

# Weekly Perspectives

Website: [www.lomam.com](http://www.lomam.com)

Email: [info@lomam.com](mailto:info@lomam.com)

[iraj.pouyandeh@lom.com](mailto:iraj.pouyandeh@lom.com)



## A Weekly View of Global Economies

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Currently, the global economy is showing only modest signs of slowing down. A good forward-looking pointer of economic activity, the total OECD leading indicator, has paused and is no longer falling. At the same time, the global purchasing managers' index appears to have perked up in the past two months, after bottoming out.

As for the Baltic dry index, which is an indicator of trading volume, it has been picking up since October. Also, global industrial production, that includes North America, Europe, Japan, China and Brazil, is holding up well and hasn't lost much momentum, on a year-over-year basis.

Commodities, though, have lost some of their shine. The broadly-based Rogers index, has managed to pick up since bottoming out in October, but hasn't been able to rebound aggressively since then. Metals, as represented by the London Metal Exchange index, are still trending higher but have been losing momentum in the past few months. Of course, oil has been the big story, with prices falling substantially since mid-year but appearing to have stabilised since October. It was, principally, oil that took a chunk of change out of the Rogers index.

Gold has been range-trading since June and has found it difficult to break above the \$650 resistance level. It is tracking the trade-weighted index of the US dollar quite closely, with a weaker greenback tending to support higher gold prices. As for the yellow metal's relationship with the EUR/USD exchange rate, on a rich/cheap basis, it is currently looking somewhat cheap.

But inflation worries aren't prevalent enough to really fire up the gold market. Using the G3 data (US, Europe, Japan) as a representation of core global inflation, it certainly isn't getting out of hand, though it is trending modestly higher. Much the same can be said about China's headline inflation.

Given all this, does the slowdown story still hold water? The answer is that if the pace of growth maintains its momentum then inflation could become a problem and force stronger action from reticent central banks. Thus far, their bark has been more impressive than their bite and this has increased investor appetite for riskier asset classes.

It was, of course, the central banks who provided the substantial increase in liquidity that has driven many asset prices higher over the past few years. And now they are playing the game of trying to fine-tune a slowdown. We hope that they will get it right, but normally this is a difficult thing to achieve.

Of the major economies, the United States is probably the one that is most susceptible to things not working out according to plan. Judging by the evidence presented by the latest data, weakness in the housing sector has spread to manufacturing, although the non-manufacturing sector is still holding up.

Fortunately, consumer spending has been lifted by declining oil prices. At the same time, the labour market is still moderately tight, with only a few recent signs of softness. This has helped to shore up disposable income even though real wage growth had been weak. As for consumer confidence,

the Conference Board's index is trending sideways, neither gaining nor losing momentum.

The Institute of Supply Management's manufacturing index is falling, along with the "new orders" index. However, the ISM's non-manufacturing indicator is still looking strong. You can look at this in two ways. Optimistically: that the economy is showing some resilience. Pessimistically: that the weakness hasn't spread that far, yet.

There are indications that corporate margins are under pressure, despite the recent downward revision of unit labour costs. Margins are now at an average level, having gradually come down from expansive cyclical highs. However, they also appear to be trending lower.

Longer-dated bonds are expensive in all the major markets, and yields have generally been declining recently. Essentially, investors are pricing in a weaker economy in 2007. The slope of the Treasury yield curve, as measured by the spread between the ten-year note and the three-month bill, is negative. Normally, this is indicative of a coming slowdown. As for the G3 yield curve, it isn't negative but very flat, nevertheless.

Frankly, global monetary conditions still aren't that tight. There are some pools of liquidity available that haven't been drained yet. And the real cost of funding isn't high enough to discourage borrowing. More than one observer has noted the healthy pace of mergers and acquisition activity, which doesn't happen if money is really tight.

Lower oil prices, comfort with monetary policymakers' stance, and M&A activity have been driving stock markets for the past few months. Many observers would agree that markets are overbought and overextended, on a short term basis. But, from a fundamental viewpoint, expensive bonds make stocks look relatively attractive. A correction in the bond market would, however, change the balance.

For the US market, equities are favoured if we compare the S&P 500 earnings yield with the ten-year bond yield. We come to the same conclusion whether we use real or nominal bond yields. At the global level, stocks are also favoured relative to bonds, in a comparison of earnings and bond yields.

Not all equity markets have been hot. Japan has been a notable exception. There is not enough space here to examine the issues in detail. But, essentially, investors have yet to make up their mind whether domestic demand is strong enough to place the Japanese economy in a takeoff stage. Meanwhile, any uncertainty about the sustainability of global growth is reflected in the stock market as exporters are, by turns, in or out of favour.

**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.*



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

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