# Weekly Perspectives

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## A Weekly View of Global Economies

17 January 2006

The consensus view seems to have gelled around a number of major themes: (1) that global growth will be robust this year (2) that it will be better balanced, in terms of its geographical distribution and (3) that central banks will not abort the recovery. At first sight, these contentions appear to depict a reasonable base-case scenario. But there are a number of risk factors lurking about in the shadows that could prevent the unfolding of a smooth storyline.

As far as the growth picture goes, there is still plenty of momentum in the global economy, and this is generally true for Europe (all right, parts of it have more upside than others), Japan, China and the United States. We are seeing the robustness of demand reflected in raw material and energy prices. Meanwhile, there are still no signals from leading indicators pointing to possible growth softness in the second half of the year.

Looking at the issue of the resolution of growth imbalances, the outlook for Europe and Japan has improved even while China's economy shows a good deal of strength. Indeed, the Chinese economy underwent an upward re-rating, last year, as government statisticians moved away from an older methodology used in central-planning days, emphasising the goods sector, to one with a better fix on the growing services sector.

In other words, the formerly undervalued services sector is now being measured more accurately. As the Chinese economy develops, services will become increasingly important and a major contributor to faster growth. In passing, we should mention that there are some analysts who have a cynical view of the quality of Chinese economic data. However, there is no indication that authorities are engaging in significant data manipulation of the sort we see in many emerging countries.

Getting back to our main point, the 'better balance' argument requires US growth to slow down. And this is premised on a modest pull-back in consumer spending offset, to some extent, by more robust business capital expenditures. However, the housing market is still holding up, even as job growth and wage gains boost household income, although we must mention the recent increase in energy prices as a negative factor.

Also, American consumers, unlike their European counterparts are banking on muted economic cycles — making them willing to take on a higher debt load and spend it in the present. This borrow- and-spend attitude often alarms some analysts, but it does have a rational basis. If the economy becomes more volatile, with bigger cyclical swings, then we should see household saving rates increase.

The experience from the past has been that consumers in the United States have often invalidated analysts' expectations that they will reduce their spending. There is a risk that they will surprise consensus forecasts again, to the upside. Under this scenario, growth may turn out to be stronger than people have currently factored into their projections.

This means that the Fed may have to be more active in curbing growth, with the target fed-funds rate rising to a higher level than currently priced in by the markets. Right now, policymakers are considered to be close to achieving neutrality with another twenty-five or, at most, a fifty basis point hike, in two baby steps. But neutrality is something of a moving target and is a function of the strength of the economy.

However, we should also entertain the possibility that US growth could surprise to the downside. It is not beyond the realm of the possible that a confluence of negative factors such as higher geopolitical risk and continuing elevated energy prices could hurt the economy. But, currently, this outcome appears to be a relatively low-probability event.

The US stock market got off to a roaring start at the beginning of the year, based on the outlook for interest rates and a soft-pedalling Fed. It has since been marking time, waiting for the full earnings season to unfold, which could introduce a measure of volatility. Other major markets have basically followed the pattern in the United States, though Japan has been notable in lacking strength.

European equity markets were unnerved by France Telecom's disappointing sales forecast. The already struggling telecom sector took another hit. And the relatively greater weighting of telecoms in European indices, compared with the US, was a drag on valuations. Problems faced by telecommunications companies are fairly well known and the sector has been one of the worst performers, over the past year, in many major indices.

Some retailers may find it tough going too, and the recent spike in oil prices has put pressure on several oil-sensitive sectors. However, there are also firms with significant exposure to global growth, and should do reasonably well in terms of sales and profits.

The stock market in the United States is discounting modest Fed rate hikes. Anything more aggressive is going to rattle investor confidence. Of course, the higher growth outlook will be better for earnings, but compression of price-to-earnings multiples is likely to weigh more heavily on the market. Other factors that could unnerve markets include elevated oil prices and greater geopolitical risk.

A controlled growth slowdown with a non-belligerent Fed retiring to the background after only one or two more turns of the screw - - leaving open the possibility of future rate reductions - - is the best outcome for the markets. Otherwise we may be due for a dose of volatility, as expectations are confounded and revised.

However, it is not clear whether we will get an extended period of volatility, of the sort that will please some hedge funds, or only a few scattered phases. There will have to be sharp changes in major macroeconomic variables such as GDP and inflation to get the first outcome. The last time that we witnessed that sort of change was in the year 2000.

The dispersion of sector returns were high back then, but have diminished in recent years. Placing major bets on either defensive or aggressive sectors requires strong cyclical moves in the economy, which we have not seen in a good while. However, there are opportunities in shorter-term swings. At the same time, it is also possible to take advantage of market moves, as risk appetite waxes and wanes and investors reach for riskier or less risky assets.

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