The €uropean Side

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The Italian Government: Starting on the Right Foot

by Vincenzo Sciarretta

Italians have their new government under the leadership of Prime Minister Prodi. And Mr. Prodi has immediately demonstrated both his stature and the road he will travel.

Only a few days ago, while the new government was speaking of austerity and sacrifice, Prime Minister Prodi gathered together his ministers and their entourages. They assembled not in Rome, where the government is headquartered, but in a wonderful villa in Umbria, which is close to Tuscany, at taxpayer expense. These are the new government leaders charged with fixing the budget.

At the end of the weekend, the ministers announced that the meeting had been a success, although they hastened to add that no decisions -- absolutely no decisions – had been reached. Still, they emphasized, the meeting was a success and that it would be repeated. Sure, why miss a weekend in a charming villa at taxpayer expense? The first name of the new Italian Prime Minister is "Romano," that is, Roman. And right now he looks very much like those ancient Romans who gladly sacrificed to Dionysus, sacrifices consisting essentially of huge lunches and vigorous drinking.

Still not convinced of the seriousness of Mr. Prodi's austerity plan? Well, consider the fact that he has just established a new record in the history of the republic for number of ministers, vice-ministers, and under-secretaries. So why should one doubt his ability to fix the Italian budget? We suspect the path of least resistance leads to higher taxes.

In fact, every day, ministers, vice ministers and undersecretaries announce the new taxes that must be introduced: taxes on your car, your capital gains, your houses, and on highways. Add to that an increase in social security contributions if you are self-employed. Beyond this, rumours are now emerging regarding an increase in the VAT, which is already at 20% in Italy.

Looking at 2006, analysts have begun to speak of restrictive measures in the range of 0.7-0.8% of GDP, with a repeat of that performance in 2007. Is it really possible that a group of people who intend to meet in villas around the country will really be able to cut public spending? If the answer is no, the path of least resistance leads to higher taxes. This restrictive policy will add to the German restrictive measures related to the VAT increase scheduled in 2007.

Remember, German and Italy together account for a large share of the euro-zone economic activity and next year they will be assuming a restrictive posture.

No excitement in bonds

A survey suggests euro-zone obligations ought to give ground just a little bit

By Vincenzo Sciarretta

Major banks in continental Europe would be surprised if any wild swings materialized in the euro-zone bond market over the next six months. As regards the 10-year German bond, they expect yields to fluctuate within a narrow trading range between 3.75% and 4.3%. Eight out of the ten banks surveyed this week by *TheEuropeanSide* lean towards a very mild bear market, while two bet on a modest decline in interest rates.

Eight banks also bet on two more hikes by the European Central Bank (ECB), while two consider a single hike more likely.

On average, rather than speak of a bear market, most analysts would describe the next months as a period of normalization in interest rates.

An easy money posture by the key central banks and the assimilation of the newly industrialized nations into the world economy was what depressed yields, according to **Thomas Mayer** of Deutsche Bank: "With the integration of the developing countries," he explains, "the policy of easy money was able to raise economic growth without unleashing an acceleration of consumer price inflation. What happened instead, as everybody knows, the ample supply of liquidity boosted asset prices. Now, the same central banks have embarked upon a gradual withdrawal of the monetary policy stimulus and we ought to witness a normalization of yields."

Analysts forecast a mild bear market for euro-zone bonds

Bank	Year-end targets	
	refi rate	10-year bonds
UBS	3,25%	4,30%
Unicredit	3%	4,40%
BNP Paribas	3,25%	3,75%
Credit Suisse	3,25%	4,2%
Société Générale	3,25%	3,75%
ABN AMRO	3%	4,25%
Crédit Agricole	3,25%	4,15%
Fortis	3,25%	4,30%
Banco Bilbao	3,25%	4%
Deutsche Bank	3,25%	4,30%

