The European Side

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THE EURO-ZONE REPORTED FROM THE CONTINENT

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Taxes, Diocletian, and Angela Merkel

by Vincenzo Sciarretta

In the glory days of the Roman Empire, under the rule of Augustus, there were 66 holidays a year. When the Empire disintegrated, holidays set a new record of 165 a year. Perhaps that was too much.

In core Europe, we see a similar trend today. Statistics show that our economic output per hour worked is the same as in the US. But we are working less and less, and less than any other people in the world. Over the last 25 years, hours worked per capita decreased by 23.5% in France, by 17% in Germany, and by 10% in Italy. At the same time, they increased by 17% in Canada and by 20% in the US. According to OECD tables, the countries where people work the least are all in core Europe. France holds the worldwide record in per capita terms, followed by Italy, Belgium, the Netherlands, and Germany. In Holland, with nine million people of working-age, one million are collecting disability benefits and not working. In Belgium, only 25% of those over 55 are still working as many opt for early retirement plans.

And while all this is going on, hard working people are severely penalized. Recently, the German government has decided to raise, as the phrase goes, the "taxes on the rich." Well, there is a limit beyond which one must be crazy to work hard. In much of Europe the marginal rate of taxation on income, including social security contributions, is probably 50-60%. Buy something and there is again a 16-20% value-added tax rate. In other words, one must earn €100 to spend, say, €30 or €40. Of course it is far better to sit down and ask the government for a contribution or some benefits.

Governments have always good reasons to raise taxes but too much is too much. In the late years of the Roman Empire, the Emperor Diocletian (284-305 A.D.) raised taxes substantially. When businessmen predicted ruin, he explained that the barbarians were at the gate. And he did have good intentions. He embarked on extensive public works meant to put the unemployed to work and to help the poor. According to historian Will Durant, however, "thousands of Romans, to escape the tax-gatherer, fled over the frontiers to seek refuge among the barbarians." Well, if ancient Romans were willing to run the risk of being killed just to escape excessive taxes, it does not take a rocket scientist to imagine what can happen in an open society where a mouse-click on a computer can move large assets abroad. What we to need in Europe is to encourage hard-working people not to penalize them.

«The dollar is landing, they say...»

In February, European banks were extremely bearish on the greenback. In hindsight, they hit the mark. A new survey this week shows an optimism tempered by moderation. On average, 1.30 is considered a good equilibrium level for the euro versus the dollar.

By Vincenzo Sciarretta

A couple of months ago we were struck by a February survey of this magazine that pointed to a very strong consensus: 8 out of the 10 largest banks in continental Europe were betting on a rising euro and a declining dollar (one bank did not provide any comment). The consensus was confirmed after listening to 5 additional international players (see the table below).

On average, the analysts articulated their reasoning as follows: "we believe the structural problems of the dollar are going to outweigh the interest rate differential in favour of the US." Today, looking back, they proved to be entirely right

This week, *TheEuropeanSide* updates the survey and finds that the prevailing view among experts is that the euro should fluctuate around the current level.

Professionals have adopted the thesis that a number of factors are working to hold down the American currency, including the higher level of global interest rates, a large very current account deficit, potentially slowing growth in the United States, and the dollar implicit message about weakness advanced in the G7 communiqué. But everything has a price, and 1.30-1.33 is considered the

YEAR-END TARGET PREDICTED ON FEBRUARY 20, 2006

YEAR-END TARGET PREDICTED ON MAY 5, 2006

The Dollar Is Doomed, They say...

8 out of the 10 largest banks in continental Europe were bullish the euro in February.
The bias is more balanced today

Banks	Analyst	on February 20, 2006		on May 5, 2006	
		target:	Trend	target:	Trend
Largest banks on the continent					
UBS	Team	1,3	Up	1,3	Sideways
Banco Santander	not willing to release any comments				
Unicredito	Roberto Mialich	1,28	Up	1,28-1,30	Sideways
BNP Paribas	Team	1,32	Up	1,32	Up
Credit Suisse	Marcus Hettinger	1,11 - 1,13	Down	1,20	Down
Société Générale	Niels Christensen	1,26	Up	1,27-1,30	Sideways
ABN AMRO	Tony Norfield	1,28	Up	1,28	Sideways
Crédit Agricole	Olivier Bizimana	1,27	Up	1,30	Sideways
Fortis	Francoise Bernard	1,25 - 1,30	Up	1,25 - 1,30	Sideways
Banco Bilbao	Team	1,20 - 1,25	Sideways	1,27	Sideways
Deutsche Bank	Team	1,27 - 1,30	Up	1,30	Sideways
Selected international players					
Merrill Lynch	Alex Patelis	1,29	Up	1,29	Sideways
Morgan Stanley	Stephen Jen	1,24	Up	1,24	Sideways
Bank of America	Robert Sinche	1,30	Up	1,32	Up
Nothern Tust	Victoria Marklew	1,35	Up	1,35	Up
Independent Strategy	Bob McKee	1,30 - 1,35	Up	1,30 - 1,35	Up

Fonte:The European side

Yes, I would diversify...

