

# Weekly Perspectives

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## A Weekly View of Global Economies

5 July 2005

### North America

In the US, the ISM (Institute for Supply Management) manufacturing index perked up in June. This broke a downward trend that has been in place since the middle of last year, but it is unlikely that a trend reversal is about to occur. So we can retain the view that the manufacturing sector is still expanding, but that it is also losing momentum.

In addition, in the latest data revision, government statisticians have raised their estimate of first-quarter GDP growth. But, as far as analysts are concerned, that is already history, and their focus is on the outlook. They know that oil price increases and interest rate hikes are going to hurt growth in coming quarters. Consensus forecasts have been edging lower - down from the rosier predictions issued at the beginning of the year.

All the same, US economic growth continues to handily outpace the performance registered in Japan and the European region. And, not surprisingly, the Federal Reserve is pretty much the only major central bank that is on a rate-increase path. All the others are either standing pat or contemplating possible interest rate cuts.

Well, the Fed did what was expected last week, namely a 25 basis-point hike. And the accompanying statement didn't surprise anybody, though some observers thought that it was slightly more hawkish than before. The policymakers are apparently more focussed now on the overheated housing market and the need for some cooling to forestall a possible crash.

Their intention is to correct the underlying imbalance caused by a somewhat extended household sector that has kept up a high rate of consumption spending, as well as investment in housing. In the overall flow of funds accounts, the money has to come from somewhere, and in this case the ultimate funding has been done principally by foreigners.

Household excess has of course been reflected in the wide current account deficit - with the rest of the world running surpluses and financing American household expenditure. We should note that the government is also a major deficit sector, financed by foreign inflows, while the corporate sector is in surplus. These are the imbalances that have been worrying folks like Warren Buffett for the past year or two.

There is good reason why the "measured" pace of rate increases is likely to be maintained. The purpose is to gently deflate the housing "bubble" because a precipitate fall in house prices will increase the chances of a sharp slowdown in growth and a possible recession.

It is a fine-tuning exercise that does involve risk. Whether they get it right will have a considerable impact on the outlook for stocks and bonds. And there is no reason why the Fed cannot indulge in an extended pause after the next hike and resume tightening if activity picks up again.

Another reason for a slow approach to tightening is that the economy and financial markets have become attuned to easy money for such a long period that they may find it difficult to adjust to a tighter environment.

### Europe

Economic growth in the Eurozone is likely to continue at a measly pace this year, with only a marginal improvement expected in 2006. Export demand will remain the principal driver of growth. The main impediments

to better performance are of course structural ones, particularly in the major countries. Change is occurring, but ever so slowly.

Currently, despite hope in some quarters that the European Central Bank (ECB) will cut interest rates, there isn't a lot of motivation for them to do so. The euro has weakened substantially versus the dollar, and this effectively eases monetary conditions. To the question: what would force policymakers to change their stance? The answer is: if the euro were to reverse course or the European economy slips into negative growth.

Managing monetary policy in the Eurozone has always been a challenging problem for the ECB. For one thing, Europe is not a unitary state, or even a federation. It is still largely a collection of sovereign states and there are political considerations in formulating policy that does not upset major interests.

Of course, some European countries have refused to join the monetary union in order to maintain policy independence. And there are renewed mumblings among others about the option of dropping the euro. But blaming the ECB is a facile way for politicians to divert blame from their own inability to face up to the tough challenges of implementing structural change.

### Asia/Pacific

Japanese domestic demand is looking a little healthier, led by private consumption. It appears that wage gains and improvement in employment conditions may have boosted consumer sentiment and spending. Meanwhile, though industrial production was disappointing, the Tankan survey of business confidence was upbeat indicating that firms are more optimistic about the trend in economic recovery.

### Bonds

Yields on longer-dated government bonds have been rising recently, in Europe and America. Even so, they remain at low levels. There appear to be a number of factors involved. In part, investors have doubts about the sustainability of growth and view oil price increases as more of a tax on growth than a boost to inflation. There is also a search for yield in a low-yield world and a flight to quality amid greater risk aversion. Risk factors to monitor are: any upside to growth in China or the US, or an inflationary flare-up that will put upward pressure on yields.

### Currencies

Sentiment is still dollar-positive, supported by US economic data and expected Fed rate hikes. Sterling has continued to slide against the greenback, despite the fact that recent UK economic reports have been better than consensus expectations.

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