Weekly Perspectives

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A Weekly View of Global Economies

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North America

After topping out in early March, stock markets have experienced a sharp fall, and investors are looking for some signs of bottoming. It could be argued, based on sentiment indicators, that pessimism has gone a bit too far and the market is searching for a reason to stage a short-term rally. At the same time, given the interest-rate headwinds, it is difficult to make the case that any rally will lead to the formation of a sustained upward trend.

The two main factors triggering the slide in equity indices were, of course, oil prices and interest rates. Fortunately, oil prices have started to decline from unusually high levels, as views about the degree of tightness in the supply/demand balance have been revised downwards. Global economic activity is still strong but there is no need for oil prices to remain - - for an extended period - - at a level that constitutes overshooting.

Any oil-price correction is helpful in enhancing consumer purchasing power and lifting corporate profit margins. And this is beneficial for maintaining growth in the world economy. At the same time, we should monitor activity levels carefully. Overly strong growth in some regions may carry the seeds of its own destruction, by stoking inflationary fires and eliciting dampening policy responses from the authorities.

Among the big economies, the US and China remain the global growth champions, being the main engines of economic expansion around the world. American consumers are continuing to spend with enthusiasm and Chinese investment expenditures have yet to slow down. Meanwhile, US corporate capital spending appears to have picked up, though executives remain cautious about the outlook.

Many firms have substantial cash flows that can be deployed in a variety of ways. As we have mentioned previously, if management can't find good use for the cash, then paying it out to shareholders in the form of higher dividends or stock repurchases may be appropriate.

The track record of managers who use accumulated funds to acquire other businesses shows that it hasn't always been in the best interests of long-term shareholders. There is also the lingering concern that if corporations are not engaging in substantial capital spending, then it may not just be a sign of caution but an indication that there aren't many growth opportunities that they can identify - - in other words, fear that the expected return on capital may be too low relative to the required threshold for viable projects. However, this sort of problem only applies to particular sectors and is unlikely to be true for the economy as a whole.

The increase in US inflationary pressure is still modest but it has been enough for the Fed to change its language and adopt a more combative stance. Policymakers have sent out the message that they are ready to prevent inflation from becoming a problem, and this translates into a tighter monetary policy than has been envisaged by the markets up to now. Pass-through of higher costs and a measure of pricing power have put the Fed on alert.

Central bank vigilance is an important factor in preventing an inflationary spiral from taking hold. So the Fed's more aggressive attitude is positive in this respect. At the same time, it is negative for growth and profitability.

Interest rates in the United States are likely to rise to a higher level than many investors had previously factored in. The real fed-funds rate has to be sufficiently punitive to bite. The lake of liquidity that has been feeding the equity market and promoting risk taking isn't about to dry up but is going to be drained to some extent.

There has been a noticeable reduction in risk appetite. The riskiest assets, such as high yield debt and emerging market equities are feeling the pinch, and the pain may not be over yet. Meanwhile, the rally in the greenback is an indication, partly of the increased attractiveness of US fixed-income yields, but also the expectation that higher interest rates, and eventually slower growth, will help to reduce the current account deficit - - and therefore relieve the downward pressure on the currency.

Europe

The Stability Pact covering deficit and debt level targets has been reformed in the direction of greater flexibility. Essentially, the new Pact lessens the pressure to reduce deficits quickly. Big countries, like Germany and France who are prone to break the rules are given greater leeway to achieve targets. Smaller countries, who play by the rules, have greeted the new arrangements with cynicism. Meanwhile, given the possibility of fiscal relaxation, the European Central Bank is likely to react with an extra degree of vigilance. Investors are also concerned about the possible impact on the long-run value of the euro.

Asia/Pacific

Rising interest rates and the mopping up of liquidity are having a negative impact on Asian equity markets. Generally speaking, valuations aren't unattractive, but they are a little stretched in terms of historical precedent. In a risk-averse environment, the prospect of more rate increases is unlikely to produce stock-market out-performance. As for Japan, flows generated by foreigners are particularly important in determining the direction of the stock market.

Bonds

The word "neutrality" has taken on a new meaning since the recent shift in the Fed's stance on policy direction. Consensus expectations are for tougher action from policymakers and neutrality is now consistent with higher interest rates than before. Under these circumstances, there is a tendency for the Treasury yield curve to undergo a bearish flattening.

Currencies

The forex markets are currently focussing on the strength of the US economy, which is generating more inflation and forcing interest rates higher. So traders have been backing the USD versus a range of currencies. Commodity currencies have been hurting, even though global demand for a range of products remains strong. The yen has been particularly weak, on the basis of deteriorating yield differentials and high oil prices.

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