

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Despite a number of risk factors still clouding the horizon, such as the hefty twin deficits - - by which we mean the current account gap and the budget shortfall - - US economic growth has kept up a decent pace. Looking forward, the expectation is that there will be a growth slowdown in 2005, but the deceleration should be moderate. This is the base case scenario, which may possibly be threatened by shock events. The pessimists and the risk averse are likely to focus on the downside.

Asian vendor-financing of American consumers is continuing, and monetary policy is still relatively easy by historical standards, even though it is clearly in a tightening mode. As for the imbalances, you may remember that they were essentially created by policymakers goosing up the economy in the aftermath of the tech bubble-burst.

We have lived with the imbalances for a long time now, and there is no particular reason why they should cause major dislocation in the global economy this year rather than next, or perhaps never, if a slow adjustment process takes place. So barring any shock events, longer lead indicators are pointing to a pickup in activity in the second half of the year.

US consumers haven't given up their deeply-ingrained shopping habits. They are happy to go on spending if the means are there. Oil prices are coming down, and there is at least some employment and income growth. Sure the Fed is turning the monetary screws, but ever so slowly.

If the Asian central banks don't pull the rug from under US households' feet - - and the betting is - that they won't, not least because it will hurt their own interests badly - - American shoppers can go on spending, though not at the same robust pace as before. So we should not count the consumer out but, at the same time, maintain a cautious approach regarding more vulnerable sectors, such as retailers.

Positive sentiment caused the stock market to overlook some iffy fundamentals in the fourth quarter and many cyclical stocks did well in apparent defiance of orthodox theory. Many areas in technology, capital goods and even materials have outperformed, while others have lagged. Of course it is always sensible to drill down to specific conditions and expectations about sub-sectors before upgrading or downgrading them. Looking primarily at broad sectors, averages out top and bottom performers that are only apparent at the sub-sector level.

Earnings growth for a broad index such as the S&P 500 is likely to be more modest this year - - in the 5 to 8 percent range. Meanwhile, firms have the means to engage in stock buybacks, or higher dividend payouts. These factors should help to support stock prices. But there is also room for multiple compression as interest rates rise, and that is a negative factor. So, overall, there should be some upside for the stock market though the going may be a bit rocky. At this point in time, stocks are cheap relative to bonds.

In terms of regional diversification, investors are likely to underweight the US because of concerns about high relative valuation. Markets in Europe, non-Japan Asia and the emerging world are inexpensive in comparison with the United States. At the same time, earnings in the US, relative to trend, are higher than elsewhere and therefore subject to greater disappointment.

In addition, there is a risk that interest rates could rise faster than in other regions putting downward pressure on bond prices as well as the stock market. Lastly, US-based investors are showing a greater appetite for international investment.

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Europe

Even after last year's run-up, European equities still appear cheap compared to other major developed markets - - sporting high free cash flow and dividend yields. While earnings growth is expected to be more modest than in the US, there is a smaller deviation from trend and less vulnerability to negative surprises.

Also, interest rates are less likely to rise as fast as in the United States. Structural reform is somewhat slow but there is increasing pressure to change emanating from Eastern Europe, where many countries have low corporate tax rates, cheap labour and less regulation. As the year progresses, appreciation of the euro against the greenback may be capped by a rise of Asian currencies versus the US dollar, taking the pressure off the Eurozone currency.

Asia/Pacific

The swings in the Japanese stock market are fairly closely tied to the global growth cycle. Exports are important drivers, and normally the market turns up ahead of an upswing in the world economy. Currently, domestic demand is not strong enough to lead the economy or the market.

At present, the economy and corporate earnings are both losing momentum. An additional risk is that the authorities may make policy mistakes. Prime Minister Koizumi is planning to reverse a portion of earlier tax cuts, in the next two fiscal years. There are also concerns that the Bank of Japan is harbouring thoughts about reversing its zero interest rate policy if the economy picks up strength.

Meanwhile, stock valuations are less attractive than in Europe. A nice feature of the Japanese market, though, is that it has a low correlation with the US. There are also lingering hopes about the restructuring story among some investors. So it is risky to be short Japan, but there is no convincing reason to be overweight either until we get a better fix on an upswing in global growth.

Bonds

Inflation fears appear to be creeping back into the US Treasury market. Economic data releases have been on the strong side and that's being priced into yields.

Currencies

Currency markets have been relatively thin and choppy over the holiday period, and we will get a better sense of direction as activity picks up. There are 3 things to focus on: (1) There is a feeling that in the short run USD depreciation has overshoot the mark and there is room for a correction. (2) There is still a belief in the US dollar's broad downtrend tendency, based on structural factors. (3) There is an expectation for Asian currencies to appreciate during the year, easing pressure on the euro.

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