Ed Bohene, ex Fed

*We asked **Edward Boehne**, former President of the Federal Reserve in Philadelphia, "If you were a central banker today in a country that held a substantial percentage of its reserves in dollars, would you contemplate some diversification?"*

His response was, "Yes, I would. With the euro, and even the yen, some change would be reasonable." He stressed, however, that "if you are a major central bank, you must be careful that diversification does not lead to destabilization.

The Chinese, for instance, may want to remix their portfolio, but they must be judicious because the US is a large market for them. So if you are a minor central bank, diversification is probably more relevant to you than for major central banks that have to consider underlying macro factors."

As a follow up to that question, we asked whether he would also take gold into consideration for reserve purposes. "If I were an Asian central banker" he replied, "and calculated the number of dollars that I have, well, I would look for some diversification... and given the options for currencies, yes, I can see some purchases. But I do not expect gold to exert any critical role in monetary authorities' decisions.

What I envision here is some diversification of portfolios into gold." (For a different perspective, see "Confessions of a Former Central Banker" in this issue).

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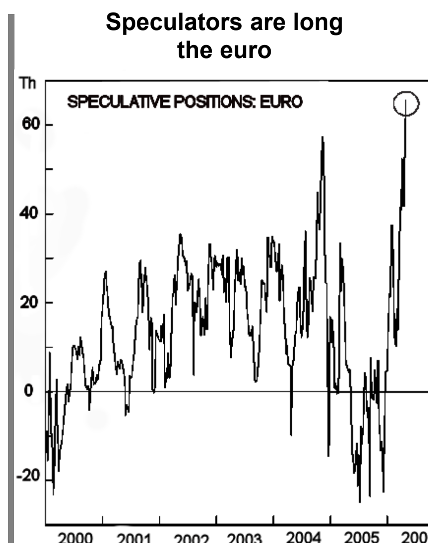
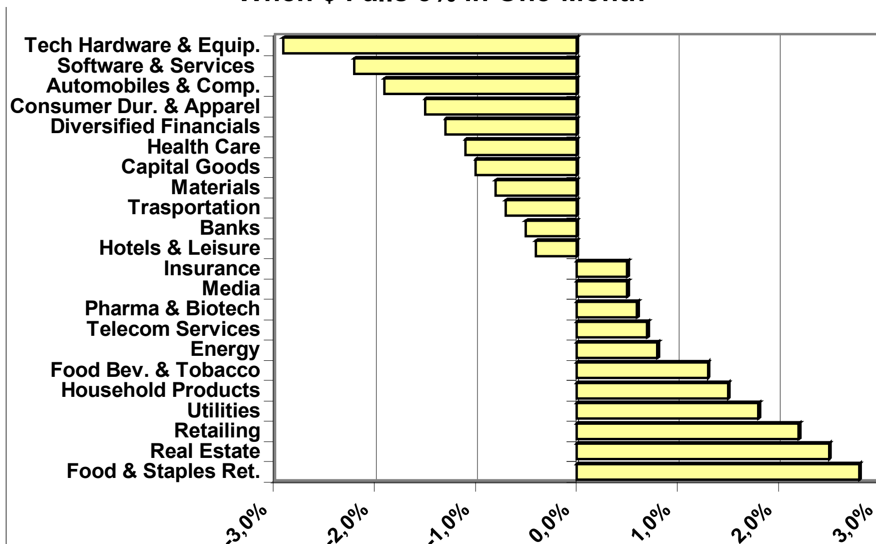


*The current rise in the euro has been accompanied by a speculative frenzy in the futures market. Long positions are so established, in fact, that they are setting records, a sign, in the past at least, that a setback or a reversal lies ahead. According to **Steve Quigley** of BCA Research, however, the risk is limited. "Currency futures are only a very small fraction of the foreign exchange market," he says, "and they are home to mostly short-term and momentum-based traders."Therefore, any setback will be easily offset by long-term investors buying the currency, as well as foreign central bank purchases."*

**Average Sector Performance
When $ Falls 5% in One-Month**



Note: Average sector relative performance in months the $ falls 5% or more against the €.

