

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Equity markets headed firmly higher last week but are now in a more vulnerable phase, with downside potential. It has been quite a run since late October, with just a few pauses to refresh. Earlier expectations that investors would finally indulge in a spate of serious profit-taking were deferred. Sliding oil prices had a lot to do with the rising optimism, and cyclicals performed nicely. Latest indications are that although investors don't appear to be exhausted, a note of caution is creeping in, and a correction is overdue.

Oil prices are finally showing a period of sustained weakness and this has eased concerns that household disposable income will be badly hurt. So Wall Street has cheered up about the holiday shopping season in the United States. Retail stocks have been on an upward move for a while, particularly among the specialty retailers. There is a good bit of momentum, and valuations are stretched. But, at some point, doubts are going to appear regarding the performance of these stocks, as we get closer to a more problematic 2005.

Steel-company profits are rising sharply, based on strong demand and huge price increases. Firms such as Arcelor in Europe and Nucor in the US are in a sweet spot, and their stocks have reached 52-week highs. Investors appear to have brushed off the concerns that caused a sell-off last month. Demand for steel will, indeed, slow down next year as the world economy cools. At the same time, China is now a net exporter of steel.

Meanwhile, carmakers and consumer durables manufacturers have been the victims of the steel-side price rises. Producers of "white goods" have suffered a margin squeeze at both ends. High input costs and tough competition from manufacturers in developing countries, particularly China.

Companies in the chemicals sector have been enjoying good pricing power. Constrained capacity, inherited from the past, has allowed them to pass on higher input costs. With customer inventories at low to normal levels and demand still fairly healthy, the short-term outlook for chemical producers is still good. However, we should note that this has traditionally been a highly cyclical sector.

Tech stocks are, of course, a customary beta play, and they have performed accordingly. As oil prices have headed lower, so have technology stocks gone higher. For now, investors have set aside any worries about the strength of corporate investment spending and the excess capacity in some hardware areas. But those concerns will eventually return.

Investors' hopes are still riding, substantially, on robust growth in the United States to drive the global economy. Domestic demand in Japan and much of Europe is weak, and both depend heavily on healthy exports. China's economy will be coming off the boil next year and in most of non-Japan Asia - - countries like Australia excepted - - consumers have still not found the nerve to spend more freely, many years after the Asian crisis in the late nineties.

With the dollar continuing to decline relative to key currencies such as the euro and the yen, trading relationships may come under strain. In particular, the Eurozone currency has taken more of a hit than Asian currencies because it is free floating while most of the latter are managed. That makes it a good anti-dollar choice. But it also raises alarm among European policy makers as the euro creeps higher.

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The long-run trend of the USD/EUR exchange rate (constructing a euro-equivalent currency before it came into existence), over the past quarter-century, has been downward - - though, obviously, with substantial fluctuations around the trend.

It is an error to straight-line trends, if we are focussing on short-term decision making. But, longer run, there are a number of unfavourable political and economic factors overhanging the dollar's fortunes and its reserve status may diminish in the future.

Europe

The Bank of England's November "Inflation Report" has swung towards dovish thinking, and it looks like rates aren't heading any higher than the current level of 4.75%. There is diminished concern that inflation will overshoot the 2% target level. House price inflation is under control and the recent soft data confirms expectations that it may ease back further. However, earlier fears that consumer spending would fall, in consequence, appear to be exaggerated. The latest evidence is that correlation between household consumption and house price inflation has fallen sharply in recent years.

Asia/Pacific

The Chinese authorities increased interest rates last month to cool the economy, but are likely to be cautious, near term, about hiking them further. They are currently waiting to see the impact before adopting a more aggressive stance. This will probably be necessary in 2005 to prevent the economy from reaccelerating. There are a number of tools that are in play: direct liquidity controls, rate increases, administrative controls and currency revaluation. The last tool is going to be introduced in a gingerly fashion.

Bonds

Last week, the FOMC pretty much re-iterated the sort of talk that everybody expected. There was nothing to surprise or excite the markets. Meanwhile, slipping oil prices have weighed on shorter-dated maturities, under the assumption that now the Fed has more reason to raise rates rather than pause.

Currencies

The euro has failed to breach the 1.30 level against the greenback, as market chatter continues about the likelihood of intervention. Even though the dollar's depreciation has been fairly rapid in the past few weeks, it has also been orderly. What policy makers fear most is an abrupt adjustment and, fortunately, this hasn't happened. There is no clear line in the sand, but given the weakness of Eurozone domestic demand, a move towards 1.35 may approach the pain threshold.

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