

Weekly Perspectives

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A Weekly View of Global Economies

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Major equity markets have registered some pretty good performances so far, this year, and it may be time for a breather. There are worries about earnings growth and the risk of rising bond yields making stocks less appealing. Clearly, Europe has led the pack, with the pan-Europe DJ Stoxx 600 handily beating its US counterpart, namely the S&P 500. Japan has lagged the other markets. It stalled, and went into sideways motion in the first two months of the year. Only recently has it done some catching up. We are, of course, referring to returns expressed in local currency terms.

The strong momentum that drove the Japanese market forward, last year, has flagged. As we said previously, valuations had become stretched. Currently, the market is still expensive, as indicated by a common valuation measure such as the forward price-to-earnings ratio. On this basis, the market is quite a bit more expensive than the global average.

The earlier concern about the Bank of Japan's move to end quantitative easing has diminished somewhat. It is apparent that the BoJ is going to carry out its tightening policy slowly, and over a long period. Besides, the politicians are ever ready to bark loudly if they think the pace is a little too fast.

So, domestic interest rates aren't a major concern and monetary policy will remain fairly loose. However, rates in the US are also watched closely. Any signs of an over-zealous Fed or the possibility of a stumbling economy in the United States will likely hurt the Japanese export sector.

With the PE ratio high as it is, investors are going to be looking at earnings growth to play catch-up with the elevated valuation. What they want to see is a strong rate of revision for corporate earnings. Well company balance sheets are healthier than they have been for a long time and firms are increasing their capital spending.

This bodes well for economic activity and profits. It also opens up the possibility of upside earnings surprises and positive revisions in analyst estimates. However, on balance, it is best to exercise some caution regarding the extent to which this is achievable.

As for fund flows, foreigners continue to be the major prop for the stock market. Domestic players have yet to show up as steady buyers. Market weakness, earlier this year, was caused by reduced foreign demand and domestic institutions selling some of their holdings. Meanwhile, international fund managers are still favourably disposed towards Japan, giving it a higher weighting in their allocations, relative to its weight in the underlying MSCI World benchmark.

The same portfolio managers are even keener on Europe, and very much underweight the US. At the same time, money flows into European equity funds have been fairly healthy. Even after the strong run this year, valuations remain reasonable in global comparisons. The forward PE ratio continues to be more attractive than the one for the US market.

In addition, Europe has, overall, demonstrated better momentum. Strong global growth and slow but steady Eurozone recovery should support earnings, which nevertheless are expected to moderate. The hope is that cost pressures will be prevented from eroding margins substantially.

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Meanwhile, merger-and-acquisition activity continues to be hot and has been an important driver of the stock market.

Some of the M&A action has been of a cross-border kind, pointing the way to greater restructuring and better efficiencies on a European scale. And this is what is supposed to be happening to make the European economic project a success. But entrenched protectionist instincts die hard, and we have seen more than one case of blatant government intervention and old-style dirigisme to thwart a takeover bid. Europeans are still far better at talking about competitiveness and innovation than actually practicing it.

There is still a tendency in Europe for people who feel threatened to go and hide behind mummy's skirt instead of facing the rigours of globalisation. If mummy is strict, the kids throw up a tantrum. Witness the current labour troubles in France.

However, competitive pressures are rising, not just from Eastern Europe but increasingly from China and India. Most European leaders and forward-looking institutions are aware of the changing global scene. The difficulty is in actually implementing a competitive agenda. The Chinese government was willing to take the iron rice bowl away from workers by shutting down state enterprises. But it is not so easy for democratic governments to replicate what an authoritarian one can do.

Passing on to emerging market equities, they have demonstrated a degree of resilience and have yet to experience a sharp correction. This much is evident when we look at the performance of an aggregate benchmark such as the MSCI Emerging Markets index. It has rebounded after a spate of selling earlier in the month. But potentially negative factors are lining up.

Global liquidity is being reduced, and this has normally been an important element in causing a correction in emerging market valuations. The winding up of positions in the carry trade has already hit a number of high-yield countries. Meanwhile, money flows into the emerging-markets asset class have been waning.

There is also a risk that commodity prices may fall. Even if one can make the case for a longer-term commodity bull-cycle, it is still quite likely that we will experience a near-term cyclical correction related to deterioration in business conditions. The performance of many emerging stock markets is closely correlated with commodity prices. As for equity valuations, they remain generally high in historical terms. Well, we have run out of space and have to postpone comments on the US market to a future column.

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