Weekly Perspectives

Website: www.lomam.com

Email: info@lomam.com

iraj.pouyandeh@lom.com

A Weekly View of Global Economies

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The global economy is chugging along nicely, helped, in no small measure, by a significant decline in oil prices since it peaked in August. This has helped to reduce expectations of higher inflation and the perceived need for central-bank tightening. However, by boosting growth, low oil prices may renew worries about an up-tick in inflation. So central bank vigilance is far from over.

Let's just repeat that there is little danger of an inflationary spiral taking hold in developed economies. The macroeconomic backdrop is not conducive to such an outcome. For that eventuality to come about we would need to see a decline in the forces of globalisation, a rise in protectionism and much looser monetary policy than we are currently witnessing. None of these things are on the radar screen. That said; there are preliminary signs of a rise in protectionism, which bears monitoring.

This leaves the central banks the task of making sure that growth does not run too far above trend, which could raise inflation a notch and increase expectations of a further rise. Recently, the Bank of England got a bit of a surprise and had to tighten by 25 basis points. Among the other major central banks, the one that is most likely to raise rates is obviously the European Central Bank. However, its hawkish reputation is not justified by its actions. In the past, it has generally been slow to act.

American consumers have shown a good deal of resilience in the face of a weak housing market. Part of the reason is that interest rates at the longer end of the yield curve, that affect mortgage rates, have been well-behaved. Another factor is that the bulk of borrowers have fixed-rate mortgages that are largely protected from rate increases.

But even more importantly, lower oil prices have had the same effect as a tax cut for the household sector. And, true to form, American consumers have been out in the malls celebrating their good fortune. In addition, the labour market has been strong, boosting disposable income.

Over in Germany, Angela Merkel's popularity is up in the polls because the economy is doing so well. The impact of the VAT (value added tax) increase, introduced on January 1, does not appear to have been as bad as feared earlier. Meanwhile, the unemployment rate continues to plummet. It fell to 9.5 % in January, down from a high of 12% in March 2005. Going forward, labour-market strength should help domestic spending even as the export sector continues to be healthy.

As for the stock market, despite a considerable rise over the past year, it is still attractively valued relative to global stocks, on a PE basis. At the same time, given the strength of the economy, bond yields have been picking up. And, except for Japan, this has also been the case for many other bond markets, in Europe and elsewhere, as investors factor in more robust global growth

The Eurozone economy is also doing well because of the high weighting that Germany has in the area's total GDP. However, the other biggies, France and Italy are relative laggards. So optimism regarding prospects for the single-currency region may have become a bit excessive. Overall, the indicators present a mixed picture, with the potential for some softening.

Monetary conditions are fairly easy and this should support growth. Inflation is low and there is little indication of acceleration. So there is no justification for aggressive tightening by the ECB. Modest interest rate hikes should do the trick.

The Eurozone's leading economic indicator is losing momentum, and the same thing applies to industrial production. Consumer confidence is still trending higher but industrial confidence appears to have topped out. The German IFO expectations index is up but the Belgian business confidence index is heading lower.

The situation is heating up in the Middle East and there is a possibility that geopolitical risk may rise faster than expected. The Bush administration's troop "surge" in Iraq appears to be aimed principally at confronting Iran. A flood of rhetoric coming out of Washington, together with a build-up of US forces in the Persian Gulf, leaves little doubt as to who is being targeted.

Zbigniew Brzezinski, a former national security adviser in the Carter administration, has put two and two together and come to the same conclusion. He thinks that the strategy is to provoke Iran into a response that would form the pretext for a military attack. The pieces are being put in place for an escalation. As with the preparation for the invasion of Iraq in 2003, the propaganda machine is getting into high gear with a slew of stories with little factual content, building up justification for an attack on Iran.

So why aren't the markets pricing in the risk? One reason is that it is a complex situation with many variables, making it difficult to forecast just how it will play out. Therefore, most people will wait for more evidence of escalation. Another reason is that recent crises in the Middle East have been contained. Iraq has been a mess for a number of years but its problems have not spilled over into surrounding countries. Similarly, the war in Lebanon was ended without spreading regionally. As a result, the average expectation is that this conflict will also be contained.

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. He manages the LOM Global Equity Fund.

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27 Reid Street
Hamilton, HM 11
Bermuda
441-295-6999

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