

# Weekly Perspectives

Website: [www.lomam.com](http://www.lomam.com)

Email: [info@lomam.com](mailto:info@lomam.com)

[iraj.pouyandeh@lom.com](mailto:iraj.pouyandeh@lom.com)



## A Weekly View of Global Economies

3 May 2005

### North America

The equity market, as represented by a broad large-cap index such as the S&P 500, has remained choppy, after slumping in the second week of April. Volatility has increased and risk appetite has diminished. Investors are uncertain how protracted the slowdown will be, and the market is reacting to every piece of news on the economy or on oil prices. It is having a difficult time forming an overall picture and getting a sense of direction.

Volatility gauges such as the VIX have risen from their earlier state of slumber, indicating that the market is anticipating more risk. However, the consensus expectation is still for a moderate decline in the equity market. Meanwhile, those most concerned with protecting their downside are hedging their bets by buying put options.

The S&P 500 has been broadly range bound, with the market failing to make a decisive move to the upside or the downside. Also, there is still plenty of rotation into and out of cyclicals. However, a larger number of fund managers are reacting to the gloomier outlook for the economy by becoming increasingly defensive. A slowing economy and rising interest rates are conditions under which defensives are expected to outperform cyclicals.

The earliest point in time when it may be safe to look positively on cyclicals again, is after the Fed has finished raising interest rates. But that may be too early to jump in, because the economy reacts with a lag to tightening monetary conditions. A safer bet is to look for a positive turn in leading economic indicators - - as well as sentiment indices - - before overweighting sectors geared to an economic upswing.

Those same indicators are currently pointing to a loss of momentum in the US economy and a modest pickup in inflation. Both bond and stock markets are focussed on the economy. They are reacting to the same economic data and positive or negative newsflow. It is not so much a case of rising bond yields sinking the stock market as of bad news about a weakening economy leading to a decline in both. Positive newsflow on growth tends to perk them both up.

First-quarter US GDP growth was lower than consensus forecasts. Consumption spending grew at a solid pace but investment expenditure was disappointing. This is not a good mix, as most people were hoping that lower consumption outlays would be replaced by higher corporate capital spending. Household finances are stretched while firms have decent cash flows. As for the core personal consumption expenditures (PCE) deflator, it hasn't broken to the upside but is high enough to remain in the Fed's gun sight.

With the Q1 US earnings season winding down, it must be said that the overall scorecard has been good. However, this hasn't fired up a lot of enthusiasm among investors who remain unimpressed by the forward guidance.

### Europe

Economic growth in the US has slowed down but it is still outdistancing the Eurozone's performance by quite a bit. High oil prices and the previous appreciation of the euro have been a drag on economic activity in Europe. Well, both oil prices and the currency have fallen from previous highs, which should give the Eurozone a breath of oxygen to allow it to revive. But don't expect the patient to jump up and start running, given the area's traditional sclerotic structural problems.

Meanwhile, faced with evident economic weakness, the European Central Bank has held off raising rates despite the worrying factor of a watered down Growth and Stability Pact. But any sign of a clear pickup in economic

activity is likely to renew expectations of a move by the ECB. In the meantime, growth divergence as well as interest rate spreads in favour of the US are keeping the euro weak against the dollar. This has the advantage of helping the export side of the Eurozone economy.

In the UK, earnings reports from retailers point to weakness in household spending. It looks like the consumer is finally succumbing to a number of negative factors. Higher interest rates, energy prices and taxes have been squeezing heavily indebted households. At the same time, the housing market is cooling, and elevated house prices that have underpinned consumer confidence in the past few years are slipping.

### Asia/Pacific

Investors are hoping for a pickup in Japan's real estate market. Last year, central Tokyo property prices rose for the first time in a very long while - - since the boom went bust more than a decade ago. Japanese as well as foreign investors are nibbling on real estate again. But early birds bought properties several years ago, waiting for a turnaround. If the rebound holds, it will help to improve confidence in the household sector and boost balance sheets in the corporate sector. The result could be a greater willingness to spend.

Meanwhile, the nationwide core consumer price index - - used by the Bank of Japan as its benchmark to set policy - - fell again, year-on-year, in fiscal year 2004 which ended in March. This was the seventh consecutive year of mild deflation. So, it is unlikely that the Bank will cease its quantitative easing and the aim of holding interest rates at near-zero levels until the core CPI shows consistent gains.

### Bonds

The market has already priced in a rate increase at the FOMC meeting this week. So what everybody will be focussed on is the language adopted by the committee. Policymakers will seek to formulate a phraseology that leaves them with as much flexibility as possible to change their stance in the future, but will assuage any concern that they may become soft on inflation.

Moderation in the ISM index points to waning economic momentum. More importantly, the payroll report at the end of the week will be very significant in giving direction to the fixed-income market. Employment numbers are quite capable of surprising observers, but barring the surprise factor the general trend in the US economy is for an ongoing slowdown accompanied by an uptick in inflation. The general expectation is for a tendency towards a relatively flat Treasury yield curve.

### Currencies

There is more talk about renminbi revaluation and a widening of the trading bands around the pegged rate, following comments in a government-controlled newspaper. The market's expectation is of a possible move during this week's Chinese holidays, judging that this would provide the authorities with a good opportunity to make the policy switch.

### Iraj Pouyandeh

Strategist / Senior Portfolio Manager

*Prior to joining LOM Asset Management, Iraj Pouyandeh worked for Sun Life Financial in Toronto, advising on the global economic and financial outlook and strategy for the company. Mr. Pouyandeh manages the LOM Equity Growth Fund.*



LOM Asset Management Limited  
27 Reid Street  
Hamilton, HM 11  
Bermuda  
441-295-6999

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