The European Side

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THE EURO-ZONE REPORTED FROM THE CONTINENT

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The European Side
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Companies moving to the UK and women moving to Hungary

by Vincenzo Sciarretta

Although the economic performance of core Europe has not been satisfactory and it has become fashionable to speak of "Eurosclerosis," corporate Europe has exceeded most expectations. In short, even States in such a state can provide investors with great opportunities. Profits have doubled in just 3 years, stabilizing p/e ratios at historically low levels. Such a development is closely linked to the EU single market and globalization. When a German automaker moves 100 jobs to Slovakia, it might not be good in the short-term for German GDP growth and employment. But what about the balance sheet of the automaker?

A few days ago, the news was that some German firms were considering registering as public limited companies in the UK in order to avoid rules that gave employees a big say in company strategy. The attempt shows the dissatisfaction of some German companies towards the system of so-called co-determination. It also highlights the golden opportunity corporate Europe has and is actually seizing: reallocate in a better environment if there are too many constraints to your business. Under this rule, governments and unions are losing their power, and with the brakes released, corporate earnings are thriving. Economic life has a slow heartbeat, a vast systole and diastole of favouring and disfavouring profits, and we have likely entered a long-lasting favouring phase.

The fact is also that in the abstract everyone is clearly for the free market. But when it comes to our vested rights and interests, the answers are not so clear.

And yet, liberalization is finding its way, moving from different points and unconnected roads. Last Thursday I was in Paris and on my way to the Ile Saint-Louis I met a friend, Claudette. Something new was in her face. We crossed the Seine by the foot bridge Saint Michel and after a few drinks I asked about her face. "Amazing, isn't it?" she answered. Well, she had spent a few days in Budapest, Hungary, in a 4-star hotel on the banks of the river Danube, and she got her renewed nose and other updates for a fraction of the price required in Paris. "That is the single market at its best", we recognised.

The Stock Market Correction Will Not Turn into a Rout

Analysts tend be optimistic despite the recent decline in equity prices.

By Vincenzo Sciarretta

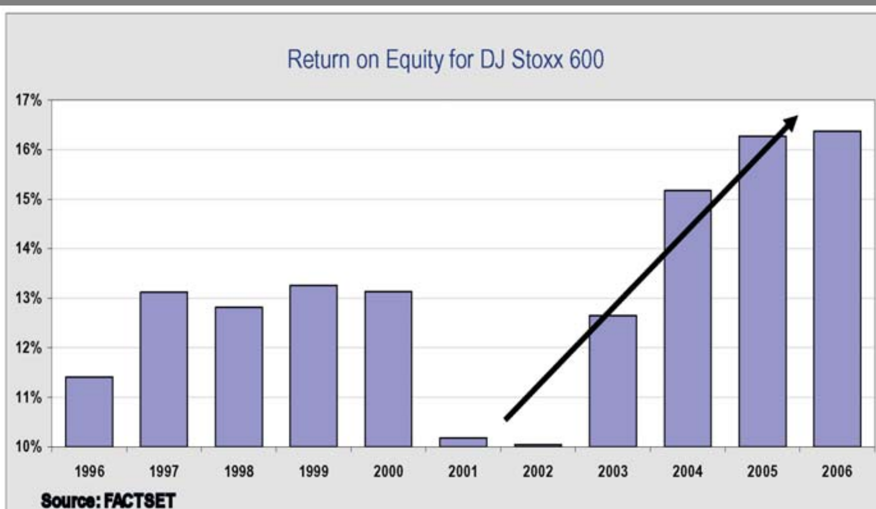
"I was out for a marketing trip," says **Robert Jukes** of Credit Suisse, recalling the recent setback of European equities, "and when I came back home I found that market mood had switched from euphoria to fear in a couple of days. However, I do think the outlook remains bullish for stocks."