Stock investors always try to look at the exchange rate since continental bourses have historically reacted to dollar swings. They usually tend to strengthen under the impetus of a strong dollar and to weaken when the greenback endures a downward spiral. Whether you are bullish or bearish the euro, you may want to take a look at this chart with the sectors' susceptibility to the ups and downs of the dollar/euro.
An old chart from Morgan Stanley

symbolic threshold for 2006. "The last time that the currency ratio of euro to dollar appreciated at a similar rate", says **Niels Christensen** of Société Générale, "was back in the second half of 2004, when it rose above 1.30, soaring to an all-time peak of 1.3665. Today, however, we see several factors that should prevent a replay of that scenario. First, the euro trades with a negative carry, that is, interest rates are higher in the United States than the euro zone. Second, the European Central Bank (ECB) is likely to insist on a policy of benign neglect as long as the common currency does not develop too much momentum. Above 1.30, we think, the ECB is likely to lower expectations of a rate hike. Third, there is the political reality: the euro zone is now running a monthly trade deficit with China of 7-8 bln, almost double the deficit of two years ago. Add to that the fact that the euro has appreciated by roughly 3-5% versus the yuan since the innovation of the Chinese exchange rate system last July. All this leads us to believe that central bankers will discourage a strengthening of the euro that is turning into a wild swing."

If structural problems of the dollar prepared the ground for its decline, various announcements and declarations set off the selling wave. The importance of the G7 communiqué as a catalyst is already well recognized, so let us not tire our readers with a rehearsal of its content. Instead, let's listen to the expert consensus what the document means. "Yes," says **Roberto Mialich** of Unicredit, "the currency market is tracing the pattern established after the Group of Seven met in Dubai in 2003." **Olivier Bizimania** of Crédit Agricole echoes this sentiment, noting that "in the abstract, the G7 statement put emphasis on further appreciation of Asian currencies to

The Euro Sceptics

With a year-end target of 1.24 for the dollar against the euro, ***Stephen Jen*** *of Morgan Stanley is among those sceptical of an endlessly strengthening euro. He contends that the optimism about the common currency is not matched by its outlook and derives from different expectations that investors bring to European and American markets. "I continue to be frustrated by the fact that investors treat Euroland as innocent until proven guilty," he writes, "while treating the US as guilty until proven innocent, particularly if we consider that the potential growth rates in the two areas will be significantly different, even if Euroland does recover toward its low potential rate."*

The analysis, he says, supports the claim. "Our calculations show that a 20% rise in the euro against the dollar, a rise that would be a reasonable projection if the current talk of wholesale diversification by Middle East funds and Asia reserves turned out to be correct, could essentially push the European Central Bank to adopt a zero interest rate policy," in order to counterbalance the effects of moves in Asia and the Middle East. Jen also disagrees with the idea that we are seeing a replay of the misalignment of 1985-86. "The US currency is sound and not overvalued. It may weaken due to cyclical forces but is unlikely to plunge for structural reasons."

Another Euro sceptic is ***Marcus Hettinger****, a foreign exchange strategist for Credit Suisse who thinks that a strong US economy combined with a positive interest rate differential would tend to strengthen the dollar. Accordingly, he has a dollar target of 1.20 against the euro by December 2006. If his diagnosis is correct, the greater dynamism of the American economic engine should continue to attract foreign capital and support the move into dollar assets.*

The dollar is vulnerable to a decline in interest rate differentials

Percent of current account financed by interest rate sensitive inflows

	Q4 1987	Q1 1989	Q1 1995	Q2 2000	Q4 2005
Bonds	*5*	*45*	*81*	*47*	*80*
Short-term	*34*	*10*	*2*	*-43*	*4*
Total	**39**	**55**	**83**	**3**	**84**

Source: *Merrill Lynch. Bonds are fixed income assets greater than 1 year in maturity. Short-term includes money market paper, bank deposit are other items. Q4 2005 is the most recent available data. The other dates mark the end of tightening cycles in the US.*

In a recent study, Merrill Lynch Chief Global FX Strategist, **Alex Patelis** calls attention to the great share of the US current account deficit that is financed by interest rate sensitive inflows. His analysis compares the share of such inflows at the end of past Fed tightening cycles with the current situation. The share today is a significant 84 per cent. The fact leads him to conclude that "in this environment, the willingness of foreigners to finance the US current account deficit should be particularly sensitive to changes in Fed policy, especially at the time when central banks outside the US are in a period of rate normalization."

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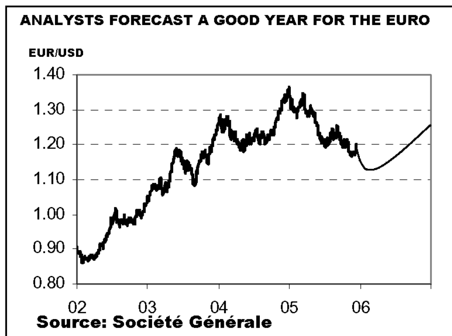

help reduce global imbalances. But market players read it for what it said indirectly, that is a weak dollar." Mialich also points out the fact that a powerful group of industrialists in the US claimed that the dollar was at least 10% overvalued, starting their lobbying in anticipation of the November 2006 congressional elections.

In addition, analysts mentioned the article by Martin Feldstein, chief economic adviser to Ronald Reagan, in which he suggested that the US should allow the dollar to go down as in the second half of the 1980s. Finally, a recent speech by Alan Greenspan arguing for stronger Asian currencies were interpreted to mean that the outlook for the greenback was bearish. In short, many got the signal that the dollar could be sold almost without risk. Skyrocketing levels of speculative long positions in the futures arena confirm that more than a few investors acted on this signal.

