The European Side

In This Issue:

- **Expect a year-end rally in European stocks...2**

Ten experts judge the outlook for the final 100 days of 2006.

- **When the good news is that there's no news...4**

Talking to maverick investor Jim Rogers

- **Yes, equities are cheap...................6**

Even taking into consideration risks, some interest rates increase and the different treatment of goodwill depreciation, prices are not stretched in the euro-zone.

- **Ask the guru...................................7**

TO RECEIVE THIS MAGAZINE FOR

FREE

YOU JUST NEED A CLICK :

www.theeuropeanside.com

Could the euro suffer a correction?

by Vincenzo Sciarretta

Several weeks ago, your editor opened a position: long the US dollar, short the Japanese yen. I noted that the entire world seemed positioned the other way. According to Merrill Lynch's monthly survey, the yen is considered the most undervalued currency around, while the dollar, together with the British pound, is deemed to be the most overvalued. Yet, the interest rate differential in favour of the United States is huge, similar to what the world saw in the first half of the 80's when Japanese investors piled into Treasury bonds in response to that differential, driving the greenback up to a boom and then down into a burst.

Your editor must not have been the only one to indulge in this line of reasoning since when early in the summer we asked the readers to send their questions to Jim Rogers, one of the greatest investors of our time, a couple of questions were centred on the parallel between the position of the yen today and in 1983-1985. (Mr. Rogers thinks that the Japanese currency may or may not rebound - no conviction about - but the greenback is doomed in the medium to long term; please, read his interview).

Could the euro suffer a setback as well?

Since May the dollar/euro has been fluctuating within its trading range between 1.255 and 1.29. In the meantime a record long position against the dollar has been built up in the futures market. Some bearish news for the US currency has emerged, but the currency refused to give ground. For instance the current account deficit was worse than expected and there's a spate of statistics indicating that a recession in the housing market is well under way. Then came further evidence that, after all, the dollar may not be so weak in the short-run: gold, sometimes a leading indicator for the dollar/euro, is experiencing a deep correction.

On the fundamental side, market participants do not recognize that in a few months, fifty percent of Euroland will be affected by a tightening fiscal policy, with the potential to slow down economic activity. In Germany the VAT will increase from 16% to 19%. In Italy it is a heavy budget necessary to bring the deficit below the ceiling of 3%.

If speculation recognizes that being short the dollar is not without risk, some positions could be closed out and the euro could correct on its own accord. Therefore, your editor has taken a small position: long the dollar, short the euro. But if the common currency breaks on the upside, it is your editor that must close his position. And quickly.

Ten experts judge the outlook for the final 100 days of 2006.

Expect a year-end rally in European stocks

A benign macro environment, attractive valuations, M&A and a large pool of liquidity mutually reinforce each other to produce the conditions for an advance.

By Vincenzo Sciarretta

As far as European stocks are concerned, professional forecasters still lean toward a good and constructive scenario for the last 100 days of 2006. Eight out of the ten banks surveyed by *TheEuropeanSide* this week expect the stock market to go up, two predict a flat trend and none foresee a decline.

Until now, 2006 has been satisfactory. Total return, including dividends, is near 10% for most continental

bourses. Foreign investors are even happier, since the euro has appreciated by 5 to 6% both against the dollar and the yen, making the gain associated with the purchase of stocks in Frankfurt, Paris, Madrid or Milan particularly excellent.

Yet, the potential for further appreciation has not come to an end, according to the analysts.

"We remain over-weighted on equity markets," says **Florent Bronès** of BNP Paribas. "A recession in the US is unlikely, we still expect some profit growth, and equity markets continue to be undervalued. The up-trend is fuelled by merger and acquisition (M&A) activity, supported by the current visibility of cash flow." The diagnosis formulated by Bronès is largely shared by the experts interviewed for this article.

However, the single most important variable is identified by the fact that European stocks are discounted from their fair value, or at least in line with the fundamentals. "Yes, they seem attractively priced, especially compared to bonds", says **Ian Richards** of ABN AMRO echoed by most of his colleagues. The price/earnings multiple (P/E) is 13 in an environment where 10-year government obligations yield less than 4%. Furthermore, market consensus expects DJ Euro Stoxx 50 earnings to rise 9.8% this year, followed by another 7.2% in 2007.