Most professionals share Jukes's point of view and refuse to panic. They believe that there may be a touch of indigestion after three consecutive years of soaring assets, but that the correction is bound to be temporary. The bullish camp is still convinced that strong worldwide economic activity, the best corporate balance sheets on record, labour-limited pricing power, and the multiplication of outlets for sales will reinforce one another to produce a rapid raise in corporate earnings. They also believe that thanks to European integration, eastward expansion, together with the opening of international markets and competition, corporate earnings can grow fast without triggering inflation.

"We hate to deal with naïve measures of value," says Mr. Jukes, "but price/earnings (p/e) ratios do not suggest overvaluation. Stocks gave ground in response to an inflationary scare, which is a momentary scare, because the dynamic of prices is contained within the constraints of the structural forces of dis-inflation, namely deregulation, outsourcing, technology, and wholesale restructuring in Europe."

In similar fashion, **Marco Ravagli** of Deutsche Bank, argues that the correction is very unlikely to turn into a rout. "When selling pressure abates," he claims, "the market ought to recover, because the fundamentals are sound." He points to oil companies, industrials, and financial names as areas where opportunities are re-emerging. "Financials stand to benefit from the current wave of mergers and acquisitions, which is far from over. Industrials are aided by eastward expansion and the Asian boom. European corporations are able to maintain a level of business well in excess of domestic demand by selling machinery and capital goods abroad under the impetus of the newly industrialized countries. And finally oil companies are simply cheap enough to run the risk. Roughly speaking, their multiples discount an oil price around $50 a barrel, which offers some margin for mistakes."

TheEuropeanSide is not finding many analysts really bearish on the prospects of continental bourses. However, some do express a few concerns and reservations. **Jean-Luc Buchalet** of Factset, for example, points to the role exerted by the common currency, saying, "the higher euro is in the process of increasing pricing pressures for our exporters. Generally speaking, a 10% gain in the euro's value would cut European firms' profits by 5%. In 2005, a



European corporations are in excellent shape

Boom, where is the boom?

Lawrence Klein, Nobel Price

Cheers could be heard stateside and history did not repeat itself last week, as GDP growth in the US was revised upwards from 4.8% to 5.3% for the first quarter of 2006. Observers have tended to see GDP revisions for the US move downwards, in recent years, while GDP estimates for the EMU have generally been revised upwards since 1999. But not this time. Leading the cheering was US Commerce Secretary Carlos M. Gutierrez who said, "We have established a solid economic foundation in America, which will allow us to build even more jobs and opportunities in the future with the right policies." Amidst all this optimism, your editor has encountered some moderate scepticism in the person of Lawrence Klein, the 1980 Nobel Prize laureate in Economics. In support of his scepticism, he emphasized that the new rules employed in America under Bill Clinton and Alan Greenspan to quantify the economic figures tend to reduce inflation and increase the gross national product.

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These 'hedonic rules,' as they call them, lower the inflation rate and were devised "in a very biased way," Klein said. "Only improvements, I mean hedonic improvements were incorporated and no hedonic setbacks. For instance they say that people are better off because of information technology, and this is true. But they narrowed seats on the airplanes and they crowded people in the airports, and made no subtractions." Because of the new rules, Klein does not exclude the possibility that a 3-4% growth would correspond to a 2-3% growth rate under the old rules for the US economy. "And that is not a boom," he noted.

strengthening currency and tighter monetary policies penalised US equities; European markets now face the same situation." Buchalet also believes that the dollar will suffer from an unsustainable current account deficit: "America needs almost $2.5 bn in foreign capital every day, an amount which accounts for two-thirds of world savings. Thus, I expect the euro to maintain a bullish bias and earnings may pay a price."

An analyst who does diverge from the consensus opinion on the negative side is **Teun Draaisma** of Morgan Stanley. While not bearish, he would suggest waiting for ideally another 10% decline before buying euro-zone stocks. He writes, "valuations are not as cheap as they appear." The reason why the consensus opinion invites scrutiny is that it is based on peak cycle figures. Mr. Draaisma explains, "2007 p/e based on IBES estimates is probably 12.5, but if one uses mid-cycle ROE of 12% rather than the generally accepted 2007 ROE of 16.6%, the corresponding mid-cycle p/e is as high as 17.5. In other words, there are many expensive stocks around and if there is any value in the market, we believe it is among large caps."

