

Weekly Perspectives

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A Weekly View of Global Economies

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North America

Last week, investors celebrated Bush's victory by pushing stock markets sharply higher, and the good mood was given a further boost by a jump in US payroll numbers. But after such a strong performance, it is normal to expect a dose of profit taking, and a pause for reflection. The market may just be reflecting a bit more on the greater risk of interest rate increases. Meanwhile, earnings-related issues may be lurking in the background.

The employment report seemed to confirm the Fed's view of a strengthening economy. However, the truth is that policy makers don't have a firmly-based view of how the economy will perform. They are generally cautious about taking a strong position, and prefer to react to events as things develop. But, of course, they assiduously cultivate the image of knowing what's going on and being in control.

Greenspan is notoriously fond of using fudgy language, and carefully avoids being tied to an unambiguous viewpoint. This gives him room to manoeuvre and adapt policy measures according to the latest turn taken on by the economy. How Wall Street deduces policy direction depends partly on consensus views about the economy, partly on interpreting the Fed and, lastly, according to what mood they're in. And, in recent weeks they have been in a good mood, though the optimism may be rocked a bit as we go forward.

Stock market action, thus far in November, seems to entail the expectation that the economy is not too far away from a reacceleration. However, the main problem with this outlook is that leading economic indicators have yet to bottom out. So investors may be jumping the gun in their anticipation of better times ahead.

It isn't impossible for the indicators to turn around faster than they have done in the past, but it is probably unwise to bet that way. Normally, we would expect a reacceleration of the economy in the second half of 2005 - provided there aren't any shock events to sabotage the recovery.

The risk of moving too soon in the cycle is that people may set themselves up for some nasty disappointments. If we are correct that the low point in business activity has not been reached, then the next set of soft numbers may rattle some nerves and cause a little pain.

The stock market has spent many months, this year, moving broadly in a sideways direction. Strong sector bets haven't worked out too well. But stock picking has also been extremely difficult, because of high correlation among stocks as well as generally low volatility. It has been tough for fund managers to beat their benchmarks.

But, if it's true that Wall Street has moved too soon in calling the bottom of the cycle, then we may be in for a spate of higher volatility - which may be welcome in some quarters. The hedge-fund hounds are licking their chops. They are under-nourished and desperately need a good meal.

The sliding dollar is currently taking a breather. For the key euro exchange rate, it was grumbling by the president of the European Central Bank that stanchied the greenback's decline, rather than any comments from policy makers in the United States.

Foreign exchange traders have been looking past good US economic numbers at the yawning twin deficits. In investor calculations, either American asset prices have to fall, or the dollar has to depreciate sufficiently to make US assets attractive enough to hold.

Evidently, stock prices haven't headed south yet, though bond prices have obliged a little, lately. Near-term economic softness may provide temporary support for bonds. But looking further forward, the risks are slanted towards higher yields.

An administration embroiled in expensive foreign engagements and favourable to low taxes will need to borrow a lot of money, particularly from foreigners, who may increasingly require a higher risk premium. In addition, there is concern about an underlying proclivity among policy makers to encourage inflationary tendencies. In part, that is what higher gold prices are signalling.

Europe

The euro's appreciation against the dollar is beneficial in one respect, namely keeping dollar-priced oil costs down and, thereby, capping inflationary pressures. At the same time, it serves to tighten monetary conditions, reducing the need for policy makers to raise rates. But, there is also a well-known negative side effect, which is to make it tougher to sell into the big US export market.

Asia/Pacific

Some speculators are again betting that China will allow its currency to appreciate against the dollar during the next 12 months. They were encouraged by comments about the need for flexibility, attributed to the vice-governor of the People's Bank of China. However, it is likely that any relaxation of the currency peg will be gradual, and geared to reforms in the financial system.

Bonds

The market was surprised by the scale of the increase in October US payroll numbers. Treasury yields jumped higher, in consequence. Apart from an expected 25 bps increase in the target fed-funds rate at the FOMC meeting this week, investors are now pricing in another hike in December.

Currencies

Bush's victory was bad news for the dollar, last week. Even good US economic numbers were interpreted negatively by traders. Currently, fears of intervention have steadied the greenback against the key European currency, the euro.

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