Weekly Perspectives

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A Weekly View of Global Economies

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After lots of hawkish talk over the previous two months, the European Central Bank finally pulled the trigger last week. It hiked the benchmark rate by twenty-five basis points from the historically low level of 2.0 percent. Jean-Claude Trichet, the President, was keen to emphasise that this was not the start of a vigorous tightening cycle.

He made a credible statement that was largely accepted by the markets. A move by the ECB was in the cards and didn't surprise anybody. Carrying out the first increase in December rather than January did not make a lot of difference.

Few people think that Trichet is a scrooge. But a group of finance ministers - - some of whom have been very naughty in not keeping their books in order - - bleated about the prospect of higher interest rates and the pain it could cause. However, the Dutch finance minister, whose country has often been critical of big-deficit bad boys, supported the Bank's move.

In fact, the ECB isn't about to bomb the recovery. All it is doing is to move from a stimulative monetary policy to a more neutral one. Given that there is still expansion steam left in the Eurozone economy, we should expect some more gradual hiking over the next year. At this point in time, it seems reasonable to expect that official rates are unlikely to exceed 2.75 percent by year-end 2006.

Eurozone growth is not likely to accelerate past its trend rate of expansion next year, and inflation isn't gathering speed. So there is no need for monetary authorities to adopt a tough policy. However, household credit is rising fast and money-supply growth is strong. So the central bank had to take a small step towards the normalisation of short-term interest rates.

Domestic price pressure in the Eurozone appears to be contained, though we would do well to keep an eye on key wage negotiations early next year and their possible impact on unit labour costs. Currently, import prices are a bigger contributor to inflation, but oil-price moderation should help in this regard. In addition, the possibility of some appreciation of the euro's trade-weighted exchange rate could reduce imported inflation risks and modestly tighten monetary conditions.

In Japan, there has been more public squabbling between the government and the Bank of Japan over the BoJ's intended exit from its quantitative easing strategy. The official nationwide core consumer price index, which excludes fresh foods but not energy, was flat in October, on a year-over-year basis, and consensus expectations are that it will move into positive territory when the November data are released.

Of course, nobody expects a rapid reversal of policy. The BoJ itself has said that it will not make a move until an upward inflation trend is established. However, the government has not relented in keeping pressure on the central bank. To this end, a minister released an unofficial measure of core inflation, excluding both fresh foods and energy, which showed no relief from continuing deflation.

In view of the differing perspectives that authorities have regarding the end of deflation, markets have broadly moved their expectation of the end of quantitative easing forward, from the second quarter of 2006 to the third. There is even a possibility of an eventual accord between the government and the BoJ, setting out a desirable inflation range as a target rather than an explicit one such as the ECB follows. And that would be rather loosey goosey as far as the markets are concerned.

Investors' expectations of continuing easy monetary policy in Japan and tightening in the US has led to sustained weakness in the yen versus the dollar. This has generally been interpreted as being positive for exporters and the stock market, as yen depreciation can be a factor in an upward revision to earnings. But the equity market has had such a strong run over the past several months that valuations are now quite high in comparison with other major markets.

As we have mentioned previously, the rise has been fuelled principally by foreign purchases. Momentum buying may still push shares higher if investors continue to believe in the story of Japan's turnaround. But the market is also vulnerable to disappointment and a correction.

Another area where fund inflows have been substantial, and investors have been bullish, is the emerging markets category. Now, this is a very diverse grouping of countries scattered on all continents. It includes oil exporters and importers, commodity producers and manufactured goods exporters, as well as potential entrants to the European Union or the euro-currency zone. In terms of investment returns, picking the right country at the right time is critical to success.

But if we were to make a general statement in reference to aggregate emerging-market indices, it is that valuations are now somewhat stretched. As a consequence, there is a risk that disappointing news could bring about a correction. If the Fed ends up being more aggressive than currently expected, the impact on the smaller more illiquid markets could be substantial.

European equity valuations are still relatively attractive, amid expectations of decent earnings growth. Meanwhile there is the possibility of more equity being retired rather than supplied to the market, which can be positive for stocks. Equity is retired via leveraged buyouts, buybacks and M&A (mergers and acquisitions) activity, while equity is supplied through such processes as initial public offerings and secondary offerings. If risk-averse retail investors in Europe find an increased appetite for stocks, that would be another supporting factor for equity markets.

Meanwhile, foreign sentiment is improving, regarding prospects for the US stock market. Fund managers who have been underweight in their allocations to the United States may begin to increase their weighting. The key issues are: an early end to Fed tightening and a smooth transition to a growth slowdown.

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