

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Concern about an upside to inflation risk has increased in the aftermath of Hurricane Katrina. But, the economic impact of the storm has merely exacerbated untoward trends in inflationary pressures that were already in place. A few months ago, leading indicators were starting to signal a pickup in activity, amid tightness in the supply/demand balance for energy products.

As for the major component of costs faced by firms, namely those associated with labour inputs, the trend is in an upward direction. Looking at the latest data, and using the most common measure, unit labour costs in the United States increased 4.2% year-on-year, in the second quarter. In addition, there is a tendency for upward revisions of initial estimates made by government statisticians.

Some materials prices, particularly those related to the post-Katrina rebuilding effort are rising. Also, energy prices continue to face upward pressure because of lingering worries about supply. The jump in natural gas prices in August, as well as high oil prices, will be feeding through into end-use and intermediate-goods prices.

Surveys conducted by Philadelphia and New York Federal Reserve banks indicate that firms are facing price increases. Not all firms have pricing power, but for those who have it, there is an inclination to pass on cost increases in order to maintain profit margins.

The price of gold has risen sharply over the past two weeks. Some of it is driven by short-term speculation but there also appears to be an underlying concern about the risk of rising inflation. Recently, gold prices have continued to increase despite some short-term strength shown by the greenback.

There has been renewed focus on an old relationship, namely the ratio between the price of oil and gold. But one cannot put too much reliance on this ratio in the current environment. It only works well when inflation is high and there aren't too many alternative hedging instruments offering protection against the erosion of value. This was true in the high-inflation period of the 1970's, before Greenspan's predecessor, Paul Volcker, brought inflation down sharply by implementing an extremely tight monetary policy.

Reconstruction in the Gulf Coast region will be expensive for the American government and is expected to add substantially to the budget deficit. The US twin deficits and the associated global imbalances are likely to re-enter into investor calculations, with implications for the dollar and interest rates.

Europe

The German elections produced the worst possible result from a reform point of view, namely a hung parliament. Both Angela Merkel, the conservative challenger from the Christian Democratic Union, and Chancellor Gerhard Schröder of the Social Democratic party were left claiming victory and the right to form a new government. The stalemate is a prelude to protracted coalition talks aimed at forming a workable government. There is going to be lots of haggling and maneuvering before an agreeable compromise can be worked out.

The CDU performance in the elections was worse than expected and this has diminished Angela Merkel's authority. It has been suggested that some voters tactically abandoned the CDU to vote for the FDP, which is a liberal party to the right of the CDU and even keener on reform. But the outcome is that a coalition of the two right-wing parties does not have a

sufficient majority and would need to team up with another partner to form a government.

Several combinations are possible, but from a reform point of view the so-called 'Jamaica coalition' (the colours of the three parties match those of the Jamaican flag) between the conservative CDU, the liberal FDP and the Greens is the best outcome. A 'Grand coalition' between the CDU and Schröder's SPD is likely to lead to lots of negotiation over reform proposals and a watering down of the agenda for implementing structural change.

The outcome of the poll shows the extent to which the German electorate is attracted to, but also repelled by, the agenda for reform. There is a recognition that the system of consensus decision making and the extensive welfare state are under threat from the forces of globalisation. But there is also great reluctance to give up the comforts and the protection. Germany is still a rich country even though it is falling behind in the growth league. The German frustration is not unique and is shared to a greater or lesser extent by some other European countries.

At the same time, the entire discourse about growth rankings and globalisation contains implicit value judgements that more is better. And, from an efficiency point of view it is possible to demonstrate that this can be the case, though there are obvious detracting factors such as the unequal distribution of the benefits and the incidence of negative externalities.

But voters are not merely economic calculating machines. They also make political and social choices, and optimal economic efficiency may not be at the top of their priority list. In terms of a collective choice, they may opt for more leisure at the expense of slower growth. Of course, it is not as simple as that. The capitalist system is global and imposes its rules far and wide, including on German firms which have to compete globally. There are tough choices to be made.

Asia/Pacific

Consumer spending in Japan is looking healthier, and sentiment may be improving, on the back of better employment growth. At the same time, capital spending by the corporate sector is on the rise. So there is greater hope of self-sustaining growth in coming quarters. Meanwhile, expectations are building for the demise of deflation by the end of this year.

Bonds

Concerns about inflation are creeping back into the bond market and Treasury yields are moving higher as a consequence, particularly for longer-dated issues. There is a modest steepening of the yield curve.

Currencies

The outcome of the German election obviously weighed on the euro. At the same time, with the Fed still on an interest-rate-hike path there may be further short-term support for the greenback. But investors should keep an eye on the twin deficits in the US.

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