

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Investors were in an upbeat mood, last week, firing up a rally on equity markets - based on a more optimistic outlook for the economy as well as earnings growth. Now that the season for third-quarter earnings reports is starting up we will soon see if the optimism is justified. Once again, investors will pay particular attention to forward guidance. Meanwhile, oil prices seem to have lost their upward momentum and this has added to the feel-good atmosphere on Wall Street. However, the oil market remains vulnerable to short-term untoward events.

We don't want to be a spoilsport and pour cold water over the renewed enthusiasm, but it is still expected that the US economy will experience a growth slowdown. And none of the recent economic reports has revealed anything that contradicts this expectation. Looking forward, a surprise upward move in any of the economic data releases won't be unusual but won't change the trend either. Be it noted that we are looking for a deceleration in the average GDP growth rate, not a sharp pullback.

It does not mean that the quarterly growth rate in the next four quarters will tamely slow down in a neat sequence, from higher to lower. That sort of thing just doesn't happen in the real world, and we may very well get a bit more speed than expected in Q3. The central question is whether the US economy merely experiences a brief pause before it reaccelerates or whether it undergoes a more extended period of slow activity?

The often-quoted "soft patch" view of how the economy will perform argues for a quick turnaround in activity. A brief touchdown is supposed to be followed by a rapid ascent to a high level of growth. For this scenario to take place it is necessary that business spending picks up before consumer spending flags.

At this point in time, looking at the economic landscape, this does not appear to be a high-probability outcome. Thus far, firms haven't shown a lot of ardour in increasing their capital expenditures substantially. At the same time, they are reticent about large-scale hiring until they see better prospects for sales growth.

Households have a big debt load to service and have little room to lower their already low savings rate. And this puts the focus on the corporate sector as the prime agent of economic growth. It is not clear that corporations are ready to fulfil this role with a lot of conviction.

So it seems reasonable to assume that the slowdown will be something more than a soft patch. But the economic signals received by investors aren't clear and one-sided, which leaves them uncertain about the economic outlook and which way to jump. They are unwilling to bet decisively because the cost in terms of investment underperformance can be high, if they are wrong-footed.

As an indication of the degree of uncertainty, the deviation of price to earnings ratios across sectors - relative to their past averages - is very low. Also, the correlation of market returns, particularly between Europe and the United States, has risen. For fund managers, this puts the emphasis on stock-picking as the primary means to add value and outperform their benchmarks.

In terms of asset class allocation, cash yields very little and bonds are pricey. So, in investors' eyes this puts stocks in a better light. The yield gap between equities and bonds still favours the former because the latter

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offers such low yields. An equity risk premium model would also tend to lean in the same direction. However, if economic growth turns out to be substantially slower this will be favourable to bonds outperforming stocks.

Europe

European equity markets are relatively inexpensive, compared with the US market, on a number of valuation measures, with better dividend yields too. The main issue that is holding back many investors is the structural argument, comparing Eurozone "rigidity" with American "dynamism". There is some truth to this point of view, but it is not the whole truth.

Asia/Pacific

Japanese data releases regarding economic conditions point to a slowdown. At the same time, the Tankan sentiment survey indicates that business confidence is still quite robust. The index has reached a higher level than at any time since the 1989 bubble peak. This result, along with better sentiment and the tech rally on Wall Street was enough to give a lift to the poorly-performing Nikkei index. However, we should note that the economy is still on a slowdown path.

Meanwhile, fund managers have generally been overweight Japan. Unless, there are further convincing signs that the Japanese economy is going to outperform relative to expectations, it is unlikely that there will be more fund inflows and a risk that current holders may decide to lighten up on their Japanese allocations.

Bonds

The dip below four percent by the benchmark ten-year Treasury note was not sustainable, and it only took a rally on equity markets and better sentiment on the economic outlook for yields to head higher. This doesn't mean to say that bond investors have suddenly become bulls on economic growth. Rather, short-term overbought conditions are usually corrected, and that's what happened.

Currencies

The Chinese authorities gave no indication that they are edging closer to greater currency flexibility, dashing hopes that they would make at least a gesture at the G7 meeting last week. All in good time, they said. Earlier remarks were uttered in diplomatic fashion to please the Americans who need to look tough for home-grown political reasons - what, with all the concern in key States about outsourcing, cheap imports and all that, ahead of an election.

Traders were somewhat relieved that China is standing pat on the exchange rate, for now. More generally, judging that dollar weakness was overdone, they helped it rally against a slew of currencies, including the euro and the loonie.

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