Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com

A Weekly View of Global Economies

18 September 2006

Stock markets have had a good run, based on weakening oil prices and receding fears of stronger central bank action to reduce inflationary pressures. According to a number of leading indicators, the global economy is losing momentum, though it is still registering quite robust growth. However, central banks do face the risk that the slowdown may be too lethargic to prevent inflation from being troublesome.

Anticipating an end to Fed tightening, there is hope on Wall Street that we will see a repeat of the 1994/95 experience when the stock market started a significant bull run. Unfortunately, the conditions today are different from what they were at that time. In particular, valuations are richer and there is not much room for long-term interest rates to undergo a secular decline.

Actually, the simple trailing price-to-earnings ratio for the S&P 500 index makes the market look quite attractive, with a PE at roughly the 1995 level. But if we are a bit more discerning and use average earnings for the past five years in the P/E denominator then the market is not particularly cheap in historical terms.

Another commonly used measure to assess relative valuation is the earnings yield compared with the bond yield. This is the so-called Fed model, ostensibly because folks at that institution focus on this relationship. It is, in fact, an erroneous model because it compares a real value (the earnings yield) with a nominal one (the bond yield). A correct model should adjust the bond yield for inflation to derive a real value.

However, erroneous or not, it is widely used on Wall Street and therefore we should be monitoring it too. In this business it is wise to focus on all those things that the crowd finds interesting, irrespective of whether people are rational or not - - and, of course, to stay one step ahead of them. Assuming perfectly rational behaviour can be a costly mistake. Naïve notions of market efficiency and rationality should be confined to school books.

In examining a chart of the S&P 500 earnings yield relative to the ten-year Treasury bond yield - - over the past dozen years - - we note that, currently, stocks look very attractive compared to fixed-income investments. The model signalled being overweight bonds and underweight stocks in February 2000 and reversing that weighting scheme in October 2002. Both of them were good calls.

Since then, the model has generally called for being overweight equities. Looking more closely at the data, we see a sort of structural break in the model with two fairly distinct phases: the period up to the year 2002, and the period since that time. And the principal reason is to be found in unusually low bond yields in the latter phase. So the model is now overweighting stocks, not so much because stocks are cheap as bonds are relatively expensive.

As for current sentiment in the bond market, the Commitment of Traders Report shows that speculators are substantially net long in the ten-year Treasury bond futures contract. So they are betting on further weakness in interest rates. Commercial interests are, of course, betting the other way.

Meanwhile, risk indicators show a degree of comfort and complacency in the markets, leaving them vulnerable to correction as a result of negative surprises. The VIX index of equity implied volatility has moved lower during the second week of September. As for the index of bond market volatility, it remains stable at a historically low level.

Looking at two other contrarian indicators, they both show rising risk appetite. The Chicago Board's put-call ratio has moved lower. And the American Association of Individual Investors' bullish sentiment index has risen to a higher level.

The high yield spread over Treasuries is at the higher end of its range over the past year but has yet to break above that level. At the same time, the emerging-markets bond spread over Treasuries remains tight.

The percentage of S&P 500 stocks trading above their ten-week moving average is now indicating an overbought market that may be susceptible to a correction. So, putting all the above arguments together, the short-term outlook for the stock market may be somewhat challenging.

However, ranged against that view is the statistical tendency for the equity market to generally outperform in the fourth quarter of the year. In fact, the last three months of the year constitutes the best time to be invested in the market.

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 Equity Growth Fund.

LOM

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

Licensed to conduct Investment Business by the Bermuda Monetary Authority