

Weekly Perspectives

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A Weekly View of Global Economies

18 October 2005

North America

According to the latest data release, the US trade deficit widened in August. A major reason was a big jump in imports, reflecting higher prices for crude oil. The trade gap with China reached an all-time record and is likely to be a focus of concern for American policymakers.

The US deficit and the associated surplus in China constitute one of the major imbalances in the global economy, but prospects for a rapid rebalancing are slim. It will only undergo slow adjustment as structural changes take place. And slow is better than fast, as the latter could produce jarring effects on both economies.

As we have mentioned previously, China wishes to put more emphasis on domestic consumption relative to investment and exports. Policy measures are going to be implemented to that end. Over the longer-run, of course, rising income levels and consumption will, in the absence of trade barriers, result in a higher level of imports, as well as a change in its composition.

There will be an increasing emphasis on consumer goods rather than just raw materials, energy and capital goods. This also holds true for several other Asian countries. Another facet of projected trends is that, as a proportion of China's total international trade, the US market is likely to decline in importance.

But it will be many years before we will see the impact of such developments. For now, the US continues to be a major consumer in the world economy and China, together with several other Asian countries form an important group of savers. Some analysts have characterised this combination as excessive consumption in one case and over-production in the other. But this wording seems to introduce value judgements into the analysis.

There is nothing either worthy or unworthy about very high consumption or saving rates. It is just a matter of choice, given market conditions. The proclivity of US consumers for a high rate of consumption has a basis in structures and policies, and the same reasoning applies to the elevated saving rate demonstrated by many Asian households. Given the circumstances, it is unlikely that in the near future we will see major reversals in the current trends.

Of course, there is always the risk of an untoward solution to the imbalances. Under this scenario, sharp changes in interest and exchange rates result in forced saving and lower output in the United States. Any other country with such sizable deficits would be more vulnerable to experiencing this outcome. But the US has major advantages because of the size of its economy, the depth of its capital markets, its record of high productivity growth, and possessing the major international reserve currency.

While there are headwinds faced by US households in the near term, possibly forcing a slowdown in consumption growth, there are also other components of aggregate demand, in the form of government and business spending that will keep the economy going. In particular, the public sector will have a more stimulative impact on the economy.

Consumer confidence is down, but the index hasn't been a good leading indicator of household behaviour in the past. Meanwhile, expectation about the future inflation rate has been edging up. This could have implications for spending decisions as well as compensation issues; though it must be pointed out that labour market conditions aren't tight enough to give employees the edge in wage negotiations.

It does not appear that the Bush administration is contemplating any tax increases to offset the expected rise in spending from the emergency bills aimed at post-hurricane reconstruction. They have an ideological bent

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against raising taxes. So it is unlikely that higher business taxes will be found acceptable, and squeezing the consumer will only add to the headwinds they face. Also there is little room to reduce government expenditure in "non-essential" areas.

Therefore we must conclude that the budget deficit is set to deteriorate, and the funding of the increased requirements will have to be provided by global high savers, particularly in Asia. The inflows are set to continue. But the Fed is still on a tightening path and several other central banks are contemplating a more stringent policy. As global interest rates rise, so will the cost of deficit financing in the United States.

There are strident voices in Congress calling for tough economic measures against China. But there is a good deal of rhetoric in the talk, aimed at pleasing local constituencies. At the same time we shouldn't underestimate the political and economic interests involved. Often, those with a political agenda try to use economic levers to bring about the changes they desire.

As for the administration, its stance has become quite conciliatory. It's not that they have gone soft on China, but more likely it is the recognition that Chinese authorities are indeed taking positive steps to effect structural change in a variety of ways. So there is less pressure applied in the interests of forcing a sharp revaluation of the renminbi. Given the interrelationships involved, the softly approach is best for all concerned.

Europe

High energy prices constitute a near-term drag on Eurozone economic activity but data releases point to a pickup in growth, when we look further ahead. Exports are doing well, notably in a region such as the Middle East which is flush with petrodollars. Business-sentiment indices are pointing upwards and the Eurozone purchasing managers' indices, for manufacturing and non-manufacturing are both higher.

Asia/Pacific

There is a consensus forming that Japan is likely to end its period of deflation before the end of the year, and register sustained inflation (i.e. an increase in the consumer price index) for the first time in a very long while. Meanwhile, the sustainability of Japan's economic rebound will have implications for its current account balance, as well as the financing of US deficits.

Bonds

Increasing concern about the prospect of higher inflation is underpinning Treasury yields. Signals coming out of Japan and Europe are also pointing to further tightening of global liquidity conditions.

Currencies

The greenback continues to show strength against the major currencies, with the main exception being the Canadian dollar. Higher yields are evidently an attraction, and the Bank of Canada is currently the only major central bank, other than the Fed, that is raising interest rates.

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