An interview with Marc Faber

Oil toward $150?

Short-term, most assets are vulnerable. Stay on the sidelines waiting for better prices. Gold is good. Agriculturals are cheap. Industrial commodities may suffer on account of a weakening economy. In Europe he owns some bonds

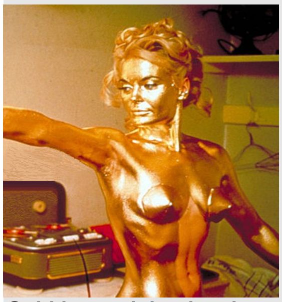
Marc Faber is accumulating gold whenever it gives ground. He would not be surprised if oil went beyond most conceivable targets, say $150, and would behave exactly as a South American leader in nationalizing his country's energy and mines. And for the short-term? He has adopted the view that most assets are vulnerable and accordingly he has chosen to stay on the sidelines holding two-year bonds. Not that bonds are good or sound, because they aren't, but because they may be a good place where you can protect yourself during the storm.

Dr.Marc Faber

Dr. Marc Faber, the cultivated Hong Kong guru, has become the Cassandra of our time. Fortunately he is a positive Cassandra since he not only predicts disasters but is also able to find great opportunities. Dr. Faber publishes a widely read monthly investment newsletter, "the Gloom Boom and Doom" report, universally known in the financial community, which highlights unusual investment opportunities. He is also associated with a variety of funds and a member of the Board of Directors of numerous companies. www.gloomboomdoom.com.

Dr. Faber, what would be the best move in commodities right now?

"The cheapest are the grains. But aside from the grains, for the typical investor, I would stick to gold, because industrial commodities could come under pressure if there is a global economic slowdown. In that hypothesis, industrial commodity demand will diminish and the Fed will start to ease in response to a weaker economic activity. At that point the dollar is likely to give ground on account of monetary expansion. Gold would benefit from this scenario."



Gold is regaining its charm

Is this your own strategy?

"Well, I already have a lot of gold. I bought gold to hold it. I am not here to sell. However, I would not add meaningfully to my position in this phase. Instead, if the price drops to between $480 and $550 per ounce, I would again accumulate more. I expect a correction in most assets to materialize and in the meantime I hold two-year US Treasury Bills. This is a short-term posture."

You'll tell us about Treasury Bills later. Some readers centred their questions on South America: in that part of the world, many countries have been moving toward communism and the nationalization of their basic resources. The development ought to be bullish for commodities…

"First of all, I think all these countries are entirely right in their policy."

Seriously?

"Why should the workers of a Chilean mine earn $80-100 per month while the mining company is making billions of dollars. I am a director of a mine in Mongolia, so of course I am not particularly happy if the Mongolians want a bigger stake in our business. In spite of that, if I were Mongolia or if I were Evo Morales or Hugo Chávez I would do the same because for the last 20 years, as commodity prices went down, nobody helped these countries."

They have the strength to ask more, you are saying…

"What I am saying is that the rise in commodity prices has shifted the balance of power in the world to resource producers. Mr. Bush thinks he is the most powerful man in the world. It's nonsense. As I said in the past, the most powerful man on earth is Mr. Putin. People such as Iranian President Mahmud Ahmadinejad or Hugo Chávez are gaining greater and greater power. If Iran starts to cut production say by 3 million barrels a day or if Mr. Putin cuts production by 5 million barrels a day then prices will double and what could other countries

Only temporary interruptions for oil

Oil is on its way up: "demand may double in Asia, while I doubt that supply can increase dramatically," says Dr. Faber

South American nationalization of resources

Venezuelan President Hugo Chávez

Bolivian President Evo Morales

"If I were Evo Morales or Hugo Cháves," says Faber "I would nationalize my country's resources the same way they are doing." Good for commodities

do?"

Going back to my question: are the developments in South America bullish for raw materials?

