Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com

A Weekly View of Global Economies

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Fourth-quarter GDP growth in Japan turned out to be better than consensus opinion expected earlier on. Consumer spending rebounded and business investment was higher, driving the strong quarterly performance that outdistanced a very weak third quarter. As a result, there was renewed speculation about central bank action to raise interest rates.

Before we can reach a conclusion about the need to tighten policy it is necessary to examine the evidence regarding the strength of the Japanese economy. A single quarterly growth figure is far from conclusive.

Looking at leading economic indicators, the diffusion index has yet to signal a turnaround in economic momentum. However, the OECD indicator is somewhat more positive, as it appears to have bottomed out and is attempting a turnaround. Industrial production is still growing at a decent clip - - measured year-on-year - - but the pace is slackening rather than picking up.

A chart of the nationwide index of consumer confidence reveals that it started trending lower after reaching a high point in April, but has now stabilised. The latest reading broke the downward trend, but we would like to see a more convincing reversal in the months ahead. Consumers appear to be cautious.

By comparison, the index based on the Tankan survey of business conditions, continues to move higher. Evidently, sentiment in the corporate sector is still quite optimistic and this shows up in the GDP report, indicating the willingness by businesses to spend on capital equipment.

At the aggregate level, corporate profits are still growing at a reasonable pace. And it appears that gross margins are holding up. At the same time, the profit share of GDP is at its highest level in the past 20 years, which leads one to wonder whether a retracement is possible.

The household sector hasn't been doing as well as the corporate sector. A good proportion of employment creation has been in lower-quality jobs, and wage growth has been slow. So, consumers have been reticent about spending until their prospects improve and they can have more confidence about the future.

In sum, the Japanese economy is still being primarily driven by the export sector rather than domestic demand. This means that we should keep an eye on the strength of global growth to gauge the outlook for Japan.

There is not much in the way of excess liquidity in the system. Money-supply growth hasn't kept up with the pace of nominal GDP growth. And velocity of circulation isn't providing an offset by rising rapidly, as it has done in some other countries.

Japan is still suffering from deflation. Core inflation is negative, although the headline number has been in positive territory since May of last year. A hopeful development is that there is a modest upward trend in the core rate, which may in due course result in an end to deflation. However, in both 2003 and 2005 the upward trend failed to breach the zero mark.

Adjusted for negative core inflation, real interest rates are obviously higher than nominal ones. As a result, creditors are favoured relative to debtors, and it pays for spenders to delay major expenditures, hoping for a lower price. This is in contrast with other industrial countries which have real interest rates that are lower than nominal ones and, given the prospect of price rises, it makes sense to spend now rather than later.

The Bank of Japan's key rate is at 0.25%, compared with the Federal Reserve's target rate of 5.25% and the European Central Bank's 3.5%. Broadly speaking, these rates are appropriate for the conditions of those economies. However, such discrepancies do give rise to investors' desire to seek profitable opportunities, known as the carry trade.

The risks posed by the carry trade have been extensively discussed in the financial press recently, which means that we do not have to repeat all the arguments. It is feared that a surprise development in financial markets could result in the forced unwinding of carry-trade positions, exacerbating volatility and imposing large losses on the participants.

It seems unlikely that a modest 25 basis-point rate increase by the Bank of Japan will roil the markets. However, prospects of a series of rate hikes could have more damaging consequences. But the Japanese economy is not showing the sort of momentum that would require such strong medicine. Still, other event risks cannot be ruled out.

It is said that the hedge funds participating in the carry trade have better risk management practices than in the past. Maybe so, but ultimately their risk relative to return trade-off is determined by the mix of leveraging and hedging that they engage in. Safe strategies generally result in modest returns, and low volatility may increase complacency.

A portion of the carry trade originates in the Japanese household sector looking for better returns than can be found at home. Housewives have been putting money into funds that engage in carry-trade activities. This is not a new role for housewives. In Japan, it is generally the case that Mrs Watanabe sorts out household finances. Hopefully, she is adept at risk management practices.

The yen has been weakening against the US dollar since December, though it has enjoyed a nice bounce recently. Its weakness against the euro has been going on for much longer, eliciting calls for a correction from European officials.

Currently, the yen's real effective exchange rate is the lowest it has been for the past twenty one years. This is a trade-weighted measure of just how competitive the currency now is, at current exchange rates. As for its relation to purchasing power parity, it is now very close to its PPP rate relative to the greenback. Since 1986 it has generally traded at a significant premium to purchasing power parity. In this context, it should be noted that we are using OECD calculations of PPP.

Looking at the stock market, its price-to-earnings ratio is low, compared to past history. Also, its PE relative to the world stock-market index is the lowest it has been for a good number of years.

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

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

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