Pan-European stocks ought to go up, they say

Bank	Analyst	Year-end target
HSBC	Kevin Gardiner	+4-5%
BNP Paribas	Florent Bronès	+4-5%
Societe Generale	Alain Bokobza	+4%
Fortis	Frank Vranken	sideways
CitiGroup	Robert Buckland, Mario Sprecafico	+4%
ING Investment	Ad van Tiggelen	+6% in 12 months
Commerzbank	Groene Meyer	+2-3%
Morgan Stanley	Edmund Ng	+10%
ABN AMRO	Ian Richards	+2-3%
Credit Suisse	Team	sideways

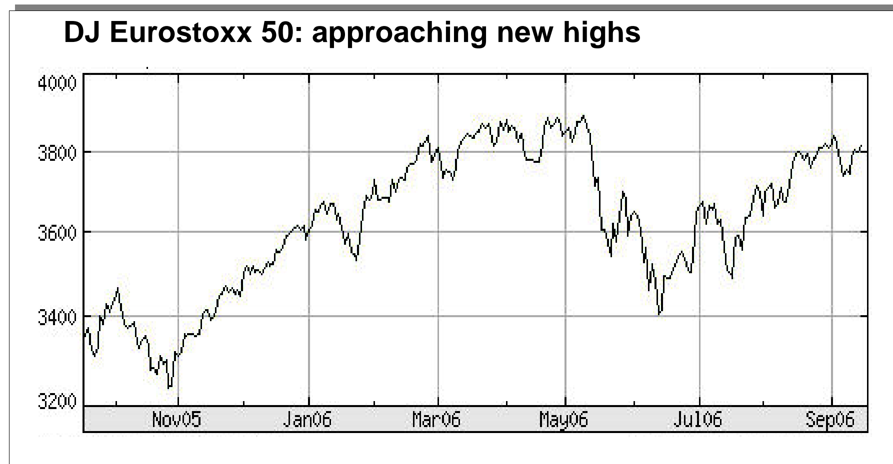
Source: TheEuropeanSide

Predictions are generally referred to the DJ Euro Stoxx 50; eight analysts see some upside potential, two a flat market, and no one a decline.

Although none of the professionals in our list think European equity markets are expensive, some consider them fair valued instead of cheap. For example, **Ad van Tiggelen** of ING Investment Management argues, "We are approaching the end of a period of extraordinarily strong earnings growth, where new profit margin records have been set almost everywhere in the world, and this has kept markets looking cheap on P/Es all the way. The relative low multiples are understandable, since investors are reluctant to pay too much on peak margins."

Others are more inclined to be optimistic in that regard. "It is true that earnings to GDP ratios attained new high grounds recently," argues **Alain Bokobza** of Société Générale, "but the trend must be viewed within the conceptual framework of a globalized world. Profits in Germany, Italy or France may out-perform decisively their countries' economic dynamism because a French or German or Italian multinational company is benefiting from the multiplication of its outlets, say in Asia or Eastern Europe. Therefore it may be misleading to contend that since earnings are high compared to the size of the domestic economy, their

DJ Eurostoxx 50: approaching new highs



Outperformance following Fed Pause

Company	Sector	Period 1 (May-'89 to May '90)	Period 2 (Feb.-'95 to Feb.-'96)	Period 3 (May 2000 to
Volkswagen	Automobiles	74.6%	19.6%	44.3%
Porsche	Automobiles	59.9%	16.2%	42.2%
Fortis	Banks	10.5%	30.2%	17.7%
Allied Irish Banks	Banks	18.6%	15.2%	35.6%
Air Liquide	Chemicals	20.0%	10.4%	45.6%
CRH	Construction	18.0%	16.7%	29.4%
Union Fenosa	Electricity	23.0%	25.3%	14.2%
Ahold Kon.	Food & Drug Ret.	21.5%	10.5%	50.4%
Celesio	Food & Drug Ret.	55.8%	28.5%	47.5%
Colruyt	Food & Drug Ret.	49.2%	17.0%	11.1%
Orkla	Food & Drug Ret.	28.8%	11.7%	33.9%
RWE	Utility	75.3%	19.0%	29.0%
Gas Natural	Utility	25.4%	49.4%	12.9%
Aguas de Barcelona	Utility	41.0%	41.5%	32.6%
Ing	Life Insurance	na	16.6%	36.6%
Resolution	Life Insurance	20.8%	47.5%	17.1%
Reed Elsevier	Media	13.2%	16.9%	58.8%
Wolters Kluwer	Media	12.8%	11.3%	35.3%
Anglo American	Mining	na	31.2%	88.2%
Muenchener Ruck	Nonlife Insurance	32.4%	15.3%	13.6%
Sampo "a"	Nonlife Insurance		15.8%	31.9%
Cairn Energy	Oil & Gas Producers	10.4%	68.6%	123.4%
Tullow Oil	Oil & Gas Producers	na	31.5%	100.5%
L'Oreal	Personal Goods	24.8%	13.7%	17.3%
Richemont	Personal Goods	40.4%	46.1%	24.4%
Sanofi-Aventis	Pharma	19.2%	22.6%	87.4%
Altana	Pharma	12.9%	21.4%	120.3%
Elan	Pharma	na	37.3%	46.7%
SAP	Software	58.8%	63.1%	12.1%
Sodexho	Travel & Leisure	28.5%	79.8%	50.2%

