Weekly Perspectives

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A Weekly View of Global Economies

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North America

Supply concerns and security fears have combined to drive oil prices to record highs. Unplanned refinery shutdowns in the US have focussed speculative attention on the possibility of tightness in the supply/demand balance. Meanwhile, a terrorist scare in Saudi Arabia served to further underpin price increases.

Oil prices are likely to retreat from recent peak levels but we still have to contend with the fundamental issue that global growth has proved to be more resilient than envisaged at the beginning of the year. Furthermore, there is mounting evidence from leading economic indicators that activity will be picking up as we go forward. If this scenario holds up, then oil prices are not going to decline much until growth slows down.

While it differs from country to country, the overall sensitivity of global growth to high oil prices has diminished since the seventies and eighties, when expensive oil was a factor in precipitating recessions. Also, it is well to remember that, in real terms, oil was a lot pricier at that time than it is now.

So, by itself, a higher oil price will not sink the global economy, though it will hurt lower-income households, and pinch the profit margins of oil-sensitive firms. Looking at US consumers, there is some offset from better-than-expected employment creation and income growth. At the same time, the latest data show that the personal-saving rate has fallen to zero. In other words, the household sector isn't putting any money aside, out of current income.

High house prices, low interest rates and dampened macroeconomic fluctuations have led households to reduce the rate at which they save. But the Fed is aiming to cool the hot housing market and this could lead to some deflation of high house prices, even as energy costs impose a bigger "tax" on disposable income. So it is important that income growth should continue at a robust pace, or that oil prices fall, if consumption is not to slow down substantially.

A number of lead indicators have turned upward in several industrial economies. Not all of them have done so, and a few are still tentative but, put together, there is sufficient evidence of a potential upturn in activity as we go forward.

In the US, the Institute of Supply Management (ISM) new orders index is rebounding. Previously, orders had slowed down as a result of an inventory build-up. And now the over-accumulation of inventories is being corrected, leading to an increase in new orders. Also, the Conference Board's leading index has made an upward turn. Elsewhere, business conditions indices in Japan, Germany and the euro area are also pointing upward.

The US July employment report was quite strong, with non-farm payrolls rising a solid 207 thousand, accompanied by a net upward revision for the previous two months. At the same time, the unemployment rate remains at 5%, while the household survey indicates even more job growth than the establishment data which generates the payroll numbers.

So the Fed will keep on tightening in 25 basis-point steps. Financial conditions remain quite simulative and it is likely that the normalised fed-funds rate is going to be north of the 4% year-end consensus estimate. As for the flatness of the Treasury yield curve, Greenspan does not believe that it necessarily portends hard times around the corner. He is probably right, because longer-dated maturities are being held down by strong demand from institutional buyers and Asian central banks, and this has actually stimulated growth.

But the potential rebound in global growth has not gone unnoticed in bond markets, where longer-term yields are now on a rising trend. What we may get in the Treasury yield curve is not just a flattening but also a tendency for an upward shift in the level of the curve. This also opens up the possibility of episodes of re-steepening.

Stock markets have stumbled lately on account of higher oil prices and fear of rising interest rates; though sentiment is still positive and this could fuel some more upside market moves. However, we should continue to monitor oil prices and interest rates. Both are symptomatic of faster growth and both have the potential to slow it down. Of the two, interest rates in the United States are likely to pose a bigger threat to economic growth in 2006 than the price of oil.

Europe

The outlook for the Eurozone is a bit brighter. Leading indicators signal a healthier pace of growth in coming quarters. A pickup in global activity is certainly having a beneficial effect, and the earlier depreciation of the euro has boosted export performance. Indeed, a fall in the value of the currency has a bigger impact than a modest cut in interest rates. The currency effect is particularly important for the biggest economy in the euro area: Germany. So the recent strength in the value of the euro is a bit worrying, and any further upside will detract from the growth outlook.

Asia/ Pacific

The Japanese Prime Minister is going to the polls seeking a new mandate for reform, after the defeat of a bill to privatise Japan Post. There was opposition within the PM's own party to reforms that had already been watered down to satisfy political interests. Any election introduces an element of uncertainty, and in this case there could very well be a change of government. For now, investors are betting that the reform agenda will continue. The corporate and financial sectors are now on a more solid footing and do not need government support. In addition, the economy is looking stronger and there are signs that deflation may be ending.

Bonds

Upbeat economic data reports are underpinning bond yields. In the Eurozone, an improved outlook for the economy has led to lower bond prices, while in the UK gilts have also become cheaper as investors focus on a better global growth picture and shelve expectations about further rate cuts by the Bank of England. And, in Japan, government bonds are weaker because investors are looking forward to a recovering economy and a possible end to the Bank of Japan's zero interest rate policy within the next year.

Currencies

Sentiment is fairly negative towards the greenback, which has been losing ground against the euro, despite good economic data, Stateside. Meanwhile, the yen has been buffeted by political uncertainty.

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