The other hot topic that has emerged in recent weeks centers on reserve diversification by international monetary authorities following the announcement of the Swedish Riksbank that they had shifted their reserves out of the dollar and into the euro. As for the professionals surveyed by this *TheEuropeanSide*, several of them manifested some scepticism, claiming that traders are acting on expectations but that, based on official data, diversification from USD to EUR is not large. "Little real change, so far", comments **Bob McKee** of Independent Strategy. "There are no real data," adds **Tony Norfield** of ABN AMRO. "Central banks would be crazy to bring on a stampede out of the dollar at this stage." The same attitude is taken by **Nancy Verret** of Fortis Bank who thinks "diversification has a minor role in this moment"

Analysts were much more impressed with the shift in the dynamics of growth and monetary policy on both sides of the Atlantic. "The two factors that kept the dollar stable last year," contends **Victoria Marklew** of The Northern Trust Company, "were the high growth differential over Europe and the high interest rate differential. Now both are softening, making it less compelling to invest in the US. This has to be considered in the context of a huge US current account deficit and a substantial fiscal deficit. Thus, market expectations will support the euro and undermine the dollar."

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«Gentlemen don't buy stocks»

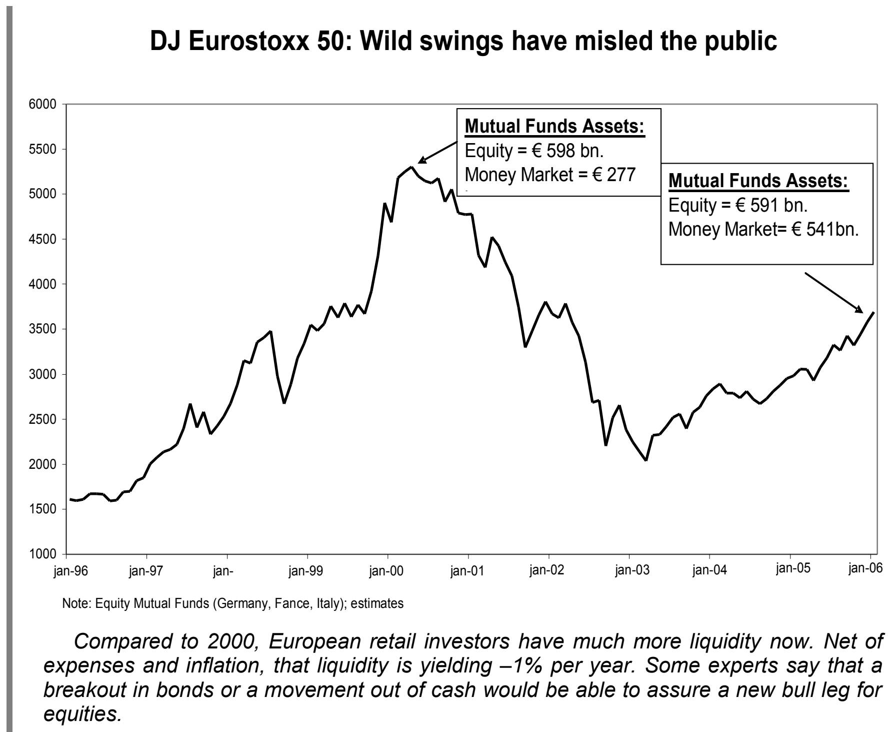
Both retail and institutional investors have completely missed the great bull market of the last three years. Some may be start feeling anxious about it. If they reallocate some cash into stocks, greater firepower may be added to the market.

Since it bottomed out in 2003, the EMU stock market has doubled but with almost no participation by families and traditional savers. Indeed, the public has been acting herd like. People bought massive amounts of shares, both in the bourses and through intermediaries, at the heat of the bubble, only to suffer the bear movement all the way down. Paralysed with fear by the mammoth losses, they have subsequently failed to benefit from the bull tendency which blossomed in 2003.

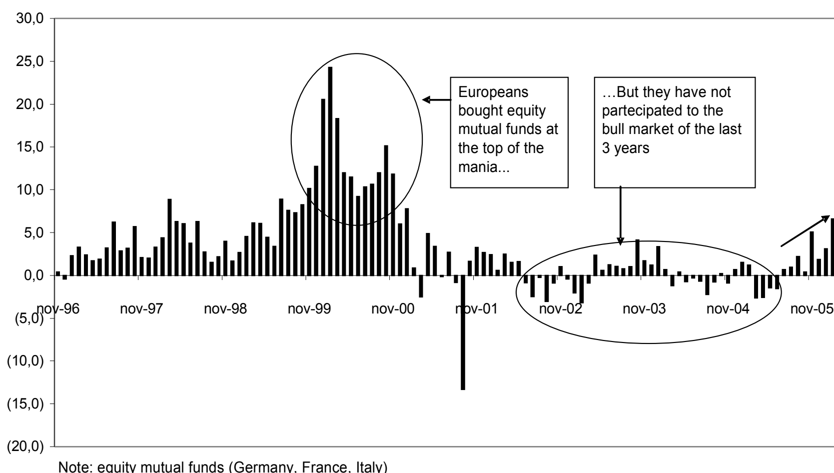
And it was not only the "weak money" that behaved this way. From 2001 to 2004, professional managers dumped their stock positions and held record-low levels of shares in their portfolios just as the market was going up by 100 percent.