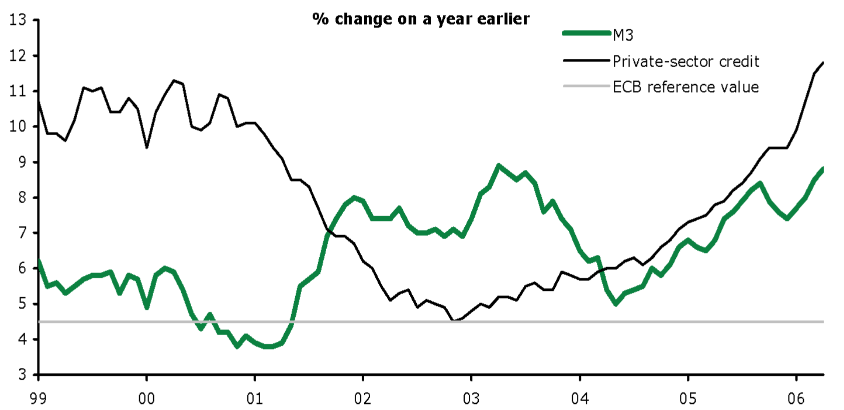
Source: TheEuropeanSide

Current values: refi rate= 2.75%; German 10-year bond = 3.95%

Mr. Mayer indicates three reasons why yields should trend higher, although marginally. "First, because the European Central Bank (ECB) is sticking with its measured approach to remove monetary accommodation; second, because the cost of borrowing is increasing on the other side of the Atlantic as well; and third, because government securities should respond to an improving economy which is expected to develop at 2.1% this year, to slow down a little bit in 2007 at 1.5-1.7%."

The single most important reason why the ECB ought to tighten its grip on monetary policy is the excess liquidity that has accumulated in the system and the fact that credit is booming. On the other hand, Mr. Tichet must approach the markets cautiously to avoid an abrupt reaction of the euro, breaking up on the upside on accounts of a decreasing interest rate differential with the dollar. It is a subtle alchemy. "International rate differentials," says Mr. Mayer, "need to be large enough to avoid a currency collapse in the current account deficit countries, but not so high as to

Euro-area excess liquidity



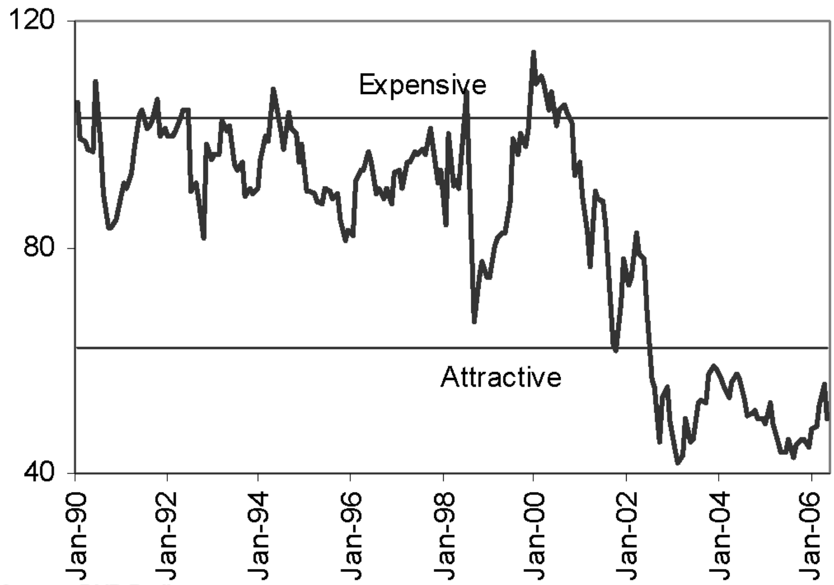
Source: ECB

Too much easy money around. The European Central Bank wants to remove monetary accommodation.

