Weekly Perspectives

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A Weekly View of Global Economies

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North America
Thus far, second-quarter earnings reports from S&P 500 companies have generally been quite positive, often beating consensus expectations - - and better than what preannouncements indicated. As a result, analysts, who had earlier lowered their pre-season earnings estimates, are now revising them higher. Still, we should wait until the season is over before summing up.

Many oil companies have reported impressive profits, which isn't surprising. At the same time, despite fears to the contrary, big technology companies such as Apple and IBM have beaten expectations - - a lot of it coming from top-line growth rather than just squeezing margins.

Meanwhile, US economic growth is still reasonably robust, inflation is contained and interest rates are low. All of which has helped to lift stock markets. The earnings picture is sufficiently positive to overcome investor fears about possible interest rate increases. And short sellers, who had been doing well earlier in the year, have been feeling pain in the past two months. However, the equity market has moved up strongly since hitting lows in April, and contrarians may now be looking for a pause or a correction.

Overall, Greenspan's testimony to Congress, last week, had a slightly more hawkish tone than what we have been hearing up to now. There is a bit more worry about tightness in the labour market and more concern about an upside to inflation risks.

Meanwhile, China's revaluation of the renminbi will add marginally to inflationary pressures in the US. It is, however, a better solution than the implementation of protectionist measures by Congress that could have an even bigger impact on inflation.

So, putting all these factors together, and taking account of the Fed's desire to cool the overheated housing market, it would be fair to say that we should now expect a higher normalised fed-funds rate than heretofore. But this also increases the risk that policymakers may end up overdoing the tightening move, whereas previously we expected them to shoot for less rather than more.

Europe
The German Ifo business confidence index rose for the second consecutive month, beating expectations. Positive sentiment was underpinned by the euro's decline versus the dollar. At the same time, the Belgian business confidence index also rose. As a leading indicator of the European economy this constitutes a positive development. The index appears to have turned up, after bottoming in May.

Asia/Pacific
As expected, Chinese policymakers made a modest start in the long-run process of revaluing the renminbi. The currency regime was changed from one based on a dollar peg to a managed float, versus a basket of currencies. This opens up the possibility of further upward moves in the renminbi. For now, the revaluation against the greenback is in the order of 2 percent.

It was an event that had been expected for a long time, but still managed to surprise and disappoint a number of observers who were hoping for a bigger move. But, as we have said before, the process of revaluing the currency will be a slow one allowing the economy to adjust to the changes as it comes to rely increasingly on domestic demand as an engine of growth.

Chinese officials confirmed the adoption of this strategy in various statements issued over the past week. It appears that full convertibility is at least five years away. This is not a fixed time line, but it does indicate that revaluation will occur in a step-by-step fashion, over a longish period of time. The authorities aren't going to give up control anytime soon.

But international pressure on China hasn't ceased and there is an expectation that more currency appreciation is in the offing in the months to come. The float will be tightly managed, but policymakers also need to address the problem of a rising balance of payments surplus and a still hot economy, both of which can be restrained by an appreciating currency.

Foreign officials, particularly in the US, will be watching to see signs of further moves by China. Forward currency contracts currently show that investors expect a gain of about 5 percent in the renminbi over the next year. However, if the Chinese economy continues to grow at a rapid pace and export markets hold up, then this may be an underestimate of the likely appreciation.

A stronger renminbi will put upward pressure on other Asian currencies to appreciate, which would tend to promote domestic demand in the affected nations. The overall impact on companies based in developed countries is to favour those which generate a lot of revenue in Asia and to disadvantage those which do their sourcing in the region.

In addition, those developed-country firms that compete against Asian companies in their home markets in Europe and the US may find a bit of relief from import competition. As yet, the size of the currency moves isn't going to have much of an impact but the betting has already started on the likely winners and losers over a longer period.

Bonds
An appreciation of the Chinese currency will put upward pressure on US inflation and bond yields. For now, the effect will be rather small but investors have already taken note of the trend. If other Asian currencies also continue to appreciate, there could be a longer-term impact on the funding of US deficits. More emphasis on domestic demand in Asia may mean lower savings to be channelled to the US.

Currencies
Chinese officials' attempts to dampen expectations of another near-term renminbi revaluation have weighed on the yen versus the greenback. The Japanese currency has given back some of the gains it made last week. Currently, the renminbi is being managed tightly, and only allowed a 0.3 per cent daily move.

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