Pure and simple: families and institutional funds have had the worst timing ever. They bought the mania and sold the value.

If one looks at mutual fund figures, the data are impressive. Since 2001, inflows to equity mutual funds have collapsed. It is also the period when inflows to money market funds started going through the roof, even though they were yielding essentially nothing, or were actually negative when inflation and other expenses were taken into consideration. In Germany, there are €72 billion in money market funds, in Italy €84, and in France €385 billion. Taken together, that amount is of the same magnitude as assets held in equity funds. But cash has been returning a real –1% per year. "Well," says **Sabine Brack**, a broker located in Frankfurt, "when you talk to the typical saver he will tell you that earning nothing is better than losing 40% as happened in 2001. They are terrified." Brack also quotes the case of a relative of hers, a retired teacher, who bought a lot of new economy names in 2000. "He took a bath. He lived the bear market almost in a state of personal despair. When securities started rebounding, he was simply too demoralized and unnerved to enter the arena again."



Compared to 2000, European retail investors have much more liquidity now. Net of expenses and inflation, that liquidity is yielding –1% per year. Some experts say that a breakout in bonds or a movement out of cash would be able to assure a new bull leg for equities.



Over the last 3 years, EMU bourses are up by 100 percent. But savers have not been involved, staying on the sideways. There are some anecdotes they may be tempted to rebalance gradually their portfolios, including some stocks.

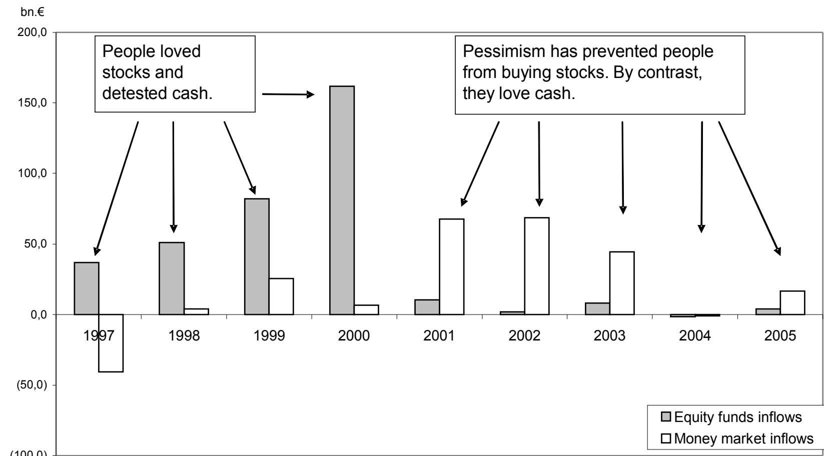
The Outlook

The point is that the behaviour of savers suggests a lingering pessimism and that if they can cast off their pessimism, a new source of money could fuel the bull market. Back in the second half of the 1970s, US mutual fund net sales were negative, and those were precisely the years which were incubating the great surge of the '80s and '90s. "In the summer of last year, 12-month cumulative inflows in equity funds hit zero," writes **Darren Brooks**, equity analyst at Citigroup. "But better news has emerged more recently with signs that retail investors are making tentative steps back

to the equity market. We expect this improvement to continue with more people looking back on three strong years for European bourses and cautiously re-raise exposure to an outperforming asset class." Recent mutual fund numbers seem to confirm that attitude with a strong outflow of bond funds and some inflow into equity funds.

"Data are encouraging," confirms **Edmund Ng** of Morgan Stanley. "The six countries we track (Spain, Germany, the UK, France, Italy and Sweden, *ed. note*) registered a net inflow to equity funds of approximately €8.5 billion, after setting a 5-year record in February." In fact a breakout on the downside in bonds has coincided with some shift from fixed-income to stocks. That should not come as a surprise. The sell-off in government securities has been meaningful, while European bourses continued to improve. Savers and managers who have been switching out of equities into bonds have forgone over 20% of performance.

According to **Kevin Gardiner**, chief strategist at HSBC, institutional players are likely to increase their exposure as well: "These equity returns," he argues, "are being watched anxiously by those life assurance and pension funds who took more glamorous bonds to the ball. With relative low equity weightings, they must be a little nervous of having locked-in unnecessarily-low returns. This might not matter much to their defined-benefit scheme beneficiaries, but it will not help win new mandates." Gardiner also thinks that "fund managers with long-term liabilities need long-duration assets to match those liabilities, and that stocks are perfect candidates."