That drag on consumption called VAT

"I fear" says ***Conrad Mattern*** *of CONQUEST Investment Advisory AG "that German people are beginning to anticipate the VAT hike scheduled for January 2007. I mean that they are probably spending now in response to the rise in VAT in 2007. The Bundesbank is monitoring the phenomenon and mentioned it in its last monthly report." If Conrad Mattern is right, we cannot attribute any great importance to the signals of a rebound in consumer spending. "It is my suspicion" continues Mattern "that current purchases may turn into a retreat next year." The worry is shared by other experts as well. "The rise in VAT" writes* ***Dario Perkins*** *of ABN AMRO "could reduce household real incomes by around 1.5 percentage points in 2007. This would be a major drag on consumption, forcing households to reduce their savings significantly just to maintain previous levels of spending. We believe the German VAT hike could stall the consumer recovery in 2007." Mr. Perkins' words are somewhat echoed by* ***Stephan Deo*** *of UBS, who writes: "the euro-zone will have to swallow a sizeable fiscal tightening. Although we are not convinced the 3% VAT hike will be fully implemented in Germany, some fiscal tightening will happen." According to* ***Timo Klein*** *of Global Insight the squeeze may approach 1% of GDP. He also thinks the German economy is likely to survive, suffering only a slow down: "the economy is developing its own momentum", he says. "Taxes are larger than expected and exports remain impressive. There should be a 0.25% non-recurring dampening effect and a 0.5% general effect. I can envision the possibility that the German economy slows down toward 1.1-1.2% GDP growth in 2007, after reaching 2% in 2006. Not too bad, given the recent track-record.*

Eurotop 300: Fed model



Source: BNP Paribas

The chart shows how undervalued European Stock Exchanges are, according to the so-called Fed Model. It measures the attractiveness of stocks compared to bonds. From this point of view, euro-zone equities are among the most depressed in the world.

prevent orderly depreciation especially of the US dollar."

Analysts agree that an additional move at the July meeting does not appear to be an option. "The word *vigilance,*" explains **Elena Nieto** of Banco Bilbao, "that traditionally announces a rate hike the following month was absent from the ECB statement, which chose to use the expression *carefully monitoring*. This means that next rate hike decision should take place the 31st of August."

As we mentioned, the survey shows two analysts prepared for a mild bull market in bonds instead of a bear market. One is **Ciaran O'Hagan** of Société Générale. He has a simple explanation for his view. "The main central banks are tightening, and this behaviour will hurt growth. The US yield curve is in the process of inverting in the expectation of excessive tightening on the side of the Federal Reserve. Moreover, the European Central Bank is acting to dry up liquidity and not to counterbalance an an overheating of economic activity. Therefore, higher interest rates will slow down GDP and push interest rates mildly lower ." Yet, if analysts are right, don't bet on any big story for the next few months.

Porsche: a good stock with some spice

By Vincenzo Sciarretta

If you are contemplating buying a Porsche, perhaps you may want to know what analysts say about Porsche, the company, and perhaps discover that you would be better off buying some Porsche shares instead of the car. Of course, if the investment goes wrong, you may very well regret you are not enjoying your Porsche, the car, this time.

Porsche reconfirmed earlier press reports that it sees a chance to reach the 100,000 units sales mark already this business year, up 13% compared to a year earlier. “I like the strong and ongoing raise in volumes”, says **Marc-Rene Tonn** of Warburg, who has a “buy” recommendation on the company and sees volumes setting a record of 125-130,000 units in 2009. “The mix is improving each year. Examples include the entry-level Cayenne and the new 911 Turbo.” But the true revolution might be Panamera to be launched in 2009, a car which is portrayed as a high-end Maserati/Mercedes rival. This program might exceed the official targets, according to some analysts. For instance **Max Warburton** of UBS writes in a recent report that “it will compete not only with Mercedes’ CLS but also with the E-Class and BMW 5-series.”

Porsche benefits greatly from the opening up of the world.
Here a picture in Prague, Czech Republic: some old cars coexist with a few luxury cars.

