

# Weekly Perspectives

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## A Weekly View of Global Economies

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Last week's turmoil on the financial markets came as a surprise to many people. A long period of low volatility had allowed them to descend into a state of complacency. Unfortunately for them, such events don't give advance notice that they are about to occur. The more astute would have worked out earlier that there was a discrepancy between risk factors and high risk appetite among investor.

And who said volatility is a bad thing. Those who were long the Swiss franc, the yen and Vix call options are pretty pleased with the turn of events. As for long-only equity investors, they have had a good run over the past seven months. Markets have been up strongly since last August, generally ignoring any untoward developments during that period. They were overdue for a correction. As usual, such bull runs continue longer than anyone expects, and it is tough to call the exact top.

The trigger that set off generalised selling was the plunge in Chinese A-shares, last Tuesday — with repercussions around the world. Of course, the fall in Shanghai and Shenzhen was only the proximate cause. The more important reason was an underlying concern about a cloudier outlook for the US economy and corporate profitability.

Chinese equity markets had been grossly overbought and a correction was inevitable. Optimists say that the year of the Golden Pig should be good for stocks. But the exuberance was just too much. It was clear that the authorities were worried about the pace of advance, and all it took were rumours of a government crackdown on buying stocks with borrowed money, and of a possible interest rate hike, to trigger the selling.

The fall in Chinese share prices does not reflect prospects for the economy. Growth is still strong and inflation is contained, although we may be on course for a modest slowdown in economic activity. The market is largely dominated by domestic investors, with lots of speculative trading by the retail crowd. But the household sector's exposure to the stock market is low. So there is little risk that there will be an impact on consumer spending.

Looking forward, the authorities may have to tighten monetary conditions to head off a possible rise in inflation and this is likely to pose some challenges for equity markets. In consequence, it is expected that stocks may experience some more weakness before resuming the next up leg.

The sell-off on global stock markets has been widespread. Generally, markets that had risen the fastest also experienced the steepest declines. Developing countries have been the hardest hit. But this is quite normal when risk aversion increases.

The Vix index spiked up sharply and other indicators of risk aversion also moved higher. Meanwhile, it was hardly surprising that government bond prices rose, as investors sought greater security. Credit spreads also widened, but not dramatically.

The traditional risk-aversion currencies of choice played their usual role. Both the yen and the swissie appreciated relative to the greenback. The two surplus-account currencies are also central to the carry trade, this being particularly true of the yen. So, the Japanese currency's rally has again heightened concerns that the unwinding of the carry trade may destabilise financial markets.

So far, yen appreciation hasn't got out of hand. It is usually the case that volatility abroad engenders greater risk aversion among Japanese investors, inducing them to keep their money at home. Hedge funds are also reducing their risk exposure and in doing so are causing further volatility.

Problems for sub-prime mortgage lenders in the US have increased risk aversion towards the financial sector, with the investment banks being the hardest hit. The cause for concern is their involvement in the securitisation of mortgages, which has been very profitable over the past few years.

There was easy money to be made and standards were lax. Now, questions are being raised about their exposure to credit risk. Credit default swap prices on the debt of investment banks have jumped recently, indicating the market's downgrading of their creditworthiness.

Other equity sectors that have declined substantially are "materials" and "consumer discretionary". This is hardly a surprise, as they are highly cyclical and do particularly poorly if there is a sharp economic slowdown.

The world economy is expected to decelerate modestly, and the biggest downside risk to global growth is weakness in the United States. Consensus views that the US housing market had bottomed at the end of last year were premature. The reality is that it will continue to act as a drag on the economy in the first half of the year.

There are signs of a softening in capital spending. As for the household sector, the job market is strong but real income growth is meagre for most people. The majority of the population do not benefit from large bonuses and stock options.

The borrow-and-spend practice based on home equity extraction is no longer viable, as it was previously. Some households have turned to other forms of borrowing to finance consumption. But this involves relatively high interest rates and is not tax deductible. In addition, credit standards are being tightened.

At the height of the market turmoil last week, it wasn't surprising to hear Ben Bernanke chirp about the US economy. His soporific comments that everything was well were obviously intended to soothe frazzled nerves. The pronouncements could have been mouthed by any salesman on Wall Street.

The underlying real message - - and obviously he isn't going to spell it out in so many words - - may have been that the notorious/famous Greenspan put option can still be exercised. In other words, the Fed stands ready to prevent a severe slide on the stock market.

Greenspan's bias was towards furnishing liquidity to avert corrections. He had a guiding hand in fuelling the housing bubble and general asset inflation. Bernanke comes from the same school of thought and is quite willing to increase liquidity if the consumer weakens or stocks plummet.

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