

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Crude oil prices have provided another nasty surprise, accelerating past highs registered in March to reach a new peak for the year. Once again, there are worries that supply may not be sufficient to satisfy demand. An inventory drawdown, rising demand for petrol/gasoline and a discouraging communiqué issued at the recent Opec meeting have all combined to push prices higher.

Last week, Opec members agreed to increase their production quotas, but that decision merely aligned the official figure with actual output. In other words, there isn't going to be much in the way of a real increase in production to meet pressing demand. The cartel's notables also pointed out that the problem is not so much a shortage of crude supply as a constraint in refining capacity.

It appears that demand for products such as jet fuel, diesel and heating oil is outdistancing refiners' ability to increase the flow. Not surprisingly, share prices of oil-refining firms have moved higher, while those of airlines and some retailers have gone the other way. But this does not constitute a trend in those sectors. Meanwhile, speculators have increased their net long positions in futures contracts - - i.e. they are betting that oil prices will remain high.

The spike in prices isn't good news for consumers and businesses. It will crimp household spending and weigh on corporate margins. The benefits of an earlier decline in energy costs are now being reversed.

China's robust industrial production and some supply/demand market imbalances have perked up metal prices. In particular, low copper inventories and an earthquake-related temporary shutdown of a Chilean mine have sent copper prices higher. Even so, the London Metal Exchange index is still below its March highs.

Indeed, there are a number of indicators pointing to a slowdown in global economic momentum. The Baltic Dry Index, which is a measure of shipping activity, has continued to trend lower since mid-April. In addition, leading economic and manufacturing indicators are signalling slacker conditions ahead. And, of course, monetary policy continues to tighten in the world's largest economy, the United States.

There are a number of positive factors that are supportive of the US dollar versus the euro. But there is also a large negative factor, namely the sizeable current account deficit. And it is to nobody's surprise that the problem hasn't gone away. Last week, the Treasury Department reported that net foreign inflows into US securities in April fell short of the figure that the markets were expecting - - thereby generating worries that foreign willingness to fund the gap may be waning.

The dollar is indeed vulnerable when such fears surface. In addition, deficit currencies - - and the USD is one of them - - come under increased threat whenever there is heightened geopolitical uncertainty. Investors tend to favour surplus currencies in such circumstances. Well the greenback did lose some ground to the euro because of the deficit problem, but it was relatively modest. It appears that the Eurozone currency's attraction as a store of value has diminished because of recent political wrangling over the budget, not to speak of problems with the constitution.

Europe

There are a number of views on what the European project is all about, and the recent shelving of the proposed EU constitution has led to a re-examination of the options. At its origin, after the Second World War, the

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goal was fairly pragmatic: to prevent any further clashes between the two main rivals, namely France and Germany. Many decades later, the plan for political integration has run into great difficulties and the two major states appear to be losing clout within the union.

It was always going to be extremely challenging to build an integrated European state, given the diversity of culture and history, as well as social and political structures. Voters are now quite wary about giving up further decision-making power to Brussels. Furthermore, it is difficult for most of them to identify with a centralised European state. As for expansionism, it generates feelings of uncertainty and insecurity. The elite's model for Europe hasn't been well received by the mass of the population.

There is another view of the European project, prevalent in Britain and some of the northern countries, which deemphasises political integration and highlights economic liberalisation and reform. This standpoint appears to be more pragmatic, except for the fact that structural change and reform is hotly contested by those sectors benefiting from protection and privileges. There is going to be lots of debate in all the member countries about the future direction of Europe. Investors everywhere will be monitoring developments more closely than before to determine if there will be major changes in trends.

Asia/Pacific

China's growth rate is still impressive, but its stock market is a tough place to make money. Operating conditions have been difficult for corporations. Many have seen their margins squeezed by high raw material and energy prices, as well as a challenging pricing environment. Nor is the earnings outlook going to improve. However, there has been some support for red chips because of speculation about a renminbi revaluation.

Bonds

An aggressive 50 basis-point rate cut by the Swedish central bank sent Eurozone government bond yields sharply lower. The Riksbank's move was prompted by prospects of slower growth and inflation in Sweden. As the Eurozone is also suffering from sluggish activity, investors have increased their bets that the European Central Bank is also leaning in the same direction. Gilts and Treasuries followed suite. Overall, the fall in yields indicates concern about the global growth momentum.

Currencies

Speculation about a rate cut by the ECB may weigh on the euro's chances of gaining against the US dollar. But the central bank may not oblige. The euro's depreciation has effectively eased monetary conditions already. Also, the policymakers tend to be hawkish on inflation, which may see some pass-through from high oil prices. Be it noted that the interest rate spread is one factor among many in determining exchange rates - - and not the most decisive one, at that.

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