Mr. Tonn stresses the role emerging markets are going to exert in the future: “sales last year improved by 75% in China to over 500 units. Remember that margins are loft on these sales because wealth people in emerging nations tend to buy only the best, as a status symbol. I envision the possibility that Porsche delivers 5,000 units in China, 4 years from now.” Of course that would have an impact for a company selling just 100,000 units. Emerging market sales, including the Middle East, could reach 15% of volumes shortly, and this could add some spice to the company (up and down of course). Finally, Mr. Tonn suggests that Porsche should be priced, at least in part, as a growth stock with a great visibility of its brand and therefore the valuation is not worrisome.

Porsche is expected to obtain an EPS of 52 this year and 58 in the 2006-2007 period. EV/sales should be 2.1 this year. The automaker keeps on having a strong cash flow.

Most analysts are happy with these numbers, but there are exceptions: one is **Alexander Neuberg** of CA Cheuvreux, who says: “The company is great and has a great top management. This notwithstanding, it looks expensive. With conservative multiples, Porsche ought to trade about 660 euro per share, which is substantially lower than the current price of 730 per share.”

Analysts love Porsche

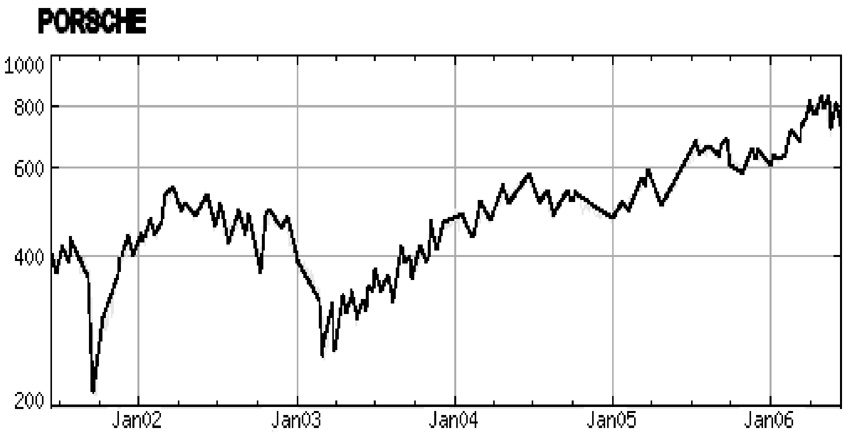
Bank	Analyst	Recommendation	Target	Released on:
Merrill Lynch	Stephen Reitman	buy	1000	02/06/2006
Credit Suisse	Mike Dean	outperform	1000	02/06/2006
UBS	Max Warburton	buy 2	950	02/06/2006
Sanford Bernstein	Stephen Cheetham	market perform	800	31/05/2006
Dresdner Kleinwort	Arndt Ellinghorst	buy	830	24/05/2006
Morgan Stanley	Adam Jonas	Overwt/Cautious	1030	23/05/2006
M.M. Warburg	Marc-Rene Tonn	buy	800	19/05/2006
BHF-Bank	Christian Breitsprecher	strong buy	1100	10/05/2006
Oppenheim	Patrick Juchemich	buy		10/05/2006
Oddo & Cie	Olivier Pouteau	buy	911	10/05/2006
CA Cheuvreux	Alexander Neuberger	underperform	660	09/05/2006
DZ Bank	Tim Schuldt	buy		02/05/2006

Source:Bloomberg

Whether you are a trend-follower or a contrarian, a large consensus always draws attention.
Current Porsche's price: 740-750

When currencies count.