Souce: Société Générale

Many sense that the US monetary authority has moved to the sidelines, thus it may be worth giving a look at the names of the European stocks which have outperformed by more than 10% over 1 year, following the last three Fed pauses.

level in unsustainable."

Fortis' **Frank Vranken**, who bets on a flat market for the next few months, also stresses that "European bourses look cheap on account of low bond yields. But if interest rates rebound, stocks do not look cheap any longer."

On the positive front, **Mario Sprecafico** of Citigroup, outlines a scenario where "commodities are in the process of moderating, relaxing pricing pressures, and inflation has been kept at bay."

Alain Bokobza proposes giving a look at a group of European stocks which have outperformed by more than 10% over the 12 months following the peak in the US federal funds rate. He has considered the three most recent pauses in 1989-90, in 1995-1996 and in 2000-01 (see table). Of course, Bokobza's premise is that the probability of a pause by the Federal Reserve is noticeable.

If we speak of risks the dominant factor recurring in our panel is the eventuality that a contraction in the US housing sector precipitates a recession in North America, which, in turn, depresses international economic activity. Risk number two is that inflation surprises on the upside, forcing Western central banks to tighten monetary policy more than currently envisioned. Finally, wholesale terrorism and a pandemic contagion are quoted as less probable threats.

Of all the professional forecasters we have talked to, Morgan Stanley's **Edmund Ng** has shown the greatest optimism, "In our opinion, the outlook for the European stock market is rosy, implying even a 10% upside by yearend. We have increased our EPS (earnings per share ed. note) growth prediction for 2006, and we think the macro prospects are benign with inflation fears having peaked and ripe for a significant downturn. Despite this attractive situation, caution is still prevailing, as proved by redemptions in equity mutual funds or massive long positions in 10-year US bonds futures, all elements providing a healthy base for the rally to go on." If that analysis is correct, there might be some fireworks to celebrate the turn of the year.

Talking to maverick investor Jim Rogers

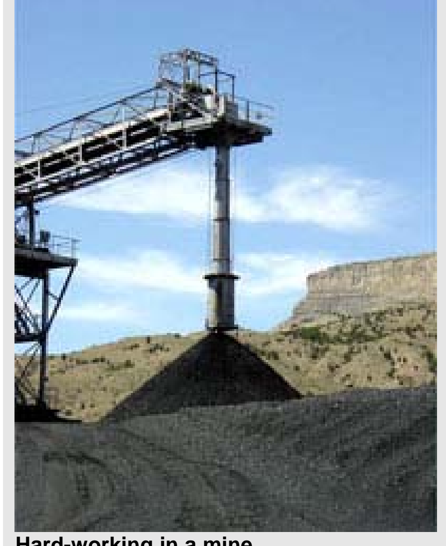
When the good news is that there's no news

You should hold your long positions in commodities. But remember, markets do zigzag and corrections will come. In Europe, defence stocks and mid-sized and small banks are still attractive.

The press usually presents Jim Rogers as the co-founder with George Soros of the Quantum Fund, as "the Indiana Jones of Finance" for his incredible around-the-world trips, or as the man who bet on the compelling opportunity which was blossoming in commodities in the late '90s when most people were going nuts over the New Economy and Nasdaq. But, above all, Jim Rogers has proved to be an accomplished form of man and an engaging personality able to use money more than being used.

