

# Weekly Perspectives

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## A Weekly View of Global Economies

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### North America

The previous drift in the US stock market has now turned into a down-drift. Investor reaction has been unenthusiastic, despite a goodly number of companies beating earnings expectations. They may have sensed that earnings momentum is past its peak. As for the forward-looking guidance issued thus far in the reporting season, it has been less than inspiring. In particular, there has been nothing of a sufficiently positive nature to lift technology stocks. Meanwhile, economic data releases haven't been hot enough to fire up investor confidence in a stronger economy.

Greenspan is delivering his semi-annual testimony before congressional committees, this week. It promises to be long on old talk about gradualism and short on any new ideas or statements that may possibly rattle somebody's nerves. People are getting tuned-in to the idea of a slower economy and a cap on inflationary pressures, and a reading of recent statistics appears to be confirming the trend. The Fed chairman would like to reinforce the impression that he is steering the economy in the right direction - - not too hot, not too cold.

There has been an underlying concern among analysts that higher aggregate demand could boost corporate pricing power. As wages increase in a slower-productivity-growth environment, this would put pressure on unit labour costs, forcing firms to protect margins by raising prices and - - voilà - - you have the makings of an inflationary spiral. But if the principal actor in this story, namely the consumer, slows down her spending, then inflationary pressures are likely to dissipate, as slower sales growth limits firms' ability to hike prices.

However, there is a bit of complication in all this. In the past, American consumers have shown a strong inclination to continue spending excessively, by taking on an ever bigger debt load. At present, US households do face a number of headwinds that should result in retrenchment. But if Greenspan is too soft on raising rates, this may provide them with encouragement to continue their leveraging practices a while longer.

If this scenario unfolds, it may ultimately force the Fed to become more aggressive, as fears grow that it is behind the curve. At which point, the overleveraged household will be smacked with rapidly rising rates, and a hard landing ensues. Meanwhile, there are indications that the carry-trade crowd have overcome their previous fears of forceful Fed action and are back in the game again. And why not, when there is profit to be made. The fleet-footed ones are reasonably adept at judging the risks and unwinding their positions if the wind turns - - but not all of them are so clever. So, in sum, the present policy of gradualism is not without risk.

Switching over to a prescriptive rather than a descriptive analysis of Federal Reserve policymaking, we must say that we are not fans of central bank fine-tuning efforts. The record shows that they are not good at forecasting the economy. So, yanking the levers of monetary power to steer the economy to a desired state, more often than not, leads eventually to greater instability. It would be far better for the economy, as well as market players, if the authorities stuck broadly to neutrality in monetary policy - - adjusted for financial innovations. Their excesses are not costless. There is a price to pay, down the road.

Some of us have had enough of central bankers grandstanding for the media, pretending not to be constrained by limited knowledge and information, and playing on market sentiment with their often manipulative, pronouncements. What we need are dull and impartial

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administrators of a neutral policy, who keep out of the way but are ready to step in if there is a case of financial distress that threatens to cause systemic failure. Best of all, they would be prevented from promoting bubbles.

A downsized Fed would be a boon for efficiency. People who take economic and financial decisions will bear the risk of those decisions. They will pay a lot more attention to risk management, rather than disregarding it in the hope of being bailed out by monetary authorities if things unravel. And there will be less noise in the markets, as the incessant chatter about the Fed ceases. But it is too much to hope for such a rational world. There are too many people with a stake in perpetuating the current imperfections.

### Europe

Eurozone growth is still, primarily, an export story. Rising demand in foreign markets hasn't fired up domestic activity. Employment creation has been slow to occur, which means that the slack in the labour market is keeping a cap on wage growth. That's good for the corporate bottom line and also for keeping inflation under control. It may also keep the ECB interest rate hounds at bay. They should, for now, be satisfied with the tightening of monetary conditions caused by the rise of the euro since its lows in May.

### Asia/Pacific

Japanese consumer sentiment, as measured by the Cabinet Office's consumer confidence index, fell in June. Changes in confidence have a fairly close correlation with spending growth, so it is hoped that the recent fall is merely a temporary slip in the generally upward trend of the index. Meanwhile, small-business sentiment has been hurt by the planned merger of the two big banks: MTFG and UFJ. The latter is a big lender to smaller firms, who may be worried about possibly negative effects from the proposed rationalisation. However, the overall impact of the merger is expected to be positive, by speeding up the disposal of nonperforming loans and strengthening the financial system.

### Bonds

Somewhat wimpy economic numbers on retail sales and core consumer inflation, last week, led to a rally in Treasury prices. The market chatter is now about a "measured" pace in Fed rate hikes, and it is waiting for direction.

### Currencies

Another batch of soft economic data has continued to weigh on the dollar. However, speculators have now built up large short positions in the greenback versus the euro and, as a result; there could be a modest dollar bounce in the near term. Overall sentiment, though, is still negative. There is the wide current account deficit to think about, and indications of diminishing foreign willingness to finance it.

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