"Yes, yes. I believe they are good for commodity prices and may be bearish for the mines. That's why I am telling people: if you want to participate in commodities you may be better off by buying the physical resources, namely physical uranium, physical copper or gold and not the mines because, if prices go up as much as I think they will eventually go, the mines may not get the full benefit because some will be expropriated, some will suffer from excessive profit taxes etc."

Would you be more surprised if 5 years from now oil were around $150 per barrel or if it were at $30?

"I would be surprised if it were at $30 per barrel."

What about $150. Is such a lofty price possible?

"Well, oil could be anywhere. I am not sure if it will be in 5 years. It could be in 3 years or in 10 years. One thing I do know is that currently in Asia we have a daily demand of 22 million barrels and this amount is likely to double. We don't know whether it will take 5 years or 10 years or 15 years, but it will double. On the contrary I am inclined to doubt that supply can be increased dramatically. The path of least resistance leads to higher prices."

At a certain point, you suggested dumping all assets, including commodities, and even selling short copper. What in hindsight and what for the future?

"A lot of asset markets have overshot in some way, under the impetus of liquidity-driven buyers. And liquidity is not expanding at the same rate as in the past and may even decelerate. This is the reason why I am not so keen on asset markets."

Let's change the topic: a few readers asked whether you have any money in the Euro-zone?

"Yes, I have some bonds."

Do you have strong convictions about this investment?

"I am bearish about bonds by and large, but I think they may rally a little bit in the expectation of a softening economy. Long-term I am not optimistic."

Are you referring to both US and Euro-zone bonds?

"In particular to US bonds. I can envision the possibility that a decelerating economy would tend to lift bonds for a couple of months. Thereafter, bonds, especially US bonds, ought to decline again."

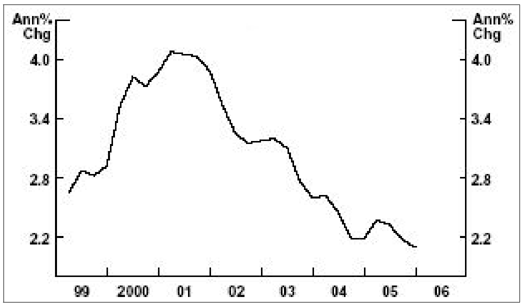
What about stocks?

"All in all, the market I like the least is the US and the markets I like the most are the Asian markets. Europe is in between. I like Asian markets because economic prospects are relatively good and whereas in several Western nations we have witnessed a debt multiplication, in Asia the debt level and the leverage of corporations have come down very substantially and government debt as a percentage of the economies (with some exceptions such as China) has come down as well. Thus I am rather positive."

Shanghai Traffic jam

Oil demand is soaring in Asia

Wage inflation under control in Europe



Source: BCA Research 2006

Labor cost: wages and salaries

In core Europe we have strong disinflationary forces in the fact that workers suffer from the competition of their counterparts in Eastern Europe and Asia. Do you share this diagnosis?

"It depends on what kind of inflation. Basically, I don't expect significant wage inflation in Europe because of the inclusion of some new countries into the Euro-zone that have lower price and wage levels than Western Europe. In addition, wages and salaries are much lower in Asia."

Where do you see inflation?

"For instance in real estate or in the service sector. For instance, nobody can tell me that Italy is a bargain. If you go to Milan, it's one of the most expensive cities in the world."

Is it possible that we experience an earnings boom in continental Europe because revenues don't go to salaries but find their way into profits?

"Corporate profits have already expanded a lot. Industries which are exporting to emerging economies, say luxury goods and capital goods manufacturers are already doing pretty well."

Is the trend likely to go on or not?

"The earnings trend is probably favourable, but this does not mean that stocks will go up."

Why not?

"Because you may have a tightening of monetary conditions and

Shanghai building site

It is well acknowledged that China is absorbing a lot of commodities for its urbanization

because the international boom may drain money from financial markets into the real economy. This has happened in the Middle East: stock markets went down by 50% in a few months. Bourses are often driven by an increasing rate of monetary ease. Liquidity is still there, but not at an increasing rate."

