

Weekly Perspectives

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A Weekly View of Global Economies

18 January 2005

North America

The US economy is entering a period of slower growth but continues to be the main driver of global activity. This poses a problem centred on the imbalances created by the wide current account deficit. If the American economy advances at a faster growth rate than its principal trade partners, there is a high likelihood that its exports will struggle to keep pace with imports. Closing the trade gap will be difficult under these conditions.

Differences in relative growth rates are far more important in determining the size of the current account deficit than currency values. A sharp pickup in GDP growth in Europe and Japan would do wonders in reducing the US deficit. Unfortunately, that is definitely not in the cards this year.

In a market economy, imbalances are corrected by price changes, and this includes foreign exchange and interest rates. However, in reality, things don't work out as simply as that because for institutional, political and structural reasons some prices are inflexible. In addition, authorities may act "irrationally", from an optimising market-adjustment point of view.

If authorities everywhere allowed greater flexibility in quantity and price adjustment on an economy-wide basis, and Asian central banks reduced their holdings of US dollar assets, we would get a substantial correction of current account imbalances but also a nasty bout of global recession.

So policymakers subvert market forces, try to avoid disruption, and muddle through, hoping that everything hangs together until global growth is better synchronised. In the meantime, the greenback is susceptible to experiencing further weakness, even though there is not much growth that the US can garner from Europe and Japan via currency depreciation.

However, we shouldn't be looking for further big slides in the dollar's value. The greenback's nominal TWI (Trade Weighted Index) is hovering in as low a range as it has reached in the past twenty five years. On a statistical basis, there is an argument for a tendency towards mean reversion. There is a potential, this year, for the dollar to stage a recovery.

American policymakers are particularly keen that the adjustments to output should take place, not by US growth coming down to European and Japanese rates but for the latter two regions to boost their domestic economy to US levels. This outcome is obviously better for the global economy than a recession. But we should also note that with a skimpy welfare system and few safety nets, the United States cannot tolerate extended periods of slow growth similar to Japan and Europe.

The decline of the dollar has also increased the chances of an upside to inflationary pressures in the US, via the possibility of rising import prices. Meanwhile, slowing productivity growth and the feed-through of relatively high energy prices may boost inflation if consumer spending does not slacken off.

An increase in inflation poses significant risk for bonds as well as the stock market. It may force the Fed into a more aggressive stance, with repercussions for global interest rates. So we should be watching both the US and China, the global growth leaders, for signs that their growth rate is indeed slowing down as expected, otherwise conditions may be ripe for inflationary tendencies to take hold.

Europe

In general, UK retail sales were on the weak side during the holiday period. Also, there is a softening trend in the housing market. But this

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doesn't mean that the British consumer is about to retrench. A study done by the Bank of England, last year, found that the correlation between house prices and consumer spending is lower now than it was in the past. At the same time, household disposable income is still growing at a decent rate. As for other economic data, they are rather mixed, but point to a soft landing for the economy.

Asia/Pacific

Foreign investors are showing more interest in Japanese stocks while locals have recently been a bit reticent about putting more money into overseas bond markets. This has helped to push the yen higher against the dollar. The Ministry of Finance has refrained from intervening in currency markets for a good while now, and traders are speculating that the MoF will stay out in order to avoid political pressure at next month's G7 meeting.

However, the Finance Minister warned that: "As the G7 statements have been saying, currency rates should reflect fundamentals. If movements deviate from fundamentals we will act appropriately". As for fundamentals, the domestic economy is relatively weak - - though the authorities haven't lost their optimism yet - - and a lot hangs on the strength of global activity. Meanwhile, Japanese lead indicators are losing momentum.

Bonds

The Fed is on a slow-tightening trajectory and measured inflation is still low. In this environment, further flattening of the Treasury yield curve is likely. But higher inflation is a definite risk factor and needs to be watched carefully. Any signs of a sharper increase in the consumer price index may compromise the flattening trend.

Emerging-market bond spreads tightened substantially last year as investors reached for greater yield. There are risks that some of that tightening will unwind this year, because interest rates in the United States could rise faster than expected to head off inflationary pressures. Alternatively, we could experience a sharper deceleration of Asian growth and a fall in commodity prices. In either case, emerging market debt and equities are now in a higher risk category, in an environment where investors are becoming increasingly risk averse.

Currencies

Foreign exchange traders have recently been betting on Asian currencies versus the US dollar. They are speculating that greater international pressure will force an earlier adoption by China of a more flexible system for determining the value of the renminbi. Naturally, any upward move in the Chinese currency will be accompanied by a correlated rise of many Asian currencies. However, the signals coming out of Beijing point to the possibility of only a modest change in the peg this year.

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