At the time of the boom-burst cycle of the dollar in the '80s, Porsche run the risk to go out of business because of the huge currency fluctuations and the fact that the United States was, and still is, such a large part of its market. Since then, the management has engaged in a large hedging program to avoid the problem again. Disclosures in the 2004/05 accounts suggest Porsche made around € 400 mn of pre-tax profits from currency hedges in that financial year, about 30% of all pre-tax profit. This source of profit will fall to nearly zero by July 2009, clearly a risk on the way for the company stock price. Is the problem manageable? The management insists that the company can, thanks to cost reduction and mix. "perhaps a situation similar to the one BMW has experienced through 2003-2006, where profits growth has been minimal because of the currency drag", contends Warburton of UBS. This is the major risk, analysts reported by TheEuropeanSide indicated for this superb luxury automaker.



A nice bull market for the German automaker

When the news of Porsche's investment in Volkswagen surfaced, there was a stampede to dump Porsche equities. Even to-day, experts are confused. The VW stake may remain a drag on the super-car's rating and will continue to expose the stock to fluctuations in VW's fortunes. Instead of being only a drag, now it looks like the agreement may help. "Porsche" writes Warburton "is in the position to demand that VW builds the Panamera probably at a price advantageous for Porsche. We have been here before with the Touareg/Cayenne project, where Porsche has made disproportionate profits. We expect the same outcome from the Panamera project: VW takes the capital risk, Porsche extracts the profits."

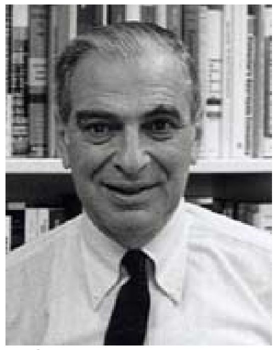
Abroad

An Interview with Nobel Prize Winner Kenneth Arrow

“This is the best international economy ever”

Yes, there are some imbalances, but positive elements outweigh them. The ‘70s with their vicious inflationary spiral are not coming back. And the dollar, hopefully, will adjust gently.

Born in 1921, Professor Arrow was a child during the roaring ‘20s, a teenager during the Depression, and a young man during the Second World War. In other words, a giant of his discipline and a man with life-long experiences gathered from a range of real economic situations. Therefore we are quite happy to listen to what he has to say. And what he says is that the international economy is in enviable shape. Better than in any other period in which he has lived. Market participants, you may want to hear his words on the dollar and inflation.



Professor Kenneth J. Arrow

Kenneth Arrow is the youngest person ever to receive the Nobel Prize in Economics, at age 51, for “pioneering contributions to general equilibrium theory and welfare theory.” He once said, “the idea that a society has to be responsible for all its citizens, those who do well and those who do not, is really a precondition of a good society.” His first intellectual passion was mathematical statistics, moving thereafter to economics.

Some say that this is the best international economy in at least a few generations: the opening up of China and India, technological improvements, and a period of relative peace compared to the past mutually reinforce one another to produce non-inflationary growth. On the other hand, others argue that there are a lot of imbalances, as shown by the size of the US current account deficit, and therefore we are on the verge of some kind of crisis. What is your view?

“I lean towards the former scenario. Of course, there is no perfection and for instance, the US current account deficit is a big problem. But overall I think the former statement depicts better prevailing conditions. The two most populous countries in the world have been increasing their income at a rate not seen in the last century. And the large and growing magnitude in trade flows attests to the degree of specialization.”

Of course this helps to keep inflation under control…

“There is no question that cheap imports help to satisfy excess demand and to keep down the price level. I was born in 1921, and it is difficult to find a period when there has been so little inflation internationally.”

Yet, the press has noted some similarities between now and the ‘70s. The American twin deficits, a bull market in commodities, and the need to finance the war on terrorism offer fertile ground for inflation. Do you share these fears?

