Weekly Perspectives

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A Weekly View of Global Economies

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North America

The US-led coalition in Iraq neatly tricked the insurgents by cleverly handing over power to an interim government two days ahead of the scheduled date. As a result, the terrorists must be hopping mad at being fooled and are bound to come back with some fireworks sooner or later. But, for now, their short-term plans have been foiled.

Meanwhile, a NATO summit meeting has been hosted in Istanbul. Yes, we know Turkey has been a member since cold-war days, but - - still - - the venue is a long way from the North Atlantic. So, obviously, a point is being made about finding a focus of attention for the alliance, in the Middle East and Asia. Also, the Bush-men are now a little more accommodative about multilateralism (la force des choses), though we'll have to see how others warm up to them.

The smooth Iraqi changeover was well-received by the markets, but without any lasting effect, given that the political reality on the ground hasn't changed much. To be quite honest, there is a lot of tough slogging ahead in Iraq, with the potential for untoward events injecting a dose of nervousness into markets.

Oil prices have experienced further declines because of recent good news about the supply situation. Norway has settled its oil-workers' strike and output is recovering in Iraq after the recent sabotage attacks on oil facilities. With geopolitical tensions a bit more relaxed, there is room for oil prices to edge lower. As we have previously noted, barring supply disruptions, the global economy can handle energy prices at these levels, without too much trouble. Furthermore, as economic momentum wanes, we should see some more easing of oil prices. At the same time, earlier expectations of a dramatic fall have been replaced with forecasts of more modest declines. Consequently, we are not seeing any significant sell-off in oil company stocks.

Scanning some other major sectors, industrials have been on such a tear over the past month and a half that we should now look for signs of exhaustion. Investor interest has been based on an expected pickup in capital spending by the corporate sector, which is enjoying very healthy cash positions. However, the information technology sector, that is in many ways also a cyclical capital-goods story, hasn't benefited from the same positive sentiment showered on the industrials.

The relative strength of the S&P 500 tech-sector index (i.e. its price performance relative to the broad index) is essentially flat, fluctuating around a horizontal trend line. At first sight, this is a little odd, given that business spending on hardware and software is proceeding at a good pace. The problem is that tech valuations are somewhat rich after last year's big run-up, and there is not too much room on the upside. Also, a lot of investors are wary about engaging in high beta plays in current circumstances.

In passing, we should note that many of yesterday's tech growth stocks are today's cyclical capital-goods candidates. In other words, earlier hot-shot issues may now have characteristics that identify them as staid performers. They can no more sport high valuations than ageing Hollywood stars can pass for teenagers, no matter how much they are tarted up. So the moral for stock pickers is to look very carefully. Nevertheless, it isn't out of the question to get a short-term tech rally if enough momentum players jump in. These folk aren't too fussy about looks, only about movement. And we have had too little of that lately, for their liking.

Writing before the Fed's FOMC (Federal Open Market Committee) meeting, it looks like consensus expectations are for a gradualist 25 bps increase in interest rates, at this gathering - - and we can't argue with that. Note that this is a view about what is likely, not what is desirable. At the same time, there is a lot of uncertainty about the outlook and nagging worries that the Fed may end up being behind the curve. Fine-tuning exercises by central banks are often poorly executed and risky, causing imbalances in the economy and over-shooting in markets.

Europe

German business confidence, as measured by the Ifo index, fell sharply this month. But French business folk are more ebullient, with the index of manufacturing sentiment riding high. Meanwhile, money supply growth in the Eurozone, as measured by M3, has moderated to 4.7%, which is pretty close to the European Central Bank's target rate of 4.5%. This should provide a bit of comfort to the ECB, though they are still watchful about the possibility of oil and tax-driven price hikes passing through into wage increases.

Asia/Pacific

There have been some softer economic numbers out of Japan, recently. Deflation, retail sales and industrial production were all worse than expected. But exports reached a record high in May, though its rate of expansion appears to be slowing.

Bonds

Just when the bond market was getting a little too complacent about inflation risk, they got a little surprise from the core PCE (Personal Consumption Expenditure) deflator for May, which matched the 1.6% rate recorded in the previous month. Notably, this inflation measure (one of Greenspan's favourites) has been rising this year. Investors didn't rush to upgrade their forecast of an FOMC rate hike from 25 bps to 50 bps. However, it was enough to re-ignite worries about the Fed being behind the curve.

Currencies

A brief look at this week's crammed calendar shows that there is a lot of event risk for the FX market, with the FOMC meeting and the employment report looming particularly large. Earlier, a higher-than-expected core PCE deflator didn't do much to ruffle the dollar's feathers, which has been trading in a fairly tight range against the euro.

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