It may be that Mr. Draaisma is right and the market is vulnerable to another corrective leg. Or the group consensus may have it right with the view that stocks are very attractive right now. What we do not hear is many experts ready to say that this correction could easily turn into a bear market Then again, we do not know if this is good news or not.

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The Swiss Franc or the Euro? That is the question.

Stability is expected. But if it comes to a choice, There is a slight preference for the franc.

Driving through Switzerland

After a brief stop in Lucerne, where a walk around the Old Town always has its charm, we drive north toward the German border. We are intrigued by several broker reports suggesting that the purchasing power parity of the Swiss currency makes the franc more attractive than ever. For what it is worth, anecdotal evidence suggests that the price level in Switzerland has come down somewhat relative to the euro-zone, although it remains in absolute terms expensive.

People living in the Confederation tend to confirm this picture.

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When the Swiss franc was pushing against the upper limit of its trading range a couple of weeks ago, **Jean-Pierre Roth**, President of the Swiss National Bank, expressed dissatisfaction with the weakness of his currency. He said, "over the past few months, the Swiss franc has even trended downward. If this trend were to accelerate and give rise to an excessive relaxation in monetary conditions with respect to economic developments, a normalization of interest rates would become even more essential." Traders may have interpreted these words as a good reason to sell the euro against the franc, and the exchange rate moved back toward 1.54, after earlier reaching 1.58. Some currency operators interviewed off the record by this magazine were disposed to believe that the recent peak of roughly 1.58 should represent a short-term ceiling because beyond that level the Swiss National Bank is expected to increase interest rates in larger steps in response to a weakening currency.

The analysts say that the single most important variable driving the exchange rate is the interest rate differential between the two economic areas. "The Swiss franc," explains **Carsten Fritsch** of Commerzbank, "may lower a little bit to retest the 1.58 resistance in the expectation that the European Central Bank (ECB)

Euros or francs? Your reporter is puzzled. We are at the border between Switzerland and Germany. Swiss consumers are attracted to Germany because prices are still cheaper. A customs agent suggested that after the introduction of the euro, prices rose a little bit in Germany.

A supermarket in Chiasso, Switzerland, 5 minutes from Italy. Many cars in the parking area are from Italy. Several items Italians find more convenient to buy in Switzerland than at home.

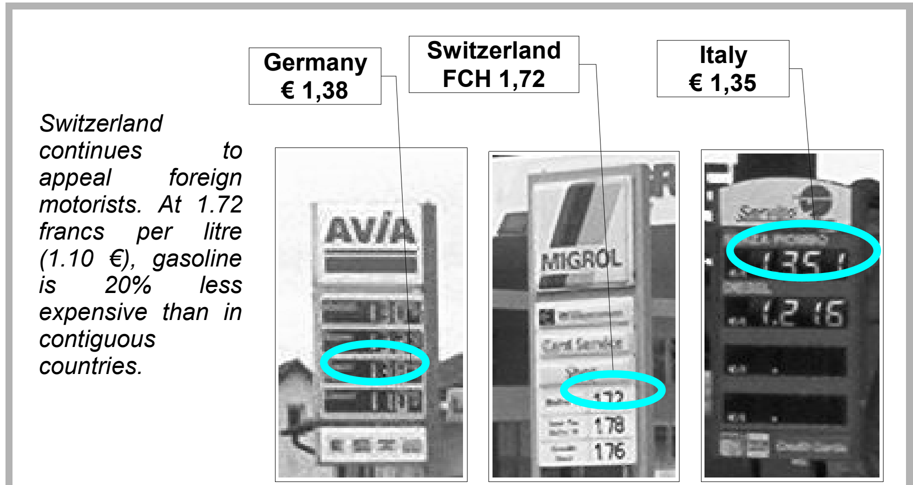
Families arrive from Italy for their shopping in Switzerland, but the activity is not frenetic, considering it was on Saturday.

would normalize the cost of money faster than its Swiss counterpart over the short run. After that, the circle should be moving into reverse gear when the yield spread is supposed to decline later this year." **Roberto Mialich** of Unicredit adds, "if both the euro and the franc appreciate against the dollar, then the euro is likely to lag behind the franc." He says, "at some point, for instance, 1,30, the ECB may start to release statements in order to slow down the euro, while the Swiss National Bank ought to show greater tolerance. In turn, this will provide support to the franc vis-à-vis the common currency."