Again, figures show the classic mistake of families as a class in being aggressive near a market top, and scary when the market has suffered a deep plunge that brings back prices in line with fundamentals.

Plentiful Liquidity

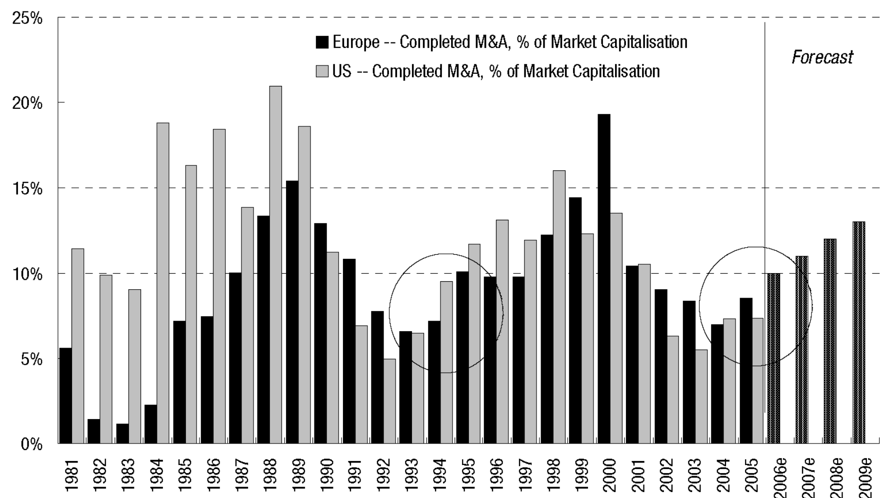
"Cash was used to pay down debt," explains Kevin Gardiner, "but with debt to equity having fallen substantially, the cash has been targeted toward other aims, including merger and acquisition (M&A), bigger buy-backs etc. I recognize that the cost of borrowing has risen in 2006, but if my analysis is correct, a long wave in M&A activity is in the process of gaining momentum."

The outlook of Brooks is similar: "The M&A cycle was at a similar stage in 1995/1996," he writes. "At the time, many investors thought that 1995 was the peak in the M&A cycle. However, it was just the beginning. We hear a very similar story from many investors now. M&A was last year's story and we have already seen the top of the cycle. We disagree. The lack of easy growth available and the fact that companies are rich in cash and that we live in a low nominal GDP growth environment suggests to us that the rare and appealing arbitrage opportunity between cheap debt and expensive equity financing will continue to close. A pick-up in M&A activity is the logical result."

Liquidity is generous at the macro level as well. The first two ECB refi rate hikes since October 2000 have not tightened liquidity conditions much, as growth in money supply is rising at a rapid rate. In March, M3 rose by 8.6%, well above nominal Gross Domestic Product and can still be considered supportive. Further, money supply tends to precede the EMU leading indicator by about six months.

In conclusion, a bull market is a strange receptacle of powers and forces. Liquidity is surely one of them. Savers' behaviour suggests pessimism is common and sentiment is weak, hardly the characteristics of a long-term top. But the cheap cost of money, the ample reserve of resources enjoyed by families, and the fact that these resources are yielding so little in bonds and money market funds may be elements in favour of this equity bull market.

Staff



According to Darren Brooks of Citigroup the M&A activity is in the same position as in 1995-1996. Namely at the beginning, and not at the end, of a cycle. The only difference is that in the mid-90s M&A was financed by equity and now by cash and cheap money.

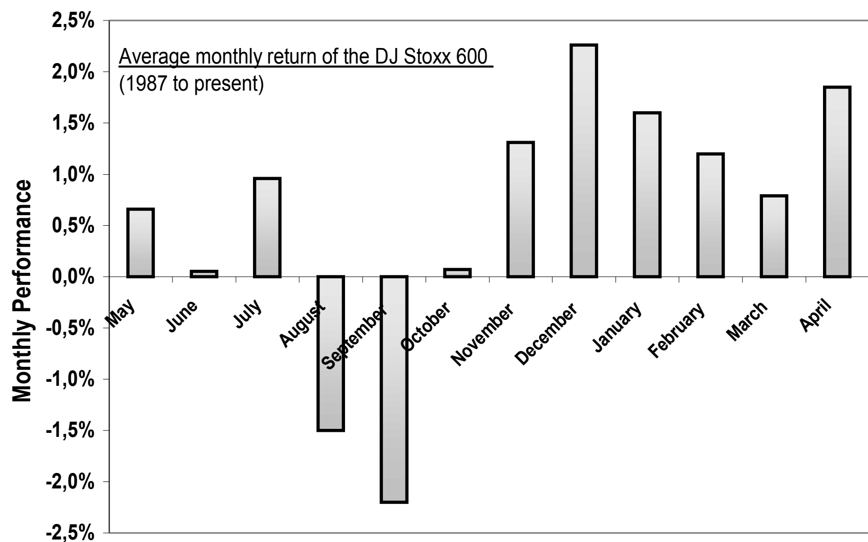
«The Season may favour some profit taking»

A few statistical tables for your consulting.