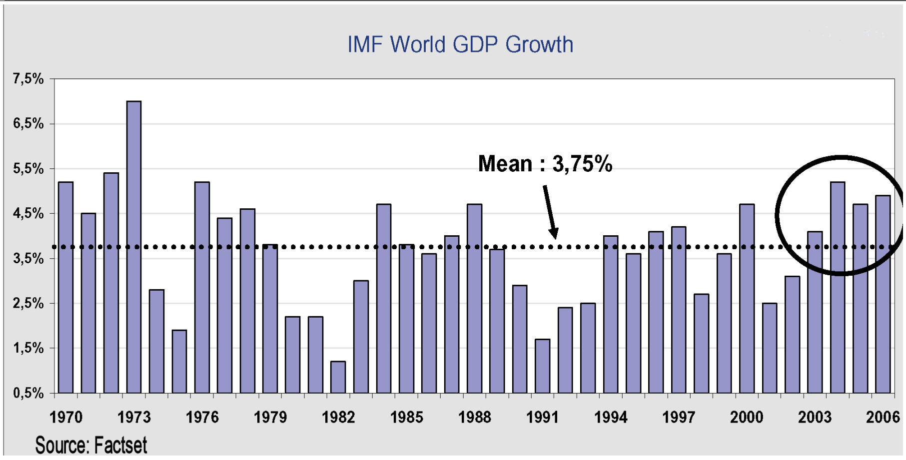
“No, I don’t. Back in the ‘70s, an inadequate monetary policy led to runaway inflation. The Federal Reserve, to some extent, did not pursue its obligations. I am afraid that Arthur Burns, the Chairman of the Fed, who by the way was a former professor of mine, was too politically involved with the Administration to do what Chairman Volcker did ten years later.”

That is your way of saying that you trust the Federal Reserve of today, isn't it?

“Yes, I think Bernanke (the current Chairman of the Fed, ed. note) is conservative. Major central banks around the world have a strong anti-inflationary bias.”

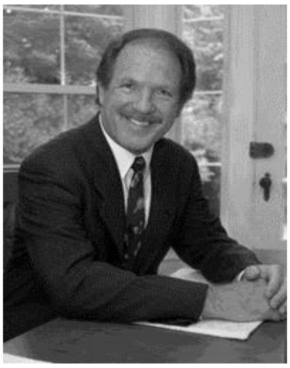
What about the need to finance a strong military posture in confronting what George Bush considers the terrorist menace?

“It is true that defence spending is rising, but I have seen the Second World War, the Vietnam War, and the Cold War. What we have now is still manageable, economically speaking. At the same time, the overall public deficit is worrisome but not huge. Thus, I am inclined to be optimistic: with good central banks we are not going to experience the ‘70s again.”



"The International Monetary Fund has revised up its world GDP growth estimates from 4.3% to 4.9% for this year and from 4.4% to 4.7% for 2007. If the IMF is right, the world economy will post 4%-plus growth rates for five years in a row, something it has not done for the past 35 years."

But inflation is higher than they say



Bill Dunkelberg, the man who pays attention to small-businesses

He is William Dunkelberg, the chief economist of the National Federation of Independent Business, an advocacy group representing 600,000 small businesses in the United States, and he believes that inflation is noticeably higher than officially stated.

"Our members declare they have been raising the prices of goods and services. Inflation based on our models, which hinge on what small businesses are actually doing should be higher." "The fact is" says Dunkelberg, "that housing accounts for over 30% of the consumer price index. Now, you may conclude that because there has been a boom in the housing sector, this part of the consumer price index has been bubbling. On the contrary, the opposite is true: as professional economists know, the government calculates inflation in real estate following the dynamics of rents. The problem, now, is that rental vacancy rates are at record levels on account of high ownership rates, and in turn this keeps rents low, stabilizing the reported cost of life."

Dunkelberg continues, "You can judge for yourself. If you believe that dwellings' values have been rising dramatically and you call that inflation, then the dynamics of prices is faster than the official figures." Dunkelberg says that, according to his calculations, core inflation, namely inflation excluding energy and food, is as high as 3-3.5% compared to 2-2.3%, which is the accredited number.

"However," he adds "the Federal Reserve has already tightened enough to slow the economy down and mitigate price pressures. Therefore, perhaps another rate hike in June is all we need."