Analysts often mention that p/es in Europe are low at 12-14 and this makes equities irresistible compared to bonds…

"Senselessness. Securities Exchanges don't move according to p/es. Otherwise US homebuilders would have not plunged by 50%. The experts who argued last year that homebuilders' p/e was low have lost 50% of their clients' money. The fact is that stock markets are discounting mechanisms and perhaps most of the good news of the global economy is already in the price since everybody knows we are in a global synchronized expansion."

Finally, there is a question regarding currencies: when looking at any survey, one notes that everyone is bullish the euro and bearish the dollar. This is confirmed by large speculative positions in the futures arena in the same direction. Shouldn't this imply that being short the dollar is not without risk?

"My reasoning can be articulated as follows: I am particularly negative on the greenback compared to the price of gold. I have always maintained that the US dollar not necessarily declines against other paper currencies; it is likely that it will go down somewhat, but it will weaken along with other currencies against gold. Accordingly, at this point I have no short position. Further, if I take into consideration that my business is denominated in dollars, then I may be net long in dollars."

Dr. Faber, thank you for your time.

V.S.

European Oil Majors enjoy a record quarter

If oil does not collapse, the chances of outperforming the market are high.

Perhaps the greatest problem with oil companies is that their investment merits are well recognized. According to a recent Merrill Lynch survey, European managers continue to aggressively overweight the energy sector and believe it to be the most undervalued segment of the stock market in the Old Continent. In particular, a net 49% of respondents overweight the energy sector and a net 32% are inclined to think it is undervalued.

The other problem is that if it comes to a choice between oil companies and oil itself, the latter may enumerate more advantages. This is the investment thesis formulated by the famous investor **Jim Rogers**, whose interview with *TheEuropeanSide* will be featured in our next issue. Jim has proven his ability to think years ahead of the financial community so his viewpoint deserves particular attention. He says, "with stocks you have to worry about the management, the government, the risk of nationalization, the balance sheet, pension plans, the greens, the environmentalists, the unions and many other things. Further, the problem with most oil companies is that they are losing their assets. Most of them have reserves which are in decline. If you buy an oil stock with 10 years of reserves right now, you may find that after a while it only has 5 years of reserves. Accordingly, if you can find an oil company which is increasing its reserves, that's probably a good buy. However, most are not, they are losing their reserves and wasting their assets."

After talking with analysts and experts, it seems that the decision to invest in oil companies or not is relatively easy after all. If one thinks we are in a period of high and even rising commodity prices, then oil companies are cheap and their outlook should be good. Otherwise one would be better off looking elsewhere. For example, **Aymeric de Villaret** of Société Générale argues that "Oil prices are likely to suffer a contraction this winter. The sector is implicitly pricing in a crude oil price of around $40/b, compared with less than $20/b in May 2004. This leaves no room for appreciation relative to our long-term assumption of $40/b." Therefore Société Générale has an underweight recommendation.

On the opposite side **Mark Iannotti** of Merrill Lynch contends that "he sees good value in oil shares on an absolute, market relative, historic or distribution basis." His investigation reaches the same conclusion as that of Mr. Aymeric de Villaret that $40/b is on average what is required to see valuations reflect current equity prices. But Merrill's analyst expects "crude and refining margins to remain well supported." For crude the focus will remain on the potential for supply disruptions on heightened Middle East tensions and Nigerian civil unrest, while in refining he sees strong demand from the US and Asia keeping global refining capacity stretched to the limit.

The second quarter of 2006 is a record quarter for the European Majors. The sector is on a 2006 p/e of around 9.2, a 0.71x market relative PER, which is a 29% discount to the historical average over the last decade.

European oil giants have been outperforming the stock market and distributing substantial dividends