive for portfolio diversification. And, then, there is heightened geopolitical risk.

The US dollar was already looking troubled in March, before it started plummeting from mid-April onwards. At that time, positive data failed to provide support for the buck. Normally, this sort of occurrence is an indication that sellers are entering the market to reduce their holdings every time the dollar tries to stage a rally.

Of course, it was only later that some of those sellers revealed their presence. As for the greenback's sharp decline over the past month, the reason is not hard to find. The main positive factor supporting dollar strength was removed by the Fed's language, increasing investors' perception of a softer approach to monetary policy.

It is not surprising that some of the most active central bank diversifiers, out of the dollar, have been the smaller ones, such as the Sweden's Riksbank. They can diversify their holdings without making big waves in the market. It is a different story, though, with those central banks that have massive dollar reserves, such as those in Asia. A significant move by the Asians will precipitate a crisis that will cause instability in financial markets and a global recession that will hurt everybody's interests. All the players in the game know this and tread carefully.

The euro has been called the anti-dollar for good reason. It is the best alternative to the greenback as a reserve currency. Investors are drawn to the euro, not so much because it is intrinsically attractive, but rather because it looks relatively good compared with the dollar.

Forming a monetary union in Europe was a flawed project. It was very ambitious to try and patch together a large number of incompatible countries with diverse economic structures and fiscal regimes. Convergence isn't happening fast enough, and there are a lot of stresses and strains. This has made the task of the European Central Bank very difficult in running monetary policy.

At the start of forming the common currency area, it would have made more sense to have constructed it in stages, with a small number of compatible economies using the euro. Later, other countries would have been allowed to join the club as they developed their economic structures and fiscal regimes. However, there was a political agenda that was being followed and we are now left with the economic consequences of that decision.

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