

Weekly Perspectives

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A Weekly View of Global Economies

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North America

The growth outlook for the US economy is still quite positive, although there is obviously some downside risk if the consumer stumbles. As the economy is operating close to capacity, with little slack in the system, it is reasonable to expect that core inflation is likely to drift higher. Elevated energy prices are working their way through the economy and there is some evidence that firms are raising prices to cover costs.

Pipeline inflation pressures are present in import and commodity prices. The core crude, intermediate and finished goods indices of the Producer Price Index (PPI) have all been picking up in recent months. It is likely that such increases will filter through to the Consumer Price Index.

The October release of the Philadelphia Fed Business Outlook survey indicated mounting inflation pressure, with the prices-paid index rising sharply. Let us think that this may be an aberration, it is well to note that the result is corroborated by evidence from other manufacturing surveys.

But there is no need to be unduly alarmed by these developments because inflation is still containable. Reassuringly, Federal Reserve chatter is still emphasising ongoing vigilance. The policymakers' viewpoint appears to be that the economy is on a sufficiently solid growth path to necessitate restraint aimed at curbing inflation pressures.

If earlier in the year there was a tendency to do it gently for fear of limiting growth, now there may be a hardening of attitude in favour of fighting inflation. It is as much a question of forecasting economic trends and taking appropriate policy action as one of maintaining credibility.

Once a view becomes established in the markets that policymakers are willing to validate inflation, peoples' expectations will be revised accordingly and this will be reflected in price setting. Expectations of higher inflation will be included in negotiations and contracts, and this will be ingrained in the system.

If neglected, this could have negative consequences in a number of ways. Monetary policy will then have to overshoot and be unusually restrictive in order to drive those inflationary expectations out of the system.

In modern monetary systems the currency is, of course, fiat money, which depends entirely on peoples' confidence that authorities will not seek to destroy its value. History, both ancient and modern, is replete with examples of authorities who have, in varying degrees, debased the currency. It doesn't happen by accident, but is a matter of deliberate policy or of policy neglect. Monetising the government's debt is a prime case of such irresponsibility.

This week, President Bush announced the nomination of Ben Bernanke to succeed Greenspan as the new Federal Reserve chairman, after the latter leaves his post in January. It is a non-controversial appointment that is highly likely to receive Senate approval and result in a smooth changeover at the central bank. As if on cue, the new appointee was quick to emphasise continuity.

The stock market reacted to the announcement with a measure of exuberance. This sudden spate of optimism appears to have been based on the view that Bernanke is likely to be more pro-growth and softer on inflation than the outgoing chairman. But there was also an element of technical rebound in a market that was oversold in the short term.

The evidence that can be mustered for depicting Bernanke as an inflation dove harks back to the time - - not long ago - - when deflation, and not inflation, was the fear du jour. Back then, he was of the view that policy may need to be oriented towards fighting deflation more vigorously, and by unorthodox means if necessary.

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But that was then, and this is now. He will soon be in the hot spot, with new challenges to be faced. There is no indication that Bernanke does not have the flexibility of approach to change with the times. In the world of economists, he can be classified as a New-Keynesian, who tend to emphasise the output-gap approach in determining inflation risks. And given current economic trends, it is unlikely that he will be any softer on inflation than Greenspan.

A solid academic background is an asset for the new appointee. The economy is a complex system and you need good theories and models to understand its intricacies. For those who dismiss models as irrelevant, it is well to remember that the models are more complicated than most of the critics. As for practicality, many a hedge fund has adapted ostensibly esoteric academic models to build profitable trading systems.

That said, one also needs to supplement academic training with experience in the real world of forecasting. In this regard, Greenspan spent many years honing such skills before he took up the Fed post. Bernanke does not have that sort of practical experience and is likely to place greater reliance on formal models. This may mean a more systematic model-based approach than we have been used to, at least in the initial phase of the chairmanship.

Another of Greenspan's distinguishing characteristics is that he is politically savvy. He knows how to move in Washington circles, and is well-connected in the private sector too. But the chairman-to-be is still on a learning curve and is likely to step gingerly until he has polished the necessary skills.

Europe

The German Ifo business confidence index rose smartly on the back of retreating oil prices and higher exports. Generally, Eurozone cyclical indicators and growth data have surprised to the upside. As for inflation, it doesn't look like it will fall below two percent. Indeed, with growth firming, we should factor in upside risks. Meanwhile, M3 money-supply growth is strong and rising. So it isn't surprising that the European Central Bank has turned up its inflation-fighting rhetoric.

Asia/Pacific

China registered strong third-quarter GDP growth, beating consensus expectations. Other recent data releases also indicate that the business cycle may have troughed, opening up the possibility of re-acceleration.

Bonds

Temporary bond market concerns about Bernanke's inflation-fighting credentials have dissipated. At the same time, data releases have been unable to eliminate the bearish tone in the Treasury market.

Currencies

A rise in the Ifo index and a slump in the Conference Board's measure of US consumer confidence perked up the fortunes of the euro against the greenback. Meanwhile, the ECB is sounding more hawkish but unlike the Fed has yet to back it up with action.

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