Analysts cite other positive Swiss developments as well. Switzerland has a very substantial current account surplus compared with Euroland, running at times as high as 15% of gross domestic product. The export sector is in great shape, as demonstrated by an 8.6% advance in April. There is also little doubt that the external performance of the country is poised to benefit from the pick-up in economic activity beyond its boundaries. That is another reason given by the experts as to why the central bank must normalize monetary policy to avoid problems in the future. Finally, the Swiss National Bank has let some comments drop on rising employment and the good health of the economy, presaging some rate hikes.

In general, professional economists would be surprised if wild swings in the exchange rate occurred. In the words of **Niels Christensen** of Société Générale, "the franc is very stable against the common currency and the mirror image of this reality is the low volatility observed in the option market." But if it comes to a choice, there is a slight preference for the franc.

Staff



Switzerland continues to appeal foreign motorists. At 1.72 francs per litre (1.10 €), gasoline is 20% less expensive than in contiguous countries.

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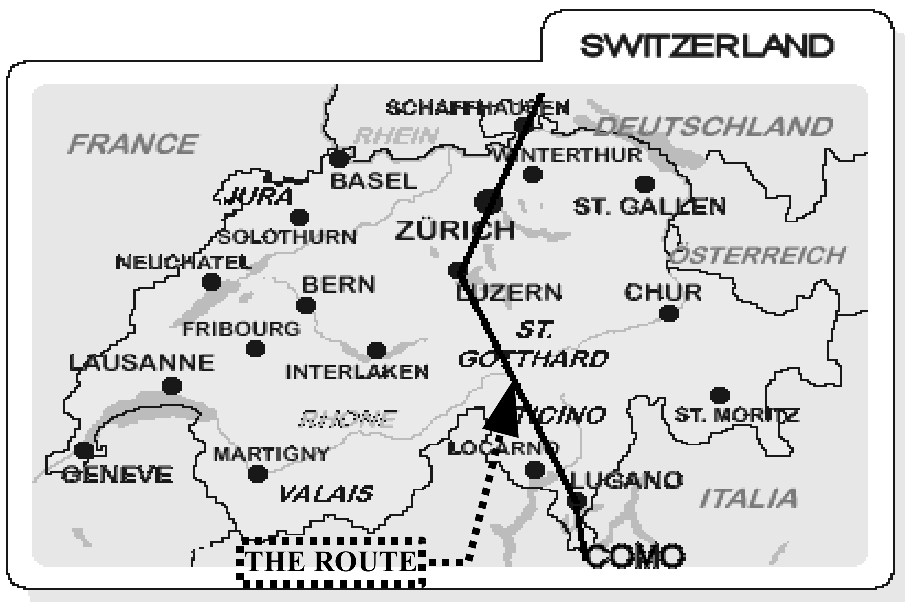
*"When the euro was introduced," recalls **Hanspeter Ehrsam**, an analyst living in Bedano, Switzerland, "I thought my country would endure some kind of deflation because the price level was significantly higher than in the rest of Europe, but as it happened, it was the rest of Europe that lifted its price level, and now the difference has tapered off." But whether the trend will continue or reverse its direction is still unclear.*

***Marc Faber**, the famous Hong Kong guru, who was born in Zurich, thinks, "the trend will go on because prices are still noticeably higher in Switzerland than in Germany." His thesis can be witnessed in practice as one crosses the border between the two countries: the Swiss are definitely going to Germany for their shopping. A customs agent corroborated this impression, agreeing that some slowing in traffic toward Germany has followed the introduction of the euro.*

The shift has been still more dramatic on the border between Switzerland and Italy. Now many items are more expensive in Italy than in Switzerland, and over the weekend one sees Italians shopping in supermarkets just across the border. As for money moving from Italy to Switzerland in reaction to the new left-oriented government in Rome, our conversations with money managers say that no such thing has happened. It was a tide some had feared.



