

Weekly Perspectives

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A Weekly View of Global Economies

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US Producer and consumer inflation numbers were softer than expected, last week. Together with slipping oil prices, this was enough to resurrect the soft-landing scenario of moderating growth and low inflation in the minds of many investors. In the financial media, some people were commenting about how wise Bernanke had been in forgoing another interest rate increase just a week before the data was released. Others are reserving judgement.

Unfortunately, things are a little cloudier than what's assumed in the sunny scenario. The political risk premium in oil prices hasn't gone away. The balance of opinion is that America and Israel were losers in the Lebanese war and the entire Middle East has become even more radicalised than before.

As the great military strategist Sun Tzu wrote in the Art of War, the worst tactic is to attack the enemy's cities. In Europe and elsewhere, the overall assessment is that America has little credibility left in the region and its policies are in shambles.

On the question of inflationary pressures, they are unlikely to subside until growth is brought down below trend. Global growth is still quite sturdy and commodity prices are holding up well. In some of the major economies of the world, monetary policy remains accommodative. Excess liquidity hasn't been totally mopped up and the real cost of borrowing is low.

The relatively benign headline inflation number in the US was not entirely convincing. In particular, there may have been a downward bias due to car dealers engaging in price discounting during the summertime in order to move inventory. It is known that seasonal influences aren't always successfully removed from the data by the statisticians.

Factoring in the possibility of a soft-landing scenario, the US stock market had a substantial rally, which appears to have run out of steam at the time of writing, on August 21st. However, it is still possible for the market to go higher in the very short term before experiencing another correction. On the other hand, if the optimistic scenario is for real and the US economy is expected to pick up speed in 2007 then we are likely to see a sustained equity market rally develop, sooner or later.

In the recent upswing, global stock markets rose pretty much in unison. These days correlation among markets is quite high and they generally swing up and down together. Often, the US market appears to provide the leadership role on which way they are going to move.

Technology stocks were the best performers in the past week, though they have been the worst-performing sector year-to-date. Part of the reason why they suddenly sprung to life is that they were technically oversold. Another reason is that there is a lot of short interest in tech stocks. Once an upward move takes hold, short covering can add fuel to the rally.

Tech stocks also tend to be highly correlated internationally. So a bad day on Wall Street is quickly reflected in the European technology sector. However, the sector has a much bigger weighting in a US index than in a European equivalent. It constitutes about 15% of the S&P 500 but less than 3.5% of the DJ STOXX 600. This can cut both ways, depending on whether technology stocks are in or out of favour. This year, it has been a drag on US performance.

Defensive sectors such as utilities and consumer-staples were looking relatively weaker last week. So is it time to dump defensives and buy the cyclicals? Well, not yet until we can see a bit more clearly when the pick-up in economic activity is likely to occur, after the slowdown phase.

Despite the recent spurt in the tech sector, value has been leading growth thus far, this year. If, at the beginning of the year, you had wisely invested in the S&P 500 value index your total returns on August 21st would have been 7.37%. On the other hand, if you had foolishly invested in the S&P 500 growth index you would now be looking at a return of precisely 0%.

European equity markets continue to look more attractive than either the US or Canada, on the basis of fundamental valuations. This is so, if we look at the ratio of price to trailing or forward earnings, or other measures such as price-to-book. Among the larger countries, both France and Germany are cheaper than the UK,

In addition, technical measures based on price and volume patterns, rather than fundamental valuations, are more positive for European markets than for the US. Looking at inflows into mutual funds in the United States, American investors are keener to nibble on international rather than domestic funds.

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