The stock market has entered that part of the year when some seasonal weakness may surface. It is a pattern well recognized by financial operators, and TheEuropeanSide proposes a quick reference for the reader who may need useful statistical tables on his or her desk. Simply put, there are two separate periods each year, one usually favourable and one usually unfavourable. The favourable interval lasts from November through April, the unfavourable from May through October.

Starting from 1987, the performance of the DJ Stoxx 600, a large European index including Switzerland and the UK, has produced an average return of –2% during the May-October season, while the same investment would have grown by +9% in the November-April season over the same time period.

Over the 19 years considered, in other words, €10.000 invested solely from May to October would have compounded a total loss in excess of €3.000. The same €10.000 invested from November through April would have grown to €47.000. The two halves of the year presented asymmetrical risks from any point of view. For instance, the six months from November through April were negative only in three occasions, and two of them occurred during the devastating bear market of 2000-2003. Meanwhile, the May-October period was negative in nine different cases.



The seasonal pattern is well established

The May-October period is usually weak		The November-April period is usually strong	
May-October period	**Performance in the 6 months (DJ stoxx 600)**	**November-April period**	**Performance in the 6 months (DJ stoxx 600)**
May-October 1987	-15,9%	Nov 87 - April 88	2,80%
May-October 1988	10,8%	Nov 88 - April 89	11,60%
May-October 1989	2,2%	Nov 89 - April 90	2,50%
May-October 1990	-11,5%	Nov 90 - April 91	16,30%
May-October 1991	-0,6%	Nov 91 - April 92	5,20%
May-October 1992	-13,5%	Nov 92 - April 93	14,10%
May-October 1993	19,2%	Nov 93 - April 94	4,60%
May-October 1994	-6,5%	Nov 94 - April 95	-0,05%
May-October 1995	7,4%	Nov 95 - April 96	14,20%
May-October 1996	3,5%	Nov 96 - April 97	23,90%
May-October 1997	10,0%	Nov 97 - April 98	30,40%
May-October 1998	-11,0%	Nov 98 - April 99	24,00%
May-October 1999	1,6%	Nov 99 - April 00	23,70%
May-October 2000	-1,2%	Nov 00 - April 01	-11,90%
May-October 2001	-18,9%	Nov 01 - April 02	4,70%
May-October 2002	-26,7%	Nov 02 - April 03	-8,60%
May-October 2003	13,7%	Nov 03 - April 04	7,90%
May-October 2004	0,5%	Nov 04 - April 05	6,60%
May-October 2005	13,4%		
Number of positive intervals: 10 out of 19 ***Average result in the six months: -2%***		***Number of positive intervals: 15 out of 18*** ***Average result in the six months: +9%***	

The monthly performance chart indicates a sharp seasonal pattern with winter and spring months strongly outperforming the other ones. August and September look like doomed months, while May, June, and October are basically flat. Without the terrible plunge of 1987, however, October would be a normal one. The months from November through April are the crown jewels of the year.

If the conventional wisdom prevailed, a normal correction might develop over the next few months, in which the downward seasonal tendency would combine with a strong euro and soaring commodity prices to favour some profit taking. But if the analysts reported this week are right, the bull market has still got the legs to run.

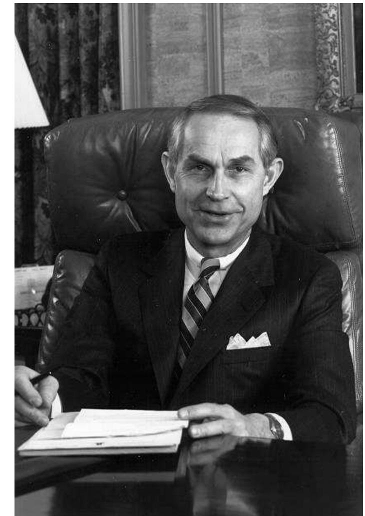
Staff

An interview with William Ford, ex President of the Federal Reserve of Atlanta

«Confessions of a former central banker»

Bond yields are going up, housing prices are bound to correct , and the Fed may raise rates more than you expect.

Talking to someone who represented the monetary authority of a country at the highest level of competence provides excellent insight into current events. And Professor William Ford does not conceal his point of view: he thinks inflationary pressures are disappointing and that this fact increases the odds that the Fed will elevate the cost of money again at some point in the future. He also bets that bond yields are on their way up, favouring a shift from stocks to bonds. And yes, there is a bubble in the housing market.