Let's go back to the US current account deficit and the dollar. Do you have an opinion on the prospects of the greenback?

"A natural thing would be a decline. I hope it will happen in a gradual way."

Do you fear a currency crisis?

"It is a possibility, although not the most likely one. Foreigners have been big buyers of dollar assets. But if the tide turns, for instance, because European or Asian investors perceive that the currency risk is high, holders of dollar assets might respond by dumping their liquid investments. Do not forget that foreigners hold huge amounts of US government securities, which are very easy to dump."

You mentioned it is not a likely scenario…

"Yes, because, the dollar exerts a crucial role in the international economy. This leads me to favour a gradual adjustment. However, there's an imbalance, no question. Savings are part of the problem. We Americans don't save. It's an incredible situation that China is a net investor in the United States."

Your studies have dwelt on the links between risk and security markets. What are your feelings on the many boom-bust sequences that investors, savers, and families have been experiencing in the last few years?

"To be frank, I have mixed feelings. I thought that the early expansion of the markets would distribute risks more efficiently. You can see this in the securitization of mortgages, which has advanced people's ability to buy houses. No doubt, however, that the fluctuations we have been witnessing have been greater than the fluctuations in the underlying realities and that is bad."

Several commentators, also in this magazine, have asserted there may be a bubble in real estate...

"It is my contention that the considerable increase in housing prices has to stop pretty soon. What the pessimists fear is that when the upward pressure abates, a correction could easily turn into a rout, engendering a collapse, like in Japan. My diagnosis is that circumstances are not so vulnerable. I expect a classical correction where house prices remain stable while general prices and salaries recover."

My final question: do you share the view that the US is outperforming continental Europe because continental Europe is suffering from over-intrusion by its governments?

"Well, the expression over-intrusion is too generic. It is the specific forms of intrusions that count. It seems to me that your welfare states function remarkably well and are not at all unbearable. The labour laws are rather a problem. There is evidence that they do amplify unemployment, especially among young people. It is also striking that in Europe, few people work compared to the rest of the world."

Not bad for us…

"Productivity per hour in Europe is high, but persons at work are simply fewer. In fact, as you seem to imply, part of the story is a choice: long vacations, short weeks. Plus, involuntary unemployment. Finally, the tax structure discourages hard work and retards the growth of Europe."

Professor Arrow, thank you for your time

V.S.

Ask the GURU

Jurgen Trojan

The stock market has been rising for three years and has now retreated by 10%. Would you say euro-zone equities are cheap, fair-valued, or expensive?

Ingrid Brunner, Frankfurt

"From the standpoint of valuation, the situation is not particularly disturbing -- especially after a three-year bull market. The current estimated price/earnings ratio is 12; and, even under the old rules in terms of goodwill depreciation, the price/earnings ratio would still not exceed 15. Is this expensive? Probably not. A price/earnings ratio of 15 means an earnings yield of 6.6% -- still attractive compared to bond yields of 4%. But since markets are liquidity-driven, and liquidity is tapering off, the real question for the direction of the stock market is whether we are near the end of the tightening cycle in international monetary policy or not. If the answer is yes, then the correction you mention is nothing more than a "zag" in a zigzag uptrend. If not, selling pressures may persist. Personally, I want to have more evidence."

Juergen Trojan, Consultant

E-MAIL YOUR QUESTIONS TO:

mailto:inquire@theeuropeanside.com

OR ON THE : www.theeuropeanside.com

OUT OF CURIOSITY

banks or usury?

In the Middle Ages, when the Church had a nearly absolute monopoly on money, it lent to borrowers at the greediest interest rates. Afterwards, when a private and secular capitalism had formed, lending money became anathema to the Church. It became a mortal sin.

A smart European bank claimed to be avoiding this conviction with the explanation that sins imply a soul. Usury was a sin when a single person committed it, but not a bank because a bank was impersonal.

Smart banks then, like smart banks now, we would say.

The European Side

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