

Weekly Perspectives

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A Weekly View of Global Economies

30 May 2006

Risk appetite has waned on global financial markets, and the riskiest class of assets have been the hardest hit. Emerging markets equities that were leading the charge at the beginning of the year have suffered some of the biggest declines.

And commodities, which have a strong correlation with the stock-market performance of many emerging countries, have undergone a sharp correction. Of course, there are some investors who now see this as an opportunity to enter these previously high-flying markets at what they now consider to be a more affordable price.

However, the environment remains a challenging one for risky asset classes. There are continuing worries about the rise of inflation. One or two upbeat data releases may change short-term sentiment about the seriousness of inflation, but the trend isn't going to reverse abruptly.

Growth in the United States, and at the global level, has to slow down from the current hot pace in order to put inflation fears to rest. Either this occurs naturally or policymakers have to act to make it happen. And, of course everybody hopes that this occurs in a smooth way, with no jarring consequences.

Essentially, it is a belief in the fine-tuning capabilities of central bankers. But, some investors are unconvinced that central banks have the finesse to fine tune the outcome. They think that monetary authorities are likely to over or undershoot in their policy actions.

In other words, the policymakers may be complacent and leave it too late before being forced to overreact. Alternatively, they may administer too strong a medicine right from the start. Looking at their actions so far, we can hardly accuse them of being over-reactive. Rather, they are dragging their feet in tightening monetary policy.

Equity markets have had a very good run over the past several years from the liquidity largesse provided by the central bank folks. In particular, the Bank of Japan's easy policy was an important factor in global liquidity creation. But the Fed had a big role too, under bubble-meister Greenspan, in pumping money into the economy.

And you all know that his successor, Ben Bernanke, has the popular nickname "helicopter Ben". This refers to his willingness to increase liquidity by unorthodox means if deflation threatens.

Currently, markets are uncertain about how serious the inflation threat is, and how strongly the central banks will react. This means that we will continue to see a good deal of volatility until the outcome becomes a little clearer. Right now, risk indices remain at a high level, which is favourable to a defensive investment stance.

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For equity markets, the hope is that the end of Fed tightening is almost at hand and, before summer ends, equity valuations can move sharply higher. Given the size of the US economy and the correlation among global stock markets, we would also witness a sympathetic rise elsewhere.

This would be reminiscent of what happened in the nineties, when the Fed ended its restrictive policies. However, the circumstances are different now, and stock-market valuations not as cheap as they were back then. Inflation may continue to be a problem after the Fed pauses, and the economy may need stronger action to bring about a slowdown. The central bank may have to renew its tightening policies after the pause, and that would be painful for stocks.

Enron's Kenneth Lay and Jeffrey Skilling were recently convicted of fraud and conspiracy. The conviction must provide some satisfaction to employees and investors who lost lots of money because of these people's misdeeds. What happened at Enron was a classic case of powerful executives engaging in illegal activities and benefiting from a conspiracy of silence.

Insiders at Enron, outside auditors, the media, as well as Wall Street analysts and investment bankers, were mum about what was happening. They all had a vested interest in looking the other way. And, of course, it was a time when high-flying stocks were popular with the investing public. So, few people bothered to examine the fundamentals. Since that time, and with the coming into force of the Sarbanes-Oxley Act, the US government has become tougher on corporate crime.

However, it is not clear that there has been a sea change in corporate governance in the United States because we continue to see cases of executive misdemeanour. For example, there is the issue of backdating out-of-the-money stock options granted to already overpaid senior executives. This is done at the expense of shareholders' interests.

Corporate crime by top executives is just as prevalent in Europe and Asia. However, there are fewer reported cases, simply because the legislation is inadequate. In some places, insider activity is considered to be normal practice.

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