

Weekly Perspectives

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A Weekly View of Global Economies

21 February 2006

US economic growth is fairly robust and it looks like the Fed will have to put in a bit more effort than consensus thinking was calling for, earlier in the year. Oil prices, which constituted a major threat to the forward outlook, have been retreating and this should reduce headwinds faced by consumers. Barring supply disruptions and political-risk factors, there is little reason for oil prices to spike up to January highs.

Last week, Ben Bernanke, the new Fed chairman indicated that he was leaning towards more tightening -- just enough, but not too much. There was really nothing in what he had to say that wasn't already priced into the market. Of course, he was super careful in saying things that would be well received by the markets. This was his first major testimony and he needed to build up lots of confidence in a sound stewardship. Well, the average opinion on the Street was that he passed his first test. Needless to say, these are challenging times and there will be plenty of occasions for him to be tested again.

As we have said before, at this stage of the game, policy is going to be very data driven. The Fed will not take a proactive stance but monitor economic activity and adjust interest rates by increments. However, both growth and inflation have been on a firmer trend, forcing policymakers to raise the fed-funds rate to head off a possible rise in inflationary pressures.

A term that has been making the rounds in the financial press and elsewhere is 'helicopter Ben'. For those who may have forgotten, this is how Bernanke was referred to, a good while back, when the Fed was in easing mode and there was fear of deflation in the air. There were worries that the economy would fall into a liquidity trap, such that attempts to lower already low interest rates would have minimal impact on output.

In an article, written at the time, Bernanke proposed alternative means for monetary policy to have an impact on activity. Dropping dollar bills from helicopters is a way of summing it up in a graphic manner. Actually, the phrase 'helicopter money' is of older vintage and is often attributed to the monetarist economist Milton Friedman.

Well Ben's past proclivities aren't worrying the markets too much, right now. If the chairman has to tighten policy to head off inflation, there is a good deal of confidence that he will do so. But it is also well to remember that policymakers in the United States have had a greater inclination to promote growth than their counterparts in Europe and Japan. If it becomes necessary to prevent a major slowdown or a potential recession they are likely to increase liquidity substantially.

The current expectation is that the housing market will be de-bubbled slowly, avoiding a sharp contraction. So far, things have been proceeding according to plan. However, in the event that a bust appears to be developing, the Fed will not hesitate to reverse course and pump liquidity into the system. A significant stock market slump is also likely to bring about the same response. In this sort of scenario a twist in the yield curve will upset many interest rate forecasts.

Speaking of yield curves, the current shape of the Treasury yield curve is a source of worry to some and, simultaneously, of little concern to others. Bernanke has situated himself squarely in the latter camp. One would hardly expect him to do otherwise, given that a flat-to-inverted curve has historically presaged the approach of recessionary conditions.

In the past, the slope of the yield curve has commonly been regarded as a good leading indicator of economic activity, as well as the fortunes of the stock market. A steep slope was deemed to predict a pickup in the

economy, while a flat yield curve was supposed to presage slower times ahead. And worst of all, an inverted curve (when short rates are higher than long ones) was believed to forecast a recession.

But not everybody is referencing the same curve, by which we don't mean the distinction between the swap and the Treasury curve but the selection of end points. Some analysts focus on the two-to-ten year portion which, at the time of writing, is inverted and could be interpreted as signalling trouble ahead. But a better range selection would be either the three-month T-bill or the fed-funds rate relative to the ten-year bond.

The latter definition appears to have a better record in forecasting the economy than the previous one. And, at the present time, this curve is flat, suggesting slowdown rather than a recession. In addition, the current context is somewhat different from preceding instances of flattish curves. For one thing, real interest rates are relatively low. For another, foreign participation in the government bond market is bigger than ever before. Low foreign interest rates, as well as the need to invest large dollar reserves have fuelled the demand for Treasuries, keeping the yield curve flatter than normal.

Certainly, in some quarters, there is an underlying concern that at some point appetite for US-dollar assets will fall, particularly among Asian central banks. However, there is no indication that there is likely to be a precipitate move out of dollars in the short term. Among the obvious calculations is that it will damage the economic interests of Asian countries.

On a longer-term basis there is going to be a trend towards diversification. A faster pace of growth in domestic demand, as well as more inter-Asian trade may gradually reduce the relevance of the current model, based on over-production in Asia and over-consumption in America.

Currently, China's trade deficit with the US and the value of the renminbi are garnering attention. The Americans are increasing pressure on Beijing to allow its currency to rise against the dollar. But it is not clear that this will do much to close the bilateral trade gap. Part of the deficit is a consequence of outsourcing by American companies, whose production facilities located in China export the output back to the United States. China has a competitive advantage across a wide range of industries and is moving upscale all the time.

There aren't that many American products for which there is big demand in China. They would particularly like to import high-tech products and military goods. But Washington has a strict ban on selling that stuff and is strong-arming Europeans to do the same. So apart from basic materials and some industrial goods, we are left with "luxury" consumer goods. However, there isn't much demand for it until China switches to a more consumer-oriented economy, which is going to be a gradual process. And, then again, Europe may have the edge in that category

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