

Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.bm

iraj.pouyandeh@lom.bm



A Weekly View of Global Economies

22 June 2004

North America

The base-case scenario in the US is still that of a slowdown in growth momentum in the second half, accompanied by deceleration in earnings growth - - following good performance on both counts in the first six months of the year. There are a number of leading indicators pointing in that direction. However, the economy does not function like clockwork, and we can't rule out the possibility of a growth spurt before the slowdown finally takes hold.

Pimco's Bill Gross said, last week, that there is an unusual degree of uncertainty in the air. He is right, and we need only mention a few contributing factors in support of his contention: the oil market, Middle East problems and China's economic slowdown. We also have monetary policy excess in a host of countries, with plenty of liquidity still sloshing around the system, as tightening moves are in the offing by a number of central banks.

And all this is happening in a world economy characterised by major imbalances between surplus and deficit countries - - over-savers in the first and over-consumers in the second. Meanwhile, significant structural changes are taking place regarding allocation of resources and patterns of activity, across the global economic landscape, even as we are witnessing slow shifts in regional political power balances.

Frankly, it is tough to carry out analysis in these circumstances, and because people do not have a good fix on how things will pan out they tend to focus on shorter-term events and form impressions based on consensus or "expert" opinion. Consequently, during those times when they are not being bombarded with lots of rapidly-changing data about the economy they may see little reason to change their behaviour - - a sort of inertia of the uncommitted. At other times, they may swing into optimistic or pessimistic action as the newsflow is supplemented by directional statements from officials or "experts".

Nor is it always the case that the latter are deliberately manipulative. Often, these worthies aren't quite sure about how things are developing either, but given their status, they have to sound confident and authoritative. So, putting all this together, it is not surprising that, in the markets, we can get periods of calm followed by chopiness and even volatility.

Right now, there is a degree of tranquillity in the US equity market, though it would be a mistake to think that investors have gone to sleep. Those traders and hedge funds that depend on volatility to turn in a decent profit aren't too pleased - - relative stillness or choppy action is unprofitable, and you need some good swings to do well. As for trend followers, this is not a game for them either. The upward trend petered out in the first quarter.

Technical indicators of the US stock market are broadly neutral, though low volume on the NYSE is still showing a lack of commitment. Meanwhile, investors' risk appetite appears to be edging up and there are now steady, if relatively modest, net inflows into equity mutual funds. In the current circumstances, it is possible that a confluence of good news on the oil market and Iraq, supplemented with positive economic data, could fire up sentiment and lead to a market rally.

But the sustainability of such a rebound is open to question. Looking past second-quarter earnings performance, operating leverage will start to fade - - a normal cyclical phenomenon. So we will experience a deceleration in earnings growth. And the stock market will have to face up to rising

The information in this newsletter is for general use only; it is not intended as specific investment, financial, accounting, legal or tax advice for any individual and should not be relied on as such. LOM makes every effort to ensure that the contents herein have been compiled or derived from sources believed reliable, however LOM does not warrant the accuracy, timeliness, or completeness of this information and material and expressly disclaims liability for errors or omissions in this information.

interest rates and decelerating earnings, sporting valuations that aren't cheap on any measure.

Europe

The Bank of England's Monetary Policy Committee has raised interest rates four times since November, and opted against gradualism by increasing them another notch at its last meeting. Intent on deflating the housing bubble, it seems to be having success, at last. Recent data suggest that mortgage borrowing and house prices are cooling. The market is sensing a less aggressive stance from the MPC, going forward. And, with expectations of rate increases elsewhere on the rise, the yield advantage that has underpinned sterling's strength may become less decisive.

Asia/Pacific

The Bank of Japan has an upbeat assessment of the economic outlook, amid rising bond yields. It has essentially stopped intervening on the foreign exchange market, which was a means of increasing liquidity in the system. However, it has no plans to end quantitative easing until inflation trends are firmly positive.

Bonds

Consumer inflation data was softer than the market expected, last week. And Greenspan lost no time to make some mollifying statements about the outlook for inflationary pressures. It was enough to shift the view about the first instalment of the expected rate-increase cycle from half a percentage point to only a quarter. The bond market also overlooked the stronger-than-expected increase in the producer price index. For now, investors have taken to the idea that the Fed has a good handle on keeping inflation capped, and this was reflected in the performance of long-term yields that have eased back from highs earlier in the month. The recent trading range may remain until the next round of data.

Currencies

The US current account deficit widened to a record \$144.9 billion in the first quarter, up from \$127.0 billion in the last three months of 2003. And this wasn't very good news for the dollar. The rapidly growing American economy is pulling in imports at a faster pace than the rest of the world can absorb US exports. Accordingly, the current account gap is being funded by foreign inflows.

Funding of the deficit is not an immediate problem. But there are reasons to be concerned. Official entities, particularly Asian central banks, are major contributors to covering the savings shortfall in the United States. They are not "rational" profit-maximising agents in their asset allocation decisions. But the costs of continuing to invest in US assets is rising and at some point there may be greater reluctance to make non-optimal decisions. At the same time, two other sources of funds are both negative: namely, foreign direct investment and net equity flows.

Iraj Pouyandeh
Strategist / Senior Portfolio Manager

Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company. Mr Pouyandeh sits on the LOM Investment Policy Committee, responsible for determining global asset allocation.



LOM Asset Management Limited
27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

Licensed to conduct Investment Business by the Bermuda Monetary Authority

The material herein may not be reprinted, in part or in full, without prior expressed consent in writing from LOM Asset Management Limited