He says of himself, "I am the worst trader on the Street", yet he created his commodity index - the Rogers International Commodity Index (RICI) - and his commodity-related funds exactly at the bottom of the bear market for basic resources in 1998.

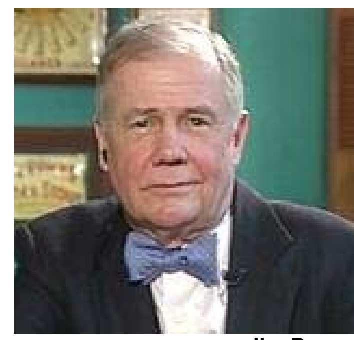
His considerations on the European financial markets have not changed significantly over the last few years. Back in 2003, this reporter received his first interview with Rogers. He was inclined to be pessimistic on the overall prospects for Western bourses, but did have some positions in the Old Continent: a few selected oil companies which could benefit from the up-trend in energy prices, defence stocks and small and mid-sized banks. His contention in favour of the banks was that the unification of Europe would lead to consolidation and a concentration of market share in fewer hands. As it happened, after a while, the banking sector started to experience a decisive merger and acquisition wave, also induced by the low level of interest rates. The argument for defensive stocks was also simple in its essence: military spending in Europe was a pale fraction of that in the US. So, if Europe really wanted to become a political entity, sooner or later it had to increase its military spending, at least to some extent. Now he says: "over the last two years I have not sold any positions on your side of the Atlantic." In other words – we think – there is still something left to go for.


Hard-working in a mine

It may be difficult to interview Mr. Rogers, as his responses often go the following way: "Well, I gave you my answer last year." Or "My basic stance is the same as in 2003." For instance, Mr. Rogers is a long-term bear on the dollar and has not changed his mind, "I own the Euro, I own the Swiss franc and a lot of other currencies; essentially the greenback is doomed. I am not a good market timer, not a good trader. But the one thing I do know is that I shall certainly continue to sell the dollar whenever it is strong. Whenever there is good news to set off a rebound."

Some readers have suggested a noteworthy similarity between the position of the yen today and in the first half of the 1980s. At the time, the interest rate differential in favour of the US currency was very great, running as high as 5-6%, and making the move into the dollar almost irresistible. Accordingly, the dollar shot up.

"At due time, commodities will be much higher," says Rogers


Jim Rogers

One of the greatest investors of our time, Jim Rogers co-founded the Quantum Fund, a global investment partnership, whose portfolio gained 4,000% in the next 10 years. He retired at the age of 37 after amassing a small fortune. In 1998, Rogers started his commodities index – the Rogers International Commodity Index – and launched a few related funds and financial products. Between August 1998 and July 2006, the index gained 268%. Three best selling books are associated with his name: Investment Biker, Adventure Capitalist and Hot Commodities. Mr. Rogers holds three world records in the Guinness Book of Records, including a 3-year drive around the world covering 245,000 km through 116 countries.

Will it likely happen again in response to the large differential existing between the US and Japan? "Yes, there was a big rally," Rogers recalls "and of course it could happen again, who knows? However, it would be a temporary correction because the dollar is fundamentally in trouble."

Mr. Rogers is still firmly persuaded that commodities are in a long-term bull market, likely to persist for several years longer. The investment thesis has been widely recognized and amply discussed: low supplies, no investment for decades in basic resources, increasing demand especially from emerging economies, nothing in the pipeline. He assures that "corrections will occur, commodity prices will fall, and a

lot of investors will panic. You, and I, however, will be buying more.” A few readers asked whether they should be seriously worried because industrial metals have been skyrocketing. His response was: “If you adjust the price of copper and other base metals for inflation they are still far below their own all time high. Thus, there may very well be a setback, even a deep one, because metals went up like a rocket, but the final top is likely to be much higher.”

Oil is better then oil companies

Readers also asked for a comment on the wave of nationalizations affecting the oil and mining industry in South America. “That is extremely bullish for commodities”, Rogers said. “You’ve never heard of a communist or a nationalized company producing more. They always produce less. Less, and less efficiently.”

