

Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com



A Weekly View of Global Economies

27 June 2006

A number of leading indicators of the US economy have rolled over, indicating the increasing likelihood of slower growth ahead. In addition, a leading index of the consumer price index points to a relatively modest rise in inflation. Nevertheless, there is a good deal of uncertainty in the markets about the outcome. And people still entertain the possibility that monetary policymakers may get it wrong.

Strong growth over the past two years has justifiably raised concerns about higher inflation pressures. Investors will remain sceptical that inflation has been capped until they see the prospect of slower growth ahead and sense an end to monetary policy tightening.

The uncertainty means that we are not out of the woods as far as volatility is concerned. Nervousness is likely to govern investor sentiment, with risk appetite waxing and waning as they try to determine which way the wind will blow.

The consensus view is that the Fed is on course to raise the target funds rate by another 25 basis points this week, with the prospect of at least another such hike by year end. However, policymakers' reactions are very data dependent. They will try to do just enough to maintain their credibility as inflation fighters, but at the same time not too much, for fear of damaging the economy. It is also to be hoped that Bernanke will refrain from any further faux pas, confusing people and upsetting expectations.

Chinese authorities are also in the mood for monetary tightening. Evidently, earlier measures were unsuccessful in reducing liquidity in the system. So they are now using pretty much all the weapons in the armoury to get the job done. The most powerful instrument at their disposal is that of upping the reserve requirement. This has a very strong multiplier effect on the money supply and is almost never used in developed market economies.

But that's not all. They also intend to raise interest rates and mop up credit creation via open market operations. But as some people have pointed out, to be fully consistent, policymakers ought to allow further revaluation of the renminbi. The reason is that, currently, in order to maintain the low-value peg of the currency, they are forced to expand the money supply as they purchase foreign exchange.

Another policy measure that they are fond of is moral suasion. This polite phrase means that they pick up the phone and tell the banks to cut back on loans or they are going to get a hiding. Of course, the Chinese authorities are going to be just as careful

as the Americans not to overdo it. They need to keep growth chugging along at a nifty pace to absorb all those workers from the countryside and declining sectors into the modern economy.

Last year, analysts were promoting the big-cap universe as the place to be, in order to ensure out-performance. Well, it didn't happen that way. But, at long last, investors are embracing big, busy stocks. That's not surprising. In leaner times, you want the cushioning comfort of the large caps.

Currently, relative valuation favours the big ones. Using a number of measures such as price-to-earnings and price-to-book, the biggies turn out to be cheaper than smaller caps. This is just as true of European stocks. But in Japan the issue is not as clear cut. So, in the land of the rising sun, value can still be found among the small fry.

And when we look at emerging markets, large caps are valued at a premium to small caps. The main reason for this anomaly is that these markets have seen substantial inflows from abroad that normally target large-capitalisation stocks for liquidity reasons. In addition, there are even more difficult issues with small companies in emerging countries than there are in developed ones, such as limited financial disclosure and closely-held ownership.

We don't want to overstate the point, but normally the small-cap arena is where you search for "growth" companies and the big-cap area is where you look for "good" companies. "Good" is broadly defined as relatively stable sales and earnings, high credit rating, solid finances, et cetera. In a slower economy, "good" tends to be favoured relative to "growth".

In addition, we must not forget the presence of cycles and themes. In the view of some analysts there is a small-cap cycle in the United States that lasts an average of seven years. And, would you know it, we are at the end of that cycle of out-performance. Even though these statistical calculations don't indicate definitive turning points, they are certainly worth noting.

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 Equity Growth Fund.



LOM Asset Management Limited
27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

The information in this newsletter is for general use only; it is not intended as specific investment, financial, accounting, legal or tax advice for any individual and should not be relied on as such. LOM makes every effort to ensure that the contents herein have been compiled or derived from sources believed reliable, however LOM does not warrant the accuracy, timeliness, or completeness of this information and material and expressly disclaims liability for errors or omissions in this information.

Licensed to conduct Investment Business by the Bermuda Monetary Authority

The material herein may not be reprinted, in part or in full, without prior expressed consent in writing from LOM Asset Management Limited