

# Weekly Perspectives

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## A Weekly View of Global Economies

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### North America

Thus far, third-quarter earnings reports haven't been sufficiently inspiring to fire up investor enthusiasm. What's more, the outlook for Q4 and 05 earnings growth is somewhat cloudy. Guidance is fudgy and firms are hesitant about making optimistic forecasts about the future.

There are a number of issues that are introducing an element of uncertainty into the outlook. Oil prices are refusing to come down rapidly, the Iraqi situation is as dodgy as ever, a Bush election victory appears less assured if we are to believe the polls, and forecasting which way China's growth is heading is tougher than ever.

Oil prices - still susceptible to event risk - have gone up rather than down over the past two weeks and this adds to concerns about a growth slowdown. The current price decline is helpful and equity markets have reacted positively, but we still need a bigger downward trend for corporate margins to get some relief. Last week, Greenspan was fairly cheery about the outlook, counting on the robustness of current economic structures to withstand energy price increases, compared with what happened in the past - namely, a nasty outcome in the form of a recession.

However, not everybody shares this optimism, though few are forecasting a recession. In particular, the bond market appears to be less convinced about economic growth prospects than the stock market. The longer oil prices stay at high levels, the dicier the growth outlook becomes. We would need further downward correction from recent highs to give equity markets a shot in the arm.

Meanwhile, US households have yet to feel the full impact on their finances, as winter approaches and heating bills have to be paid. At the same time, the large trade deficit that widened in August to the second highest level on record is dampening expectations about the strength of third-quarter GDP growth.

The polls currently show that the two principal presidential candidates are neck-and-neck in voter intentions. But we still think that Bush has the edge. He can play the security card and the "war on terror" issue more effectively than his opponent. This counts with the older and more conservative crowd that vote in larger numbers than the younger and poorer sections of the electorate. Most voters don't want to struggle with complex issues; they want to have their fears assuaged.

The quality of Chinese economic data has never been good, so that it is not easy to tell how hot or cold the economy is at any given time. Right now, the latest indications are that the economy is not slowing down as fast as expected. Indeed, some indicators of activity, such as foreign direct investment appear to be picking up, along with production in certain basic-materials sectors. If this is true, then it has implications for how far commodity prices need to correct in the short run.

Normally, in this phase of the business cycle when a slowdown in the economy is expected, a traditional ploy is to overweight defensive sectors. The problem is that this time around two of the major defensive sectors, consumer staples and healthcare have been handing investors whacking bad returns relative to the market index.

Take healthcare, in which the pharmaceuticals sub-sector figures large. Drug companies have been under a cloud for a good while. Their new-product pipeline is drying up, even as generics begin to squeeze margins on off-patent brands. At the same time, there is an impending threat of regulatory price controls, as healthcare costs soar.

Merck's problems with Vioxx made an already bad situation worse and hurt the entire sector, which is, nevertheless, poised for a short-term bounce from oversold conditions. Be it noted, though, that the industry still faces significant structural problems and investors are hesitant to commit.

As for the consumer staples sector, we previously mentioned the challenges they face regarding price competition and margin compression. So it is little wonder that, with defensives such as these, fund managers are willing to take a bit more risk in growth sectors, even though in terms of cyclical indicators this may be somewhat counter-intuitive.

### Europe

Europe has outperformed the US, year-to-date, as measured by the performance of the DJ STOXX 600 relative to the S&P 500. This is so, in both local currency and USD terms. Also, valuations are generally more attractive in Europe. Meanwhile, fund managers appear to be warming up to the region.

### Asia/Pacific

The current relief from record-high oil prices is helping to lift Asian equity markets, including Japan. However, the clouds haven't dissipated entirely because of doubts about the strength of global growth.

### Bonds

The bond market's concern about a growth slowdown appears to be greater than its fear of inflationary pressures. Meanwhile, there are signals from Fed notables that they are prepared to pause in the rate-increase cycle if economic data are on the soft side. It also appears, in the latest data release, that foreign investors pared their purchases of US bonds in August relative to July. But the "old news" didn't weigh too heavily on Treasury prices.

### Currencies

Mixed economic data, Stateside, weren't strong enough to support the dollar versus the euro. In addition, the wide trade gap and evidence of slower portfolio inflows into the US turned sentiment against the greenback.

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