

# Weekly Perspectives

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## A Weekly View of Global Economies

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### North America

The US January payroll numbers, reported last week, were biased downwards by weather-related issues. Largely ignoring the special factors, the bond and equity markets experienced a strong one-day rally. The data provided a measure of comfort for fixed-income investors who had their fears about inflation allayed. However, those worries have probably only receded to the background for now and may return with the next set of robust economic data.

There are really two major forces at work regarding inflation. On the one hand, ongoing globalisation, outsourcing and rapid industrialisation in emerging countries reinforce a deflationary trend in the world economy - for a wide range of traded goods, as well as some services. But, on the other hand, for the US economy, there are inflationary tendencies in play, via monetary liquidity, input cost increases and the low value of the dollar.

It isn't obvious which one of these two major forces has the upper hand in present circumstances. Clearly, deflation via globalisation is a long-run secular trend, while the factors underlying inflationary pressures are cyclical in nature and will therefore have a shorter-term impact, over the next year or two only.

We should also note that even if we project an upside to cyclical inflationary pressures, the outcome is likely to be a relatively modest acceleration in US inflation, unless, it is allowed to take root by policymakers expressly validating it. Barring this, the factor that would alter the scenario substantially would be a rise in protectionism, which is still an outlier event.

According to the latest survey, US households anticipate a modest 2.75% annual rise in inflation over the next five to ten years. So it appears that they currently hold fairly stable expectations regarding inflationary tendencies. This means that they will interpret large price fluctuations, including positive and negative swings, as aberrant events around the main trend. It will take a sequence of large price increases to cause an upward shift in household expectations.

In these circumstances, it may be difficult for corporations to raise prices in the face of consumer resistance. The evidence is that firms have been able to make higher prices stick in some sectors, but the practice isn't widespread or we would be picking it up in the aggregate numbers for the consumer price index or the PCE (personal consumption expenditure) deflator.

As for the equity market, people are hopeful that the easy monetary conditions that the Fed had so generously provided over the past couple of years will be undone at a slower pace, and be capped at a lower rate, than initially thought. Unfortunately, there are no guarantees from the Fed in this regard, and the market faces other headwinds besides monetary tightening.

The recent 25 basis-point increase in the target fed-funds rate by the FOMC (Federal Open Market Committee) was widely expected, and they are likely to continue hiking rates as long as the economy shows sufficient strength. They have the delicate task of balancing the dual goals of (1) demonstrating enough resolve to prevent inflationary pressures from building up, while (2) allowing moderate growth to proceed unhindered. This is a fine-tuning task that is normally difficult to do but has, fortunately, worked well thus far.

As we have said before, policymakers don't have a grand strategy in place but are feeling their way forward, one step at a time. In doing so, they have had a lot of luck on their side. The US dollar is still the major global

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reserve currency and Asian central banks continue to show a great appetite for low-yielding American fixed-income assets.

US corporate cash flows are still at healthy levels due, principally, to two major factors. For not thing, capital spending has been on the weak side, allowing the accumulation of large cash positions that are being used for share buybacks, acquisitions and possibly higher dividend payouts. At the same time, decent margins have underpinned high profitability.

The risk is that an increase in capex, or a margin squeeze, will reduce the size of these cash flows. Looking at the profit share of GDP, it is reverting to the mean after deviating substantially from trend in the past two years. This also ties in with cautious corporate guidance on revenues and earnings for 2005.

### Europe

Despite weak growth and excess capacity, Eurozone inflation has demonstrated a degree of stickiness, refusing to move down substantially. This is largely due to the fact that there are lots of fix-price rather than flex-price markets in many Eurozone countries. At the same time, it does not mean that there is a major risk of inflationary pressures building up.

### Asia/Pacific

Chinese authorities have reiterated their mantra that the current pegged exchange rate for the renminbi is appropriate and they are in no hurry to change. Meanwhile, high oil and commodity prices have increased corporate input costs and are feeding through to inflation which, nevertheless, remains contained.

### Bonds

Inflation-risk scares were notable by their absence in the US Treasury market, last week. Rather, the weak payroll report put a damper on such fears, causing the ten-year note to rally sharply. In addition, there are fewer worries that foreign official demand for US fixed-income instruments will wane any time soon. However, foreigners concentrate their buying at the shorter end of the maturity spectrum where they often account for over two-thirds of indirect buying.

Yields on longer-maturity European 'governments' have also fallen due to strong investor demand. Indeed, many finance ministries are busy issuing long-dated bonds to take advantage of market conditions.

### Currencies

Greenspan made some optimistic comments, last week, about US growth prospects and the possibility of the current account deficit narrowing. Also, he wasn't fearful about Asian central banks refraining from putting money into American assets. In addition, the Bush administration has submitted plans to Congress aimed at reducing the budget shortfall via spending cuts. The newsflow was positive for the dollar. Against the euro, traders bought back shorts as the dollar rallied through technical trading levels.

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