Weekly Perspectives

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A Weekly View of Global Economies

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North America
A fall in oil prices, combined with a couple of upbeat economic numbers out of the US, has helped to give a lift to the equity market. But don't count on a firmer trend and a decrease in volatility, as the market tries to get a better fix on the economic outlook.

The latest data on oil inventories in the United States puts them at the highest level in six years. Meanwhile, the president of Opec stated that the cartel will continue pumping at the current high rate. In addition, a report from the International Energy Administration said that oil demand growth had eased in China and the US in the first quarter because of slowing economic activity. Putting it all together, it means that supply shortages are unlikely, and oil prices should continue to trend lower.

There was little surprise that oil stocks tumbled. A correction was expected, even though the industry will still be capable of decent earnings at prices well below current ones. Stocks fell in all markets because this is an international business, and sector effects are large. In other words, oil stocks are highly correlated and there are relatively limited gains from careful stock picking.

Other than oil, commodities in general are showing further weakness. The CRB index of seventeen commodities fell 2.2 percent last week, and has dropped 9.1 percent since reaching a 24-year high in mid-March. The fundamental supply/demand situation is no longer favourable to higher commodity prices.

Meanwhile, the dollar's strength is also prompting investors to take profits in dollar-denominated commodities. Speculative long positions are being unwound. As for stocks in the 'basic materials' sector, they are taking a bashing - - none more so than metals and miners. When the business cycle turns down it is normal to see this sector under-perform.

The greenback is showing quite a lot of vigour against a range of currencies. Investors have shifted their focus from the current account deficit problem to the relative strength of the American economy. It may be slowing down but it is still outperforming the European and Japanese economies. However, any downbeat economic data coming out of the states will curb the dollar's rally.

The US trade deficit narrowed in March. The result was better than expected and helped to temper some of the worries about structural imbalances. However, the data was biased upward by a sharp rise in civilian aircraft exports that are unlikely to be repeated. There was also a fall in imports. The net result is that first-quarter GDP growth is likely to be revised higher. Meanwhile, other data releases have painted a less rosy picture of the forward outlook for the economy - - wholesale inflation ticked up and industrial output fell

US retail sales figures were on the strong side and allayed fears that American consumers are about to retrench. At the same time, it appears that they are in a sour mood, as indicated by disappointing data on consumer confidence. Meanwhile, Wal-Mart, which accounts for good chunk of retail spending, wasn't in tune, reporting earnings that were worse than expected. Analysts put this down to poor management execution and slow international sales. Target, which is largely in the same category as Wal-Mart has been doing fairly well.

Tech stocks have been outperforming, of late. In part, this is because investors rotating out of hard-hit cyclicals, such as materials and industrials, - - or overbought defensive sectors - - are putting money into technology. Another reason is that they are looking forward to the end of the Fed tightening cycle, because the tech sector normally does well when the Fed is done.

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The problem with this view is that if the economy does show more vigour, and inflation surprises on the upside, policymakers will be forced to tighten more than expected. And this could be tough on cyclicals, including technology. In the tech sector, it is still a safer bet to keep betas low.

Hedge funds have been hogging the headlines again. There are rumours and reports that some big names are feeling pain. In the recent spate of volatility there has been opportunity aplenty to lose as well as make lots of money. It is quite likely that some funds are limping badly, but it is tough to tell if there is sufficient damage to pose a systemic risk to the financial system.

The best bet is that fears may be exaggerated, as the biggest funds have made considerable efforts to improve their risk management systems in the past few years. And, hopefully, banks have learnt a lesson about lending to over-leveraged hedge funds.

Still it is not beyond the realm of possibility that in their craving for better returns some managers may have chomped on more risk than may be warranted in volatile conditions. The markets reaction has been in the direction of greater risk aversion regarding some firms in the financial services sector, particularly investment banks with big proprietary trading desks. Corporate yield spreads have also moved to account for greater perceived risk.

Europe
The Eurozone economy continues to look weak and hopes for a stronger recovery still depend on robust export markets, a fall in the euro, moderation in commodity prices or easier monetary policy. The ECB is unlikely to ease. So the impetus has to come from the first three factors.

Asia/Pacific
Japan's economy grew twice as fast as consensus estimates, in the first quarter. But the news didn't help put a floor under a falling stock market. Deflation worries are countering growth hopes.

Bonds
The US bond market appears to be doubtful about stronger economic growth. Treasury yields have been moving lower even when the data has been upbeat. At the same time, Treasuries have been supported by risk-reduction trades out of corporate bonds, as well as demand from hedge funds smarting from CDO problems.

Currencies
Hopes for a renminbi revaluation have been dashed again, as Beijing refuses to budge under international pressure. The yen was hurt as a consequence, and continued to lose ground versus the dollar. Apart from its perceived link with the renminbi, the Japanese currency is showing weakness because investors are unconvinced about an economic recovery. Meanwhile, the commodity currencies have been looking for a floor after experiencing strong selling pressure. Sterling is also hurting, on account of weak economic data.

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