

# Weekly Perspectives

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## A Weekly View of Global Economies

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### North America

Citigroup's earnings report certainly disappointed the Street. The financial conglomerate fell short of its revenue targets in fixed-income trading. But it is not alone in facing these problems. Other firms in the financial services sector have also found it tough to forecast interest rate trends and the yield curve slope, with untoward consequences for the bottom line.

Unfortunately, there may be more pain down the road if the yield curve continues to flatten and possibly invert. We should also note that the financial services sector has the biggest weighting in the S&P 500 index. So any earnings disappointments in this sector are likely to weigh heavily on the index. However, before the reporting season started, financials and healthcare were the only sectors, apart from energy, with net positive profit outlooks.

Consumer inflation in the US remains subdued and this has been a factor in keeping long-term interest rates range-bound at a low level. As a result, rising yields haven't become a factor in precipitating stock market declines -- a risk that has been present in previous Fed rate-increase cycles. But, if policymakers are intent on cooling the overheated housing market, then they have to continue tightening until they see some results, even though they have to be careful not to overdo it. And, this could still present challenges for stock-market valuations.

Bond yields would have to stay low, and fall some more, if they are to help shore up price-to-earnings multiples. Failing that, investors have to shift their focus to expectations of good profit growth if they are to be persuaded to pay more for stocks. Consequently, earnings reports and management guidance will be important factors in determining the equity market's direction.

It appears that consumption expenditure by US households is still fairly robust. Job creation and income growth have been sufficiently strong to keep them spending. Elevated house prices and low mortgage rates, along with recovering stock markets, have tended to offset higher energy prices.

An earlier inventory-led correction in output may have run its course, which should give firms an incentive to increase production, going forward. But it's too early to call for a reacceleration of economic growth until leading indicators have bottomed out and turned up.

Hedge funds have been struggling to put in a decent performance this year, after a pretty mediocre result in 2004. We're talking about averages here because there is, of course, considerable variation by style. For example, short sellers registered negative returns last year but are now doing quite well. And, we must add the usual warning about the poor quality of the returns data. But taking all that into account, and examining performance over the past ten to fifteen years, we can't help but notice an overall downward trend in returns.

The hedge fund business has become an awfully crowded field as both retail and institutional money has sought an alternative to traditional investment vehicles. However, there is no longer any easy money to be made by hordes of managers trying to exploit the same supposed inefficiencies. So they have to be creative and innovative without taking on excess risk -- and that is tough to do, as only a few succeed. As one unkind financial commentator put it, "There are 2000 hedge fund managers, but there aren't that many smart people in the world".

A good many of the funds being set up nowadays are by former traders at investment-bank proprietary desks who hope to implement the skills

they learned trading the banks' in-house money. Whether or not the skills are transferable, size appears to matter. Smaller start-up funds tend to do better than larger established ones, with performance deteriorating as they get bigger. Also, adaptability to changing market conditions is an important issue. A one-trick pony isn't going to last long.

One of the main contentions of the hedge fund business is that their strategies are broadly uncorrelated with the market. But that is only partly true. Some strategies are explicitly directional, while others are only partially market neutral. There are also a set of relative value strategies that depend on volatility, and would struggle in a low-volatility environment. So, for long-only investors in traditional funds, obtaining diversification via hedge-fund investments is not at all simple.

An ongoing feature of the business is the increasing presence of institutional clients relative to private money, and this trend is having an impact on the industry. Institutions want greater insight into manager strategies, more risk-management controls and better performance evaluation. Add to this increased demand from authorities for tighter regulation and you find that the dividing line between hedge funds and traditional funds is becoming even more blurred.

### Europe

The rise in oil prices has been feeding through to headline inflation in the Eurozone, even while the core figure remains subdued. Rising energy and food prices, along with indirect tax increases should continue to put pressure on the headline number. As a result, it is unlikely that the European Central Bank will contemplate easing monetary policy despite generally weak reports on economic activity.

### Asia/Pacific

Decent growth in the US is good news for the Japanese economy. At the same time, domestic demand is showing some signs of life.

### Bonds

Investors are already factoring-in a positive growth outlook by Greenspan before he presents his semi-annual report to Congress. Meanwhile, there has been good demand for 10-year Treasury notes as yields have edged higher. However, traders are looking closely for any indication of a tougher stance on monetary policy.

### Currencies

Hopes of continuing interest rate hikes in the US are keeping sentiment dollar-positive, with the greenback doing well against a number of currencies. Meanwhile, Germany's ZEW survey of investor confidence rose sharply, helping to support the euro from further weakening. At the same time, there are rumours that central banks, hoping to diversify their substantial dollar holdings, have been buying euros, thereby preventing it from a sharper correction.

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