

Weekly Perspectives

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A Weekly View of Global Economies

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Lagging behind the Fed, two other major central banks, in Japan and the Eurozone, are signalling their intention to tighten policy. This will represent a further reduction in global liquidity. However, unlike the Fed, there is no need to raise interest rates substantially, though forecasts representing the consensus view may be underestimating how many turns of the screw will be necessary before policymakers are done.

It appears that the squabbling between the government and the Bank of Japan, which we witnessed last December over the direction of monetary policy, is now well behind us. Some politicians are still a bit uneasy about the issue, but the prime minister has essentially given the go-ahead to the BoJ. A number of ministers have also harped on the same theme, namely that the Bank should be allowed to decide, without political hindrance, on when to end quantitative easing.

Facing up to the need to end the long period of keeping interest rates at zero has been a little difficult. Part of the reason is that the government is keen to keep the growth fires burning - - and who would blame them, after experiencing many years of economic underperformance - - and partly it is because hasty tightening of monetary and fiscal policy had on a previous occasion aborted a budding recovery. Nobody wants a repeat of earlier mistakes.

We recall that the BoJ adopted quantitative easing in March 2001 in response to slumping stock markets and poor prospects for the economy, not to speak of the potential for a financial crisis given the state of the banking system at the time. However, as the record shows, growth remained generally anaemic and deflationary conditions persisted until recent times.

Happily, the economy is on a sounder footing now and expectations have been rising for an end to quantitative easing. The tone of current government rhetoric means that some analysts are now betting on the central bank's March 8-9 meeting as the occasion for setting the conditions for a policy shift. However, there is no hurry to do it in March, and policymakers may well delay the move until April.

The process of normalising monetary policy will be relatively slow one, carried out over a long period. Initially, the BoJ will begin to reduce the amount of excess reserves it puts into the banking system. Then, it will start to raise the overnight call rate. In other words, policymakers will move from focussing on volume to targeting rates.

The central bank has always said that it would not abandon the zero interest-rate policy until inflation turned positive and demonstrated some upward momentum. Well, core year-on-year consumer inflation, which is the focus of the Bank's attention, did just that in November and December. And, it is forecast to remain in positive territory. What's more, it appears that consumers' expectation of future inflation is on the rise.

If, as expected, nominal interest rates increase at a slow pace, then real rates are likely to be meagre at best, and most probably negative, as

inflation picks up. This may prompt a reallocation of near-cash balances to alternative investments that promise a positive real return. In other words, the risk of holding cash increases and there is an incentive to re-allocate funds to assets such as equities and foreign-currency assets. At the same time, improving labour-market conditions, better compensation and rising inflation may all contribute to higher household spending.

The Japanese equity market had a very strong run last year, but became tactically overbought and has undergone a correction this year. Earnings expectations may have run a little ahead of what could be delivered. That said; the outlook for corporate profits is still good. In addition, monetary policy will remain fairly loose despite an end to quantitative easing.

So the market will find support from these two factors. On the other hand, valuations are definitely on the high side. Many stocks are selling at price-to-earnings ratios that are two standard deviations greater than their average PE over the past few years. So if momentum does return to the market, the upside may be curbed.

The European Central Bank is widely expected to raise rates by 25 basis points at its meeting on the 2nd of March. President Jean-Claude Trichet has clearly signalled the move, so there won't be any surprises. Recent data show that there has been a pickup in both consumer and business lending, leading to concerns that low interest rates are encouraging excess borrowing.

Meanwhile, there are indications of a speedup in economic activity. At the same time, nobody is expecting runaway economic growth that will unleash inflation demons. But there is sufficient vigour to necessitate some rigour in monetary policy. And the ECB is going to deliver it.

Up to now, Germany has played an important role in containing Eurozone inflation. The big size of the German economy and its perennial underperformance has weighed down on the region's overall inflation rate. But cyclical indicators for Deutschland have been looking rosier in recent months.

One reason why the ECB was exercising caution last year was the concern about the negative impact of tighter policy on big underperformers such as Germany. But that worry may be receding now and replaced with uneasiness about higher inflation.

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