If it comes to a choice between commodity and commodity-related companies, Jim Rogers is definitely in favour of the direct investment in commodities. “With stocks you have to worry about the management, the government, the balance sheet, pension plans, the greens, the environmentalists, the unions etc., etc…and the problem with for instance oil companies is that most of them are losing their assets. Most of them have reserves which are in decline. If you buy an oil stock that has 10 years of reserves right now, you may find after a while that it only has 5 years of reserves. Thus if you can find an oil company which is increasing its reserves and will continue to increase it reserves, that’s probably a good buy. However, most are not increasing their reserves. They are losing their reserves. And wasting their assets. They are not finding new reserves. And this is true for copper, zinc and any other kind of commodity company. I don’t think oil companies are compelling in this moment compared to oil. Not for me…no.”

Many thanks for our conversation, Mr. Rogers.

V.S.

Inflation or not inflation: that is the question.

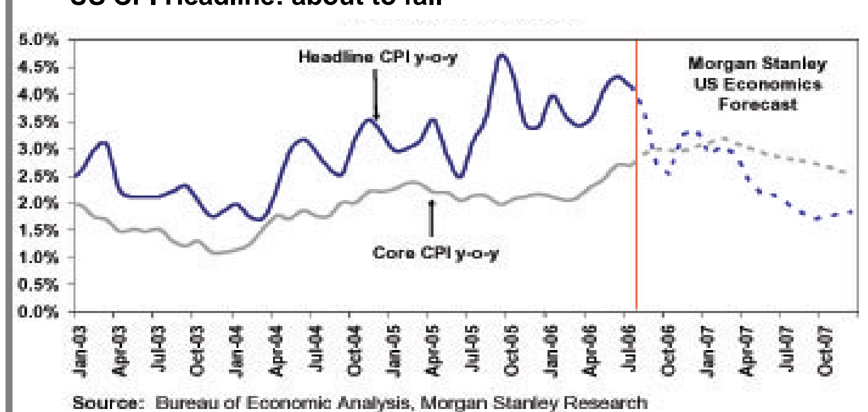
If history is any guide, we may be heading into an inflationary phase. By looking at secular charts, one notes that periods of rising commodities usually go hand in hand with rising prices. Jim Rogers belongs to this school of thought. “No, question”, he says, “inflation is here. Prices have been going up. Governments have been lying about inflation, and inflation is going to worsen.” Of course there’s another influential school of thought. It argues that globalisation is keeping prices under control. Especially in core Europe, workers have to compete with their counterparts in Eastern Europe, under the menace of watching their jobs move eastward.

“Yes”, is Mr. Rogers’ answer, “but if the price of copper goes up, it does not matter. The pressure on wages is there because the cost of living is going up for everybody everywhere. All of us have to buy petroleum and copper and zinc and lead which, in turn, puts more pressure on wage gainers. Perhaps German or Italian or Belgian salaries are not running as fast as they used to run, but they are certainly going up.”

Finally, it is Mr. Rogers’ point of view, that if it comes to a choice between euro-zone bonds and US bonds, he favours euro-zone bonds for the currency and “for every other reason.”

However, at least on a temporary basis, many analysts think inflation is turning down on account of lower commodity prices and a softening economy. The greatest worries regarding inflation were about US inflation. Morgan Stanley has written a few strong sentences about this. In a recent report we read, “Katrina happened 12 months ago, and as a result, with falling commodity prices and the positive base effect, our US economists forecast for headline consumer price index to fall from 4.3% last month to 2.4% next month. Gasoline prices have plummeted, adding US$ 80 billion to US consumer’s spending power, not to mention the positive impact on sentiment.” Not bad, one would say.

US CPI Headline: about to fall



Yes, equities are cheap

Even taking into consideration risks, some interest rate increase and the different treatments of goodwill depreciation, prices are not stretched in the euro-zone.

By Juergen Trojan*

The stock market is gradually recovering from the unnerving break it suffered in May-June and is regaining a new lease on life. In fact, the setback fits in well with the seasonal pattern that typically shows some weakness in the May-October period, to be followed by an advance in the subsequent months. In my opinion, the DJ Euro Stoxx 50 - currently changing hands around 3,800 - has the potential to move toward 4,000 or even 4,500 after the traditional weakness of September and October.

I would like to emphasize that, yes, stocks are cheap in the standard comparison with bonds and also if we take into consideration some adjustments to account for risks, expectations and changes in the rules. Tracking it through history, usually earnings yields are in line with bond yields. When earnings are below government bonds rates you may have a good buy opportunity in the stock market. This method has been amply discussed as the Fed model.