Abroad

An Interview with Professor Robert Shiller

What's the next bubble?

The man who saw the folly of the Nasdaq written on the wall inspects the markets in search of risks you would never want to see materialized.

There has been much talk about the stock market "mania" of the 1990s, especially in hindsight. But few saw it before the crash. Among this latter group, Robert Shiller not only predicted the inevitable collapse, but also wrote a thoughtful and highly practical study of bubbles, in his famous book "Irrational Exuberance," a book that made Shiller one of the financial prophets of our time. Today, he thinks, "stocks are still expensive, although not in a dramatic way." Commodities have started to show some of the symptoms of a bubble, while home prices are definitely risky in certain areas.

Professor Robert Shiller

Robert Shiller is Professor of Economics at Yale University. He has written on financial markets, behavioural economics, macroeconomics, real estate, statistical methods, as well as on public attitudes and opinions regarding markets. An influential author, Professor Shiller has stressed the importance of developing instruments that allow individuals and market participants to manage risks in housing. The Chicago Mercantile Exchange has just introduced a housing futures index that factors such risks and is based on Shiller's studies.

It is six years since the Nasdaq peaked, which is actually not a very long time in terms of boom-bust cycles in financial markets. In other words, many required a longer time to digest the excesses. Can you offer a conceptual framework for understanding the course of future events as regards US stocks?

"Of course it is hard to predict. I do not have a sharp forecast as I had in 2000 for the Nasdaq. Back then, the stock market was in a dramatic situation."

Would you say Wall Street is cheap, fair-valued, or expensive?

"The market has responded to an important progress in corporate earnings. However, I suspect participants have over-responded, and consequently the price/earnings ratio (p/e, ed.note) is high. Especially if you calculate it the way I do, which divides the price by a long-moving average of earnings. This way the p/e is quite high, although not as much as in 2000. Overall, I still think the market is likely to disappoint as an investment."

I call from Europe and I note that the rebound in US stocks has been almost neutralized by the decline of the dollar versus the euro. Meanwhile, some old leaders such as Microsoft or Dell continue to deflate badly in euros. Any comments?

"Yes, that is why I invest more in Europe and abroad than I do at home. I think the dollar has a good chance to depreciate even further and so I am not particularly bullish on America."

Let's shift to commodities. I have read your observation that "commodities markets resemble the technology stock bubble of the 1990s." Could you elaborate a little bit on this?

"Well, actually, I am not calling it a bubble, but I think a lot of commodities are moving according to a thesis that can lead or that has led to a bubble. The thesis is both magnetic and straightforward: the demand emerging from the opening up of China and India cannot be matched by an appropriate supply. You always need a simple, engaging and agreeable thesis to build up a self-reinforcing trend. The problem presents itself when you push the reasoning to the limit and buy and buy."

But you are not sure that limit has been reached, are you?

