Weekly Perspectives

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A Weekly View of Global Economies

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The US stock market took a breather on Monday, after ending Thanksgiving week on a higher note. But the momentum that has been driving the market higher may not have waned. One day's trading is not enough to indicate a change in direction.

Shoppers were out in force after the holiday and turnover was healthy, but there was unease on Wall Street that volume was pumped up because of heavy discounting, and that can't be too good for retail margins. There is a lingering concern about the staying power of the consumer who needs to be enticed by deep price cuts.

As for the housing market, which is an important factor in household behaviour, a cool-down would represent a positive development for the economy, preventing the need for a tougher monetary policy. House price increases may be slowing down in some areas, though the still-elevated asking price represents an affordability problem for some potential buyers. At the same time, there has been a decline in home equity lending at banks. So it appears that we are beginning to see further signs of cooling in the housing market, and that will cheer up the Fed which has been aiming to achieve just such an outcome.

The consumer remains the mainstay of US economic growth and everybody will be watching to see how the household sector fares under more challenging conditions. As we all know, what the Fed wants to do is to rein in an overly rapid rate of growth that could have untoward consequences for inflationary pressure. More importantly, any sensible policymaking entity may want to prevent the build-up of inflation expectations that would subsequently be difficult to reverse.

Targeting the housing market is a good way of taking some steam out of the economy, and hopefully it may not require too many turns of the screw to achieve that end. And it would still leave real rates sufficiently low so that corporate capital spending is not seriously compromised.. What policymakers need to do is to demonstrate sufficient anti-inflation vigilance without overreacting in the short run. Going for inflation overkill can seriously damage growth prospects. None of the major central banks, in the US or elsewhere, is faced with conditions that need strong action.

As we have said before, the structural backdrop is favourable. Ongoing productivity growth and the process of globalisation are sufficiently powerful to prevent any serious outbreak of inflation. The monetary authorities in Europe and America have issued plenty of signals that they won't fail in their task of preventing a price spiral from developing and the politicians are generally keeping trade-protectionist sentiments in check.

For now, market fears about an overly aggressive Fed have receded. But those concerns may resurface if US growth does not slow down. In that case, the central bank may have to extend its tightening cycle and this could make the environment more challenging for the stock market. A rebalancing of global growth whereby a slowdown in the US is offset by faster growth in Europe and Japan would be the best outcome. This would extend the sustainability of US growth without the risk of a hard landing.

Part of the reason for ebullience in the stock market in recent weeks is the expectation of a more limited interest-rate increase cycle. But of course there is another key factor that has an impact on valuations, namely earnings. The problem is that a slower economy will likely weigh on earnings growth. The trend in US productivity growth is still positive and wage inflation is contained, but the profit share of GDP is already at a high level which means that further gains will be more difficult to generate.

If the Fed feels that it has achieved neutralisation with only one or two more interest rate hikes, of twenty-five basis points each time, then that will diminish the risk premium attached to stocks and perhaps allow some expansion of multiples. In other words, expected cash flows, even if they rise more modestly, will be discounted at a relatively low rate.

We should be watching the signals from leading indicators in the next few months, but the likelihood is that they will point to slower global growth in the second half of 2006. Central banks in Europe and Japan are expected to engage in some modest tightening which will erode part of the interest rate gap relative the United States. This is likely to reduce some of the attraction of holding dollars, particularly versus the euro.

If the growth slowdown in the global economy is judged to be a necessary phase to work out excesses and allow adjustments before a longer-run expansion is made possible, then investors may consider stocks an attractive asset class, taking account of the entailed risks. But obviously the development of this scenario isn't a given and there are uncertainties involved, which may result in volatile periods.

As for the short term, major global stock markets have had a very strong run in the past few weeks. Sentiment and momentum have undoubtedly played a part, as fund managers hope to register gains before the end of the year. The Morgan Stanley emerging markets index has risen significantly from its October lows, and there appears to be renewed foreign appetite for Japanese stocks.

The equity market has risen sharply over a short period. Technical and sentiment indicators seem extended, so that a pullback would not be unexpected. However, timing a correction is difficult when there is so much momentum, with the possibility of the rally being fuelled by late-comers as well as short covering.

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