Once before, in the 1990s, it worked pretty well, and you could foresee the year end target for the German Dax with a range of 2-3%. What about now? The DJ Euro Stoxx 50 is going for 12 times earnings. Turn it around, and you have an earnings yield of 8.3%. That's far higher than 10-year bond rates, currently at 3.8-4%, suggesting stocks are attractively priced. However, some adjustments are necessary.

Fed model and the Pan-European market

Continental stocks are very attractive based on the classical Fed model which compares earnings yield with bond yield. Some say the model is not working any longer. Some say it is a good time to buy.

First of all, the change in the treatment of goodwill depreciation has boosted earnings by approximately 20% as far as the DJ Euro Stoxx 50 is concerned. This cuts the earnings yield to 6.6%. Then, let's assume interest rates are on their way up and add some risk. With this in mind, we have 6.6% for stocks and say 5% for bonds: the spread has tapered off, but keeps on favouring stocks.

Bottom line? European bourses are not expensive. If the DJ Euro Stoxx 50 rises to 4,000, or even 4,500, it does not cease to be in line with the fundamentals. I would not anticipate a move into the expensive area because conditions are not appropriate for this to happen.

Jurgen Trojan

Equally significant is the fact that the market action itself is somewhat encouraging, if not convincing. When shocks occur, the market seems strong enough to survive. Remember when oil prices were consistently rising? Stocks refused to go down and only for a few days during the Israel-Lebanon war did buyers retreat. Or do you remember when British police announced they had arrested several people in connection with a terrorist plot to blow up aircraft flying from the United Kingdom to the United States? Well, market participants did not lose their nerve and the intra-day fall was as modest as 2%. Both may be signs that our bourses are perhaps in good shape.

Some weakness may be associated with September and October - months traditionally vulnerable to setbacks but thereafter I would not be surprised if there was a successful attempt to reach new highs. Liquidity and valuations are there.

***Juergen Trojan, advisory, member of DVFA**

FOR YOUR ADVERTISING ON
THE EUROPEAN SIDE
SEND TO:
ADVERTISING@THEEUROPEANSIDE.COM

Ask the GURU

Conrad Mattern

I have a question on some German leading indicators: how do you explain that the Zew index has plummeted while the Ifo index is not signalling such a dramatic contraction? Do you have an answer?

Gabriele Cimini, Teramo (Italy)

I don't know whether I have the answer, but I have an opinion.

ZEW is only about expectations, Ifo is the geometrical average of current assessment and expectations. The expectations of the ifo-index is also clearly on a downward trend. Thus the difference is not that big.

Another reason is the panel. Ifo surveys corporations, ZEW surveys financial experts. Due to the cyclical swing, the World Cup in Germany and the VAT-hike next January (from 16 to 19 percent) demand has increased right now. Corporations think that this is due to their special situation (Behavioral finance labels this fundamental attribution error), they ignore that this is not a special factor to them but a factor for Germany which will fade early next year.

Financial experts don't focus on the demand for single products but look at the aggregates. They don't rely on this attribution error right now.

Thus, they give a better impression of how it will be. ZEW is clearly superior to the Ifo index at the moment.

Dr. Conrad Mattern
Conquest Investment Advisory AG
www.conquest-investment.de

E-MAIL YOUR QUESTIONS TO:

mailto:inquire@theeuropeanside.com

OR ON THE : www.theeuropeanside.com

OUT OF CURIOSITY

The true meaning of "company"

The word "company" comes probably from "cum panem", in Latin meaning something like "with bread". In fact, the early companies were formed by members of a same family such as a father and his sons or a man and his brothers, people who shared the same bread.

Subsequently, strangers were gradually accepted.

A man could be a partner of many companies and build his own empire. When Francesco Datini, an entrepreneur of the XIV century who lived part of his life in France and part in Tuscany died, he had amassed a fortune equivalent to what the King of France got from all his States in a year.

The European Side

VIBARO EDITORI S.R.L.
P.IVA 01623730676
C.da Torrito snc
64046 Montorio al Vomano (Te)
Italy

Information contained herein has been obtained by sources believed reliable but is not necessarily complete and accuracy is not guaranteed. Contributors may have any positions in the assets mentioned in this magazine.

THE EURO-ZONE
REPORTED FROM THE CONTINENT
www.theeuropeanside.com