Weekly Perspectives

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A Weekly View of Global Economies

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Global stock markets have extended their run from September into October and risk appetite remains high. There seems to be considerable confidence among equity investors that monetary policymakers will be successful in their endeavour to dampen inflationary pressures without compromising growth prospects. Oil prices declining well below earlier expectations have certainly helped the central bankers in their task - - a gift to policymakers.

Global M2 money-supply growth continues to edge lower. Meanwhile, excess liquidity, which takes into account both output growth and inflation, as well as money supply, has diminished further. Looking at the details of the global average, one can note evident regional differences. For example, excess liquidity is more abundant in the Eurozone than in the United States.

As a general measure of the real cost of borrowing, the G3 (US, Japan, Eurozone) average 2-year real interest rate has flattened after creeping upward over the past year. It was, of course, often in negative territory during 2003-2004. Currently, it remains well below the average real rate during the 1995 to 2000 period.

So, overall, one can say that monetary conditions have become more restrictive but are not overly constraining. This is in keeping with the careful step-by-step approach adopted by the central banks. Among the major regions, conditions in the US are, of course, tighter than in Japan or the Eurozone.

Not surprisingly, much attention is focussed on the prospects for economic growth in the United States. Their business cycle is at a later stage than in Europe or Japan. And, as for monetary tightening, the Fed has obviously put in more effort than the other central banks. The main question over the past few months has centred on whether they need to increase interest rates another notch or to refrain from further action, waiting for the economy to slow down of its own accord.

The main risk was that inflationary pressures would be too stubborn, forcing belated interest rate hikes. But a helpful factor that had not entered into earlier calculation has been the dramatic weakening of oil prices. This has reduced the threat of a boost to headline inflation and also the need for further Fed tightening.

Weakness in oil prices has also extended the rally in the stock market. The rationale is that it will shore up consumer spending and help corporate profits. This is obviously not a groundless argument. But it isn't the full story because the impact on consumers is being more than offset by extended and unanticipated weakness in the housing market.

Indeed, the Fed, along with foreign observers, are all focussing more attention on the state of the housing market. Chatter in the financial media about possible interest rate cuts isn't farfetched. Preventing a housing crash would be at the top of the Fed's list of priorities. It is an event that would have a dramatically bigger economic impact than any stock-market crash. Not only would the economy go into recession, but it would also take a long time to recover.

Slumping oil prices may have cheered Wall Street but, along with generally weak commodity prices, it may be an indication of moderating activity ahead. Unfortunately, slower growth is not going to help the corporate earnings outlook. In addition, up to now, robust profit margins in the energy sector have been a big contributor to S&P 500 earnings growth.

Stock markets are moving higher just ahead of earnings reporting season. The underlying premise is that the growth slowdown in the US will soon give way to a reaccelerating economy, based on business and consumer spending and a benevolent Fed. Over in Europe, markets have been boosted by mergers-and-acquisition activity.

In the past two months the early cyclicals have been outperforming. We are of course referring to the following sectors: consumer discretionary, financials and technology, although some technology sub-sectors could be classified as mid-cyclical. Also, growth stocks have begun to outperform value.

Many global stock markets are showing quite a bit of correlation with those in the US, often echoing what happens in America. There is a reason for this. At this stage of the cycle, developments in the American economy will have an impact on growth prospects elsewhere.

Global growth will slacken if the US slows down. Europe and Japan are registering steady but unexceptional performance and China can't carry the growth torch by itself. If we examine leading indicators of the global economy, they do point to slower momentum ahead.

Currently, there is a discrepancy between underlying expectations in stock and bond markets. Longer-maturity bonds are pricing in a slowdown, even as the stock market marches higher. Meanwhile, many observers have pointed out the fact that the Dow is beating the other US stock-market indices.

One of the obvious characteristics of the Dow is that its components are companies with a very large capitalisation. Investor preferences for such stocks may represent a sort of risk aversion because large-caps are deemed to fare better under difficult economic circumstances. It is also notable that stock markets in emerging countries have fared relatively poorly over the past few months.

The MSCI emerging markets index has underperformed other regions. Weakness in commodity prices has hurt certain countries while others have been downgraded because they are substantial exporter to the United States. A major exception is India, which has been an out-performer, partly because of its relatively closed economy.

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