# Global Perspectives


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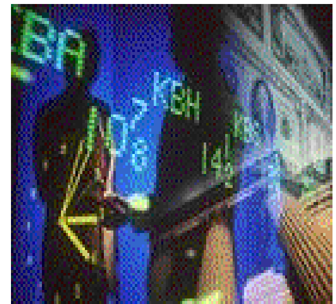

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Growth in the Eurozone is holding up well, boosted by a fairly robust German economy. The latest data on the unemployment rate and business confidence in Germany paint a positive picture. For the single-currency region as a whole, sentiment indices and the jobless rate also look good. Meanwhile, the UK economy has shown more strength than expected and consensus betting is for another interest-rate hike by the Bank of England.

As for the European Central Bank, given the pace of money-supply growth and rising core inflation, it is unlikely that the ECB has stopped its rate-increase cycle. The president of the Bank, Jean-Claude Trichet, has rightly noted that monetary policy remains accommodative.

Over in China, the authorities have tightened monetary policy again to rein in the economy's runaway pace. The idea is to bring growth down to a targeted eight percent annual rate to prevent the economy from overheating. Thus far, the incremental tightening hasn't had much of an impact but, more recently, preliminary signs of growth moderation have surfaced.

One of the government's policy intentions has been to shift aggregate spending from capital expenditure to consumption, and there is growing evidence that this is happening. In the longer run, the goal is to rely increasingly on domestic demand rather than exports to drive growth. Another objective is to diversify export markets.

The government has set up an agency to handle a portion of China's massive foreign exchange reserves. It is evident that US dollar holdings are very large, and diversification into other currencies is likely. In addition, the new agency's goal may be to diversify out of government securities and into other financial as well as real assets. As for the renminbi, it is difficult to run a tight monetary policy while simultaneously trying to maintain a pegged exchange rate. They have to work very hard at sterilisation of money supply created via implementation of exchange-rate policies.

Domestic demand in the Japanese economy continues to be lacklustre, with exports expected to compensate for slower growth at home. So any slowdown in the global economy will compromise Japan's prospects. On the question of monetary policy, the central bank's stance remains cautious. But steps towards a normalisation of interest-rate policy do make sense, even if the economy isn't particularly strong. And some policymakers are beginning to understand the reasoning.

The household sector is a big saver, and a buyer of interest-rate products. Higher rates would help in boosting disposable income. In the meantime, the Bank of Japan's ultra-low interest rate policy has been a factor in the flood of liquidity that has been driving global markets in recent years. A move towards normalisation will hurt many strategies, including the carry trade.

Global investors continue to focus attention on developments in the US economy. The reason, of course, is that there are more downside risks in the United States than in other major economies.

Ben Bernanke is getting flak again for mixed messages coming from the Fed. The March 21st statement, released after the FOMC meeting, appeared to open the way for interest rate cuts, sending the stock market into party mood. Then on the 28th of March, appearing before the Joint Economic Committee of Congress, the Fed chairman emphasised the threat of inflationary pressures, which made equity investors very nervous.

Bernanke's problem is that we are getting both a softer economy and sticky inflation, and being a data-dependent guy he flits from one issue to the other, according to how the data releases stack up. Plus, he has to address many audiences, on Wall Street, Main Street, in the corporate world and Washington. The messages are pitched to have some appeal to all of the above.

Evidently, the housing market is still in the process of undergoing a correction, which will be a drag on the economy for several more quarters. This is consistent with previous historical experience. The cheery crowd, who called a bottom in the housing market last November, had obviously lost their sense of history.

Recent data on the state of the US economy have been pretty gloomy. However, the Chicago Purchasing Managers Index was a bright spark, spiking sharply higher. The jump was unusual because it has been trending lower for about a year. As for the housing market, February new home sales fell 3.9%, following a 15.8% decline in January, even as unsold inventory jumped to the highest level since 1991.

Meanwhile, the Conference Board consumer confidence index fell. But what is notable about this index is that the 'expectations' component is showing greater weakness than the 'current situation' component. And it is the former rather than the latter that has a greater correlation with future economic activity. Elsewhere, recent data on consumer spending indicates that petrol prices are biting again.

The durable goods report was weaker than expected. But it is consistent with weakness in business capital spending. This trend has been evident for a while but it has only recently become a focus of attention. The large cash balances that corporations have built up via retained earnings and higher borrowing has found a use in stock buybacks and M&A (mergers and acquisitions) rather than capital investments.

Business spending is correlated with job creation. So the weakness in capex will eventually be reflected in softer employment conditions. Another thing to note is the high inventory-to-sales ratio. If this is the result of unanticipated inventory accumulation, then we should expect lower future production, in order to work off the excess stocks. A combination of slower business and consumer spending may result in several quarters of growth that is well below trend.

Slower productivity growth and rising costs will put pressure on corporate profit margins. They will also be a factor in causing sticky inflation. The upcoming earnings-report period is likely to provide more disappointments than usual unless analysts revise their estimates downward, beforehand.


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