Weekly Perspectives

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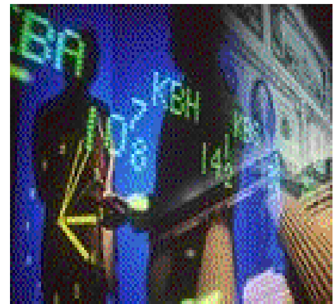

A Weekly View of Global Economies

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North America
As expected, equity markets rebounded from their lows, but continue to face challenges ahead. In short-term oversold conditions, many market participants stand ready to pounce on a piece of good news that can fire up optimism. The prospects for the market would be worrisome, indeed, if positive factors failed to generate any enthusiasm. If the overall tendency is to sell on good news, this would be an indication that there is little support to prevent bigger downward moves.

Such is not the case presently. While risk appetite has diminished from earlier somewhat euphoric levels, people haven't lost it entirely either. They are more cautious but not unwilling to indulge in a bit of risk. As always, there is a relationship between return and risk - - greater returns are generally associated with the assumption of additional risk.

Emerging market equities have bounded back from their earlier lows, and cyclical sectors have recouped some of their losses. Hard-hit cyclicals have been at the forefront of the recent rally. Industrials, materials and technology sectors have shown some short-term resilience. As for energy, which is a sort of defensive cyclical, it is still being supported by oil prices that have bubbled up again.

Actually, this business cycle has been somewhat unusual in term of sector rotation. Many people had expected the cyclicals to start weakening in the fourth quarter of last year, which broadly didn't happen. Partly, this is the result of structural problems in many defensive sectors, related to weak pricing power, lack of innovation, regulatory issues and intense competition. We only need mention the pharmaceutical sector, which continues to face a number of challenges.

In addition, technology tends to benefit from investors' hopes for exceptional growth prospects, while commodities have been driven by the China story. Hence the reluctance among investors to overweight defensive sectors aggressively, despite warning signals about a turn in the business cycle.

Leading indicators are still pointing to a loss in momentum for the US economy. At the same time, inventories are rising at a fast clip. Either firms are anticipating a pickup in sales or there has been unanticipated inventory build-up and a need to slow down production and de-stock. Meanwhile, interest rates are on the rise and consumer confidence is wobbly.

The next few months will be very important in determining the fortunes of the global economy. In the past, growth in both China and the US has shown a greater degree of resilience than most people had initially expected. And, of course, how well they continue to do will have an important influence on prospects for the rest of the world. It could happen that they may surprise on the upside, but the balance of positive and negative factors argues for more downside than upside risks.

The Fed is trying to implement a careful strategy of heading off inflationary pressures without squeezing growth unduly. The intention is to rebalance growth from consumption spending to investment expenditures, without overdoing it in terms of hurting consumers' confidence and willingness to spend, or diminishing corporate profitability.

As for China, the data - - which is of poor quality - - is pointing to continued robust growth. But, with inflation on the rise, some tapping on the brakes by the authorities is likely. And, let's just mention that a slowdown in consumption spending in the United States will also have an impact on Chinese exports.

It appears that Chinese authorities have another issue at the back of their minds. The economy is restructuring fast and there is a need to absorb large numbers of workers into the labour force, with redeployment from low to high productivity employment. A rapid growth rate facilitates this task; otherwise the government may face social and political trouble.

So they have been willing to tolerate a measure of overheating in the economy and a rise in inflation. It is an open question whether they have become particularly adept at fine tuning growth, via policy measures, so that they can pull the levers just in time, without causing an abrupt change in the economy's speed.

Europe
Many forecasting institutes have been reducing their estimates of this year's economic growth in Germany to a bare minimum. Meanwhile, the Ifo business confidence index has fallen to its lowest level since September 2003 - - registering the third consecutive month of decline. This is a bad sign for second-quarter growth in Germany, and for the Eurozone as a whole, because of the size of the German economy.

Asia/Pacific
Speculation about a change in the renminbi's pegged rate is making the rounds again. Comments by the Governor of the People's Bank of China seem to imply a possible change in policy. However, most observers doubt that a swift change in direction is in the works. Cynics think that Chinese authorities are issuing these statements in order to counter rising concern abroad about the penetration of Chinese imports into local markets. Meanwhile, speculation helped to boost the yen, as traders expect knock-on effects on Asian currencies if the renminbi is to be revalued.

Bonds
The shorter end of the Treasury yield curve is, naturally, showing more sensitivity to inflation scares and the possibility of a more aggressive Fed stance. So the personal consumption expenditure (PCE) deflator - - to be released this week - - will be watched closely for any signs of strength. As for the ten-year note, the data releases on economic activity have not been sufficiently robust to cause a spike in yields. So the overall tendency is still towards a flattening of the yield curve.

Currencies
The US dollar has shown a bit more strength against the euro, as traders focus on the relative vigour of the American economy compared with Europe. So sentiment is dollar-positive again. In an overall sense it is true that US growth performance is more impressive than that of the Eurozone, but the forex market may need to see ongoing confirmation of this in data releases if the greenback is to make even more headway against the euro.

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