

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Last week, Wal-Mart reported weaker-than-expected quarterly profits, complaining about high oil prices and issuing a less than cheery outlook. The mediocre results didn't come entirely out of the blue, but it helped focus attention on the state of consumer demand.

In passing we should also note that energy costs aren't the only dark clouds hanging over the giant retailer. Its management doesn't get high marks from analysts for vision and execution - - matters that have little to do with high oil prices.

Well, it didn't come as a surprise that low-income households are feeling some pain. But investors took the opportunity to send the shares of retailers, catering to the income-challenged segment, lower. And, the negative mood extended to retail stocks in general.

However, American consumers aren't about to cut back sharply on spending, although the retail sector has probably not seen the last of sceptical stock investors. Incomes are still fairly well supported by decent job growth, and the key housing market is holding up. But, going forward, we should continue to monitor job creation, the housing market and interest rates to gauge the impact on consumer behaviour.

The saving ratio is exceptionally low, reflecting household confidence in a stable environment. It is also supported by robust net worth. So the thing to watch out for is an event that would cause a negative wealth effect, thereby prompting households to increase the rate at which they save out of current income.

A typical example would be a substantial stock-market reversal. But a far more important event would be a fall in house prices, because of the considerable weight of real estate in total net worth. However, the current house price "bubble" is not of an extreme nature and it would take a big rise in household borrowing costs to cause a bursting of the "bubble". One factor to consider, in this context, is that roughly two-thirds of mortgage debt in the United States is fixed rather than variable.

Meanwhile, the Fed is turning the monetary screw slowly. Evidently, it does not want to bring about a sharp slowdown in consumer spending or to cause too much pain in the banking system. But given the strength shown by the economy, it does have to go on tightening until it sees some softness in domestic demand.

As we have said before, lead indicators are still pointing to a pickup in global growth momentum. There are some promising signs coming out of Europe, and Japan may have turned the corner. As for China, it appears that policymakers are willing to let growth proceed at a fast pace as long as inflation is contained and the current account surplus does not shrink rapidly - - neither of which is a serious concern right now.

What are the risks to the sustainability of the present growth spurt? Well it is possible that the Fed may end up tightening more than expected and US households will be prompted to increase their saving rate. Also, Chinese authorities may be forced to take tougher action to rein in investment spending. Alternatively, the European and Japanese growth pickup may turn out to be more fragile than currently trends suggest.

Profits of S&P 500 companies were up 11.9% over the second quarter, according to Thomson Financial, which crunched the numbers. The outturn was well ahead of the 7.4% gain initially estimated by analysts at the beginning of July. And the consensus estimate is now for a rise of 16.3% in the third quarter. But the risk now is that having underestimated earnings, analysts

may now err on the side of over-optimism, which may make it more likely that companies will fail to beat elevated expectations.

At the aggregate level, corporate profits in the United States are at a cyclically high level, as measured by the ratio to GDP or to wages and salaries. And this introduces the possibility of more muted profit growth and reversion to the mean in the above ratios.

Strong consumer demand and low interest rates, as well as rising productivity, have boosted corporate top and bottom lines. And corporate balance sheets and cash flows are still fairly robust. But the forward outlook isn't as encouraging as heretofore regarding consumer demand and interest rates. So it's up to the corporate sector to boost aggregate demand by increasing capital spending. This would have the advantage of maintaining rising productivity and profitability. The ball is in the corporate court.

Europe

Better news is coming out of Germany, the Eurozone's largest economy. Investor confidence, as measured by the ZEW survey, jumped to the highest level in a year and a half. Positive sentiment was boosted by rising exports and improving profits, though high oil prices remain a concern. Meanwhile, German second-quarter GDP growth was in line with expectations, with a glimmer of hope provided by better performance from the domestic economy. So the overall picture is brighter, though we will have greater confidence in sustainability if oil prices and the euro oblige by weakening.

Asia/Pacific

Investors are taking a positive view of the upcoming general elections in Japan. Some of the political uncertainty has dissipated and the expectation is that a reform agenda will be pursued after the elections, whoever wins - - though Koizumi is expected to remain in office, with a stronger hand. So the stock market has been performing well. In addition, the market is strongly correlated with a pickup in global lead indicators, which are rising. As for valuations, Japan compares favourably when measured against other developed stock markets.

Bonds

Demand for Treasuries is weighing on the benchmark 10-year note yield. High oil prices are being interpreted as a dampener on economic growth. However, looking further ahead, if the global growth momentum does not peter out and becomes sustainable then yields may have to head higher. In particular, we should keep an eye open for higher Japanese government bond yields and a possible signal by the Bank of Japan about abandoning its zero interest rate policy. This isn't about to happen, but it is a potential risk factor on the horizon.

Currencies

The appreciation of the yen against the greenback appears to have met some resistance. As for the euro, it is range bound and does not show a clear short-term direction versus the US dollar.

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