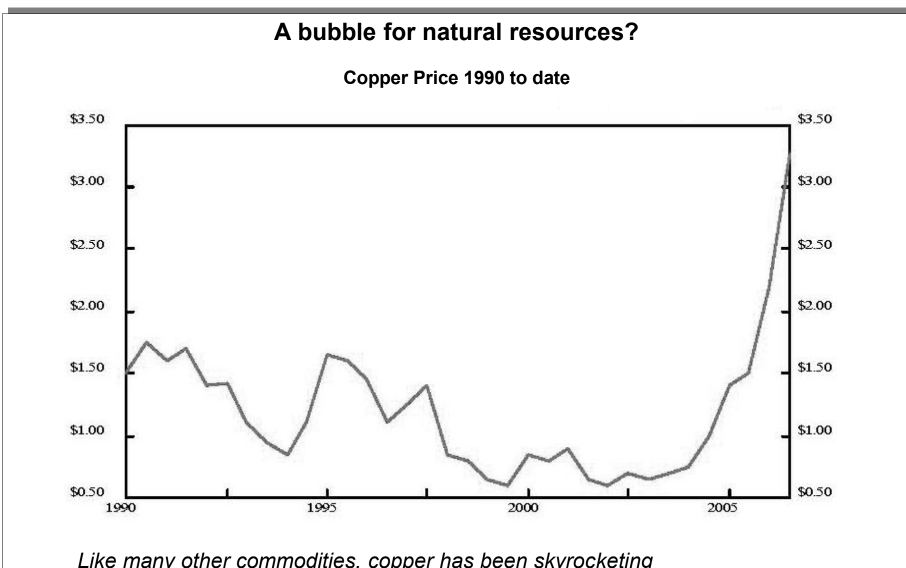
"There is an exaggerated attention to the thesis, I mean the China and India story. Of course, the story is true; the vulnerability arises if people over-react. But yes, you are right. My analysis is tempered by the insight that it is very hard to understand what the price of these commodities should be in the existing context."

Some argue we are back to the '70s. Would you agree with that?

"To some extent, I would agree. The oil boom was then associated with what was called the great population scare. People thought that the world

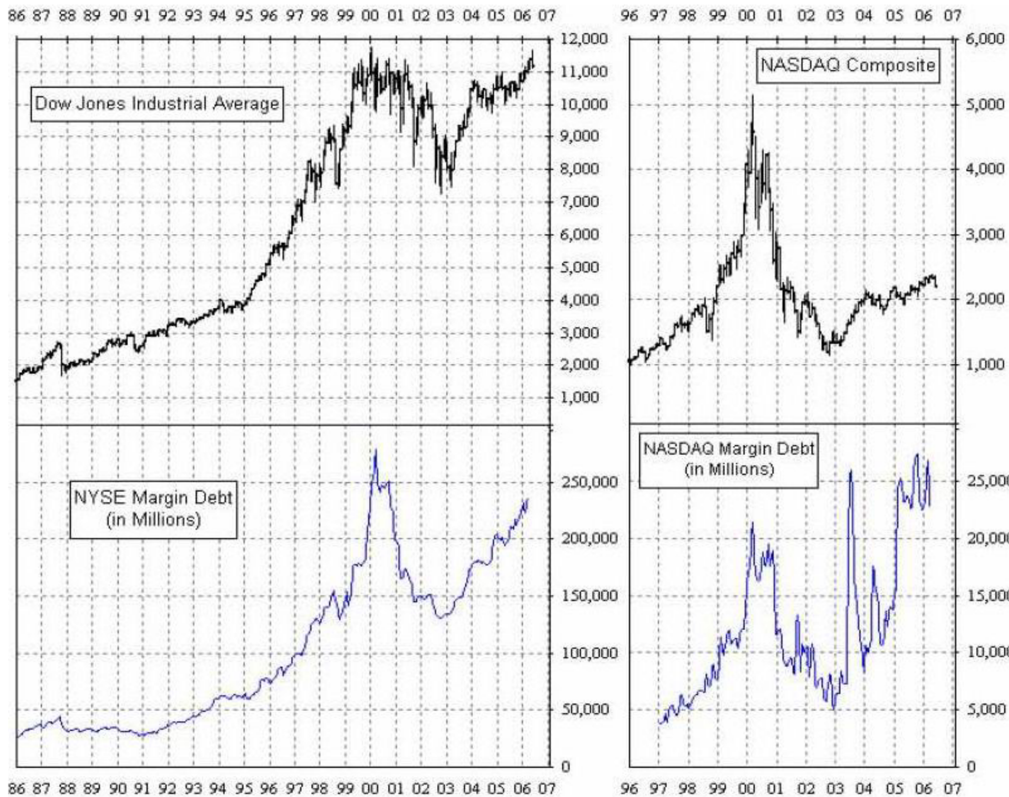
A bubble for natural resources?

