A word about the global economy

There is considerable uncertainty regarding the state of the US economy. For the better part of 2006 the US economy was thought to be under inflation risk. The Fed Funds rate has, however, been left unchanged in 4 of the last FOMC meetings, this since a sharp correction in energy prices has taken pressure of CPI which peaked at 4.3% in June 2006 and is currently running a comfortable 2.5%. Indeed sentiment has shifted in favour of easing. This is predicated on current growth staying below the unobserved long term equilibrium growth rate. There is a risk that this rate of growth has as real investment has sought higher returns in developing economies and that even a lower current growth rate my be at risk of inflation. This remains to be seen.

Both new and existing home sales have seen a sharp slowdown but appear for the moment to have consolidated. Given the importance of the consumer in the US economy and the reliance on the consumer on extracting home equity to finance consumption this is an area of concern.

On the labor market front, data continues to be volatile. Late 2006 data indicated a robust labor market but the dynamics of restructuring an economy away from manufacturing towards services expects some volatility. The January initial jobless claims number was higher than expected.

Retail sales have actually softened through 2006 indicating weaker consumer demand. US economic growth is firmly supported by the corporate sector, as evidenced by the increasing proportion of profits as percentage of GDP. The marginal product and hence the price of labour, it would appear continues to slow.

Indicative of the state of health of the US economy is the USD which has been weak against EUR and GBP throughout 2006. Seasonal year end effects should be discounted which would discount weakness against JPY and other Asian currencies.

All the signals point toward a soft landing in the US economy. What remains are large scale imbalances which need time to work out. Global inflation is under control, growth rates are healthy and there is a healthy trend of active diversification taken by all quarters from China and India directing their engagement towards Europe and Africa and away from the US and Europe reciprocating. This results not in a marginalization of the US economy, which would be unrealistic given its size and importance, but a diversification of systemic risk on a global scale. The re-emergence of Japan as a global economic force reinforces this diversification. Eurozone GDP grows at 2.7%, unemployment continues to fall for a second year running, and inflation is running at 1.9%, within ECB tolerances. The Japanese economy is running at 1.6% growth, revised down but healthy nonetheless for an economy just recovered from a long depression. Asia ex Japan, remains highly leveraged to the US economy but is also actively diversifying exposure by increasing inter-Asian trade. Commodity driven economies within Asia ex Japan will find increasing exposure to the Chinese economies while service economies will find increasing dependence on India.

The price of this stability and growth is active management of inflation and inflation expectations, which has led to an almost concerted effort of central banks from China, to the EU and England and the US, to restrain liquidity. Only the Bank of Japan keeps policy fairly benign.

More later about the impact on Markets.