Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.bm

iraj.pouyandeh@lom.bm

A Weekly View of Global Economies

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North America
Oil prices have nudged a little lower from their recent record highs and this has injected a dose of confidence into the stock market, which has rebounded from year-to-date lows. And now investors are waiting for some positive economic data to give them reason to push it a little higher.

Meanwhile, there are lingering worries about consumer spending, and the news that Wal-Mart had reduced its forecast for August same-store sales to a lower growth range (0 to 2%), from earlier estimates of 2 percent to 4 percent growth, didn't go down too well with the Wall Street crowd. It matters because the retailer is huge, and has sophisticated tracking systems. Certainly, the Fed thinks they are important enough to warrant watching their numbers carefully. Going forward, investors will continue to monitor consumer behaviour, given its significance for overall activity.

Technology stocks have had a nice bounce from short-term oversold conditions. An accompanying factor is that gloom about corporate tech spending has been somewhat overdone. The current quarter (Q3) could see a bit of a rebound in capital spending, because of fiscal incentives on accelerated depreciation that expire after December. This means that orders on equipment, for future delivery, may have to be placed now. However, looking further forward, it is hard to see a substantial reason for continuing strong growth in tech spending.

The bullish case for the technology sector is premised on a re-bound in US GDP growth in 2005, accompanied by a renewed upward flight of the Chinese economy, after it touches down for a soft landing. But this is not the base-case scenario. It is more likely that the US and the global economies will decelerate to a more leisurely pace, at least for the first half of next year.

Many Asian stock markets tend to have a measure of correlation with the US technology sector. Furthermore, higher oil prices have been weighing on importing countries in the region. So, an improved outlook, on both counts, should help lift these markets in the short run. Further down the road, though, slower growth in China and the global economy will pose challenges for these countries.

The energy sector has been losing ground recently, as investors have started to bet that it has peaked, and oil prices are on the way down from cyclical highs. It is true that decelerating oil prices are often correlated with declining equity prices in this sector. But oil stock valuations may not be all that out of line. It depends on your view of equilibrium oil prices in a lower-growth environment. In the opinion of oil-sector analysts, current stock prices are discounting a per-barrel price of $25.

But, if the eventual supply/demand adjustment results in a price range of $30 to $35, rather than falling to the mid-twenties, then there may be too much pessimism priced into current valuations. However, investors have memories of sharp corrections in previous cycles and are acting accordingly. Speculators are also a problem, causing price swings as they flit from one sector to another, while chasing momentum.

Looking at the prospects for overall corporate profit growth, it is likely to fall substantially, and this will cap hiring intentions. Raw material input costs are feeding through and unit labour costs are edging up because of slower productivity growth. Weaker sales growth will diminish pricing power and squeeze margins, reducing upward inflationary pressures, but hurting profits.

Europe
According to the July Frank Russell survey, European fund managers are overweight continental Europe but underweight the UK by 3%, relative to the benchmark. This may come as a bit of a surprise to some investors, because they consider the UK market to be a defensive one that should attract some interest in a slower-growth scenario. However, looking at it from another viewpoint, there are still a few clouds hanging over big-cap UK stocks. Large institutional investors have been reducing their exposure to stocks in the United Kingdom, in favour of bonds as well as foreign equities. A lot of selling has already taken place, but there concerns that more may be in the offing.

Asia/Pacific
High oil prices are not particularly good for Japanese corporate profits, but won't loom large as long as sales are rising and firms can pass on cost increases to the end consumer. In other words, a reversal of deflationary trends is more important for the bottom line than raw material input costs.

The prolonged period of deflation in Japan has rendered the holding of liquid assets such as cash and bank deposits an attractive option for households and firms. If the rise in oil prices sets off inflationary expectations and induces economic agents to move out of cash into alternative assets, both real and financial, it could initiate a virtuous circle of growth and inflation. But these arguments only hold true if oil prices stabilise and move lower, from current high levels. A prolonged period of high prices will be damaging.

Bonds
Yields on the 10-year Treasury note have edged up again, after a spate of profit-taking and locking in of profits. Meanwhile, the impact of oil prices on the economy is broadly two-edged. On the one hand, it reduces aggregate demand and lowers activity. On the other hand, it promotes cost inflation. Thus far, the bond-market view is that the first is having a larger effect than the second.

Currencies
There hasn't been much in the way of data, recently, to confirm expectations but short-term sentiment has swung in favour of the dollar on hopes that the US economy will outperform. Traders have simply pared back net long positions in the euro. If we get some positive readings on economic releases, this week, the short-run dollar rally may be extended but it doesn't yet constitute a reversal of medium-term trends.

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.

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27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

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