Weekly Perspectives

Website: www.lomam.com
Email: info@lomam.com
iraj.pouyandeh@lom.com

A Weekly View of Global Economies

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The US stock market, after taking a breather in the first half of April, staged a strong rally on the 18th but experienced trouble generating further momentum and pushing past earlier highs. What fuelled the rebound was a combination of decent earnings reports, and hopes for a near-term end to Fed rate hikes. Since then, renewed fears have surfaced about the threat of rising inflation and consequently a more active central bank.

Higher bond yields are a challenge to equity market valuations, but the underlying hope on the Street is that solid earnings growth will come to the rescue. However, it is not only necessary to observe superior performance in the current quarter but also to have confirmation that the forward outlook continues to be robust.

In this regard, we will need to see rising momentum in analysts' forward earnings revisions to indicate a degree of sustainability. But in the near-term, a week of positive earnings reports, accompanied by slipping oil prices and bond yields, could well send the market higher.

Metals such as copper and zinc have continued to advance, as the commodity story still finds believers and buyers. There is also a good bit of speculative element in the market, with hedge funds being quite active. Meanwhile, emerging market equities are benefiting from the strong rise in commodity prices, and of course the hedge funds are playing those markets too.

At the same time, money flows into mutual funds, focussed on emerging markets, have picked up again. This demonstrates high risk appetite. The long-term investment case for being in emerging markets is a good one. And, yes, there are a couple of positive things that can be said about them, such as government budget discipline and trade surpluses, that were absent in previous cycles. However, all said and done, cyclical risks are increasing rather than declining.

The emerging markets story, like many other stories in the investment world, is an example of a theme. It is self-feeding and can go on for a long time before a precipitating factor causes a break. Predicting when that will occur is difficult to do. At any rate, timing skills are essential, and some hedge funds are going to be better at exiting than the majority of individual investors.

The surge in oil prices over the past month has clearly been related to concerns about rising political risk in a number of OPEC countries. If those fears are dispelled, oil prices could come down sharply from current high levels. However, the political problems regarding Nigeria, Iran and even Venezuela are ongoing and don't appear to be subject to a speedy solution. So it is not out of the question that flare-ups in political risk and oil-price spikes may recur.

So far, the global economy has been able to absorb high energy prices better than most analysts had expected. But it is not Teflon coated and at these higher levels, oil will have a negative effect on consumer demand and corporate profits, as well as giving a boost to inflation.

Recent strident demands by industrialised countries for a revaluation of Asian currencies had a knock-on effect on the yen, which rose sharply. Not unexpectedly, anxiety about the fortunes of exporters led to a sell-off on the Japanese stock market. In the meantime, the Chinese haven't budged on the issue of revaluing the renminbi, despite a lot of American pressure. The policymakers in Beijing think that slow rather than fast appreciation makes good economic sense.

President Hu Jintao is currently busy touring Africa, doing commercial deals and setting up trade links. China has also made successful inroads in Latin America, which the United States regards as its sphere of influence. But the Chinese come bristling with business contracts, not guns and ideology. Meanwhile, Latin American electors are putting more governments in office that want to act independently of Washington's wishes.

The pressure by the G-7 and the IMF on Asian surplus countries to revalue their currencies has a side effect, namely making it easier for inflation to head higher in big importing countries. Along with monitoring other indicators of possible inflationary upside, investors will be watching central banks to see how vigilant they are going to be in fighting inflation.

In essence, the liquidity that they created during the period when the economy was slumping has been driving global equity markets for the past few years. Only recently have they begun to drain some of the liquidity from the system, and they have been cautious in this task. Bond investors, in particular, may want to see how much conviction is going to be demonstrated by the monetary authorities if economic activity levels continue to be strong.

It pays to scrutinise what monetary authorities are up to. Trusting that they will do the right thing may not always be wise. After all, the monetary system is based on a fiat currency, which relies on the public's confidence that the integrity of its value will be maintained by those who control it. There have been many periods in the past when they have failed to do so.

It is unlikely that we will get a repeat of the 1970's when central banks were quite willing to validate inflation. But it is sensible to learn from history and to monitor events closely. There are a number of people, who - - horror of horrors - - would like to abolish central banks and replace them with rule-based or commodity-based monetary systems. Looking at the historical record, a good case can be made that central banks have caused more instability than stability.

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. He manages the LOM Global Equity Fund.

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

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