

Weekly Perspectives

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A Weekly View of Global Economies

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North America

In an already tight demand/supply situation, any sign of trouble in an oil-producing country such as Nigeria, or weather-related disruptions, is enough to cause a rise in prices. Sentiment in the oil market is currently geared to look for increases rather than decreases. It didn't help, either, that US Secretary of State, Colin Powell, openly admitted that the rebellion in Iraq is intensifying.

He contradicted President Bush and interim Iraqi Prime Minister Iyad Allawi's rosier outlook. But reports coming out of Iraq appear to support Powell's more sober assessment. The coalition is finding it increasingly difficult to control the Sunni Triangle. Unfortunately, there is no easy way out of the Iraqi quagmire and it will take a lot more in terms of men and money to turn things around. The Bush administration is hardly likely to air these issues a few weeks before the elections, but will have to face up to them soon after that - assuming the President is re-elected. Meanwhile, the instability in Iraq will continue to keep the oil market jumpy.

The spike in oil prices is hurting broad equity indices. Investors are factoring in the negative impact on consumer spending, and therefore the corporate top line. At the same time, it boosts input costs and unless companies can pass it on in the form of higher prices, there is a squeeze on margins. Obviously, some sectors are hurt more than others, such as autos and airlines, but nobody can escape fully from its effect.

The problem is that high oil prices are being sustained for a more extended period than we initially expected. And the longer it goes on, the more likely it is that global growth will be hurt. The estimated resilience of the world economy to high energy prices was premised on a limited period of pain.

All of this bad news comes at a time when many firms have been issuing negative earnings warnings. As for the forecasts made by equity analysts, they have also been edging down their forward estimates, which are probably still too rosy. Normally, in an upswing, they tend to underestimate and in a downswing overestimate the actual outcome.

The twin deficits in the United States - being the current account gap and the budget deficit - can easily become a matter of concern, down the road. But, currently, there is little indication that foreigners are running away from US assets. Inflows have been more than sufficient to cover the external deficit and mop up the high issuance of government bonds.

Asian countries have been a major source of funding for the deficits. And there are no signs that the flow is about to dry up. Some people have called this provision of funds "vendor financing" at the macro level, similar to what firms do at the micro level. Asians have high saving rates and produce lots of goods, surplus to their consumption needs and available for export. In contrast, Americans, have low saving rates, and are ever ready to borrow and consume.

By buying US paper, policymakers in Asia finance the current account deficit and keep interest rates low. The overall result is to provide cheap credit and inexpensive goods to American consumers.

This has allowed households in the United States to continue spending at a high rate, even while inflation remains moderate. In addition, low interest rates have further boosted spending via elevated house prices and the refinancing of mortgages at cheaper rates.

In the short run, it is unlikely that Asian countries will reverse their policies. Even so, we should look out for any possible change in sentiment. In the longer run, as integration and diversification in Asia takes hold, there will be less reliance on the US market and fewer reasons to peg currencies to the greenback and finance deficits on the cheap.

Europe

The German Ifo business-sentiment index for September fell, as corporate managers worried about export growth. Meanwhile, domestic demand remains in the doldrums. Consumer confidence may have edged up, recently, but it isn't translating into more spending. A tough job market makes households reluctant to go shopping.

Asia/Pacific

Japanese data releases on the economy have been on the soft side. The trade surplus fell substantially in August, from a year ago, dragged down principally by the rise in oil prices. The focus of attention, this week, is on the release of the important Tankan business confidence survey. However, the momentum in industrial production appears to have topped out and the leading indicator of economic activity has been heading lower for a number of months. It remains to be seen if the Tankan survey will contradict these signals.

Bonds

Investors remain unconvinced by Greenspan's belief that the economy has "traction". Uncomfortable about the high oil prices, and jittery about Iraqi instability, they have been embracing longer-dated bonds. As a result, the yield on the benchmark ten-year note was pushed below four percent. It appears that fixed-income fund managers have gradually been increasing the duration of their portfolios.

Currencies

The yen has weakened, under pressure from rising oil prices, as well as mushy economic data and falling stock indices. Meanwhile, the Canadian dollar has been on a streak, helped by the rise in oil prices and traders' hopes for further interest rate increases.

Elsewhere, there is renewed speculation about a possible revaluation of the Chinese currency. In theory, this would help to cool an overheating economy and rising inflation. In practice, authorities in China aren't too keen on the idea, yet.

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