Copper Price 1990 to date



Like many other commodities, copper has been skyrocketing

Margin Debt Surpasses 2000 Peak



Louise Yamada called our attention to a slightly alarming scenario as regards margin debt and Wall Street and offered the two charts on the left to support her view. Ms Yamada was head of technical analysis for Smith Barney, before founding her own company in 2005. She argues that the roller coaster ride of stocks over the last few weeks "raises the spectre of the possibility of margin calls," because statistics show a high level of margin debt. "In the case of the NYSE," she explains, "margin debt levels are close to those of 2000; in the case of the Nasdaq, margin levels are even higher than those in place in 2000." She concludes, "it is an overhang that could prove problematic in a rapid decline, as seen in the Indian equity market a couple of days ago."

Source:www.lyadvisors.com

population was getting out of control and the trend would exert a pressure on resources. It was part of the reason why we had two oil crises, in my opinion. This time the story hinges on the development of a large part of the world that had been lagging rather than on population growth, but there are many similarities of course."

Bulls usually express their reasoning in a very cogent way. They say: "we know where the new demand for oil is coming from, but we do not know where the new oil should come from." Do you have an answer?

"No, I do not have an answer. Perhaps the answer will come from the development of nuclear power, oil sands, ethanol, etc. and by economizing our needs. Also a global warming danger is surfacing. We have to operate within environmental constraints. Ultimately, these challenges must be addressed and our response may contain the demand for oil and keep the price in line."

The bulls would reply to your arguments: yes, but everything you mentioned is at best a few years away. And in the meantime, energy prices can keep on rising…

"I know, I know. My contention is that if we establish a clear policy now, the outlook can affect the price of oil today. In fact, the issue is the long-term one about running out of oil; and if we are aware that an alternative does exist, prices are likely to go down sooner than later."

The Chicago Mercantile Exchange launched on Monday, May 22, futures contracts based on indexes of home prices from research started by you and

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Professor Karl Case. You expressed concern on the prospects for home prices. Are you still worried?

"Yes, the outlook for housing in the United States and abroad is very uncertain. That is why we have created a market for home prices. In any case, you are right, I have a bearish bias. I lean toward a hard landing scenario for some of the regions where prices have gone up dramatically. As an example in Los Angeles between 1989 and 1997 real prices corrected by 40 per cent and I suspect a comparable rectification could happen again in certain areas."

Can you mention any names?

"Cities where prices have shot up a lot, including San Diego, Phoenix, Las Vegas and Miami. Buyers and sellers are moved by psychology, which is so hard to predict. A good reason to have a market for home prices."

Do you see any signs that the upward trend for real estate may be approaching its top?

"Inventory. Homes for sale have increased a lot in the last 6 months, which could prepare the ground for a reversal."

Some argue that if housing and stocks suffered a setback, the Federal Reserve would cut rates aggressively because consumption is asset-driven. Do you share this view?

"I believe so. Bernanke is trying to follow Greenspan's footsteps (Ben Bernanke is the current Chairman of the Federal Reserve and Alan Greenspan his predecessor, ed. note). His policy consists of cutting rates before it gets too late. Remember that in 2003, when the great deflation scare materialized, he was publicly concerned about the possibility of a liquidity trap."

However, right now the economy looks quite strong.

"I am not going to contest your assertion. But I see a vulnerability in the real estate market. Should it drop, then a vibrant activity could easily turn into a decline. An indicator I am looking at is the consumer sentiment, which is giving ground. It seems to be falling in part on account of high oil prices and in part because housing is cooling."

Wouldn't it be dangerous to cut rates in a commodity bull market?

"Yes, this is the problem. We might even enter a stagflation regime again. If energy continues to develop its own momentum and the economic trend turns down, the Central Bank will be confronted with difficult choices."

Professor Shiller, thank you for your time.

V.S.