Professor William F. Ford

Professor William F. Ford is a former President of the Federal Reserve Bank of Atlanta, and currently holds the Weatherford Chair of Finance in the College of Business School at Middle Tennessee State University. He formerly served as Dean of the Business School at the University of Denver; President of First Nationwide Bank; and as Senior Vice President of Wells Fargo Bank. He also served as Executive Director and Chief Economist of the American Bankers Association.

Let's start with monetary policy: the financial community has adopted the view that the US central bank is about to stop, or at least to pause, its tightening. Do you share that view?

"Well, recent statements point in that direction, I mean, in the direction of a pausing. However, I would say that the fate of future Fed's decisions remains unresolved. We simply do not know."

You were a central banker yourself, you may have an opinion.

"Let's go back a little bit. Everybody knows in the March minutes that central bankers indicated that the end of their rate-raising program might be near. They would not have written such words if they were then seriously concerned about the threat of inflation. But since that meeting some bad news has come to light."

Are you referring to the March consumer price index (CPI)?

"Yes, I am. It was far too high even if you take into consideration the CPI data minus food and energy. The April CPI numbers will come out on Wednesday. Subsequently, they will see the May CPI numbers before their June 28 meeting, and those figures are not likely to be comforting. Therefore, If I had to bet today, I would argue that a need might emerge to tighten the grip on monetary policy later this year. That said, I want to repeat myself. The fate of future moves is unresolved at the present time. And I think that people at the Federal Reserve do not know for sure what they will do. Decisions are data-dependent."

What factors on the table?

"You know, the economy is showing a good dynamism. And if we created another 200-300 thousand jobs per month for the next 3-4 months, we would be looking at a fairly tight labour market, meaning wages might start to go up. Productivity gains are another element which may decelerate as usually happens toward the end of a business cycle and that does not help. By contrast, we have to take into consideration that in the next 6-18 months the delayed effects of the past tightening will come on stream. Thus, I think the situation is not unequivocal. As I mentioned, it is data-dependent."

In the past, the end of a tightening cycle often ushered in a recession. What about this time?

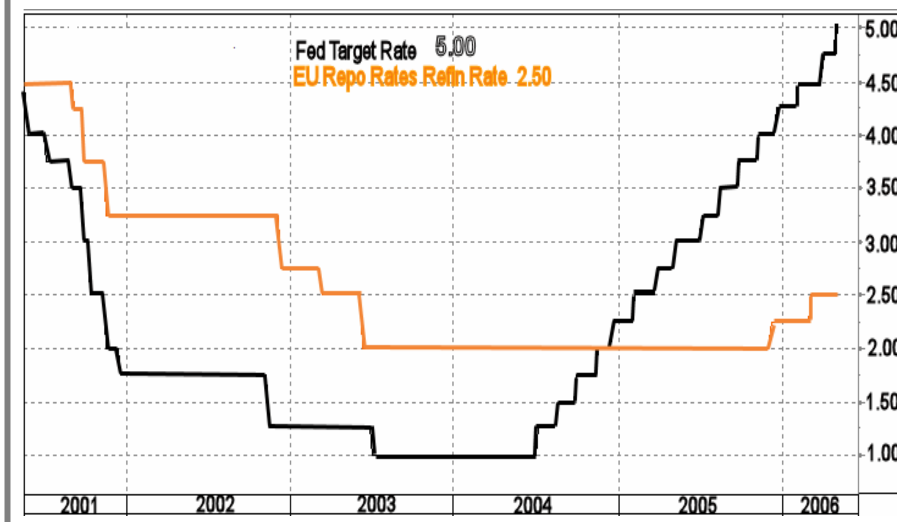
"You are right. You are right for the past. But the single most important variable is how much you tighten. Let's say for instance that they stopped on May 10. In this case, you are talking of an 8% prime rate, a 5% fed funds rate and a 6.5% mortgage rate. Those are not figures which are going to precipitate a recession. Yet they are likely to slow down the economic activity."

Do you have any figures in mind?

"Perhaps we may have a 3% real GDP growth for 2006 compared to the 3.5-4% we experienced in the last two years."

Some claim that monetary authorities in Asia and in oil-rich countries may diversify their reserves into gold, the euro, the yen, and forth. If you were a central banker now,

The cost of money in Europe and the US



would you buy any gold?

"Well, a more serious diversification which is beginning to happen, as I understand, is putting more reserves in euros in addition to dollars. Asia holds a very large share of our publicly traded debt. Exporting money is our best export industry. Thus diversification is reasonable. But as far as gold is concerned, I must say that there is not enough gold running around."

Would you buy any gold as a central banker?

"I would not buy gold as a central banker, certainly not in the US. I don't think Alan Greenspan has ever hoarded any gold in his 18 years as far as I know. But then what is the sense of having those miners in South Africa going a mile or two into the ground to get some metal out and then you store it again in a room? It's a stupid process."

Do you have the same opinion when it comes to emerging economies buying gold?

"I understand that. When you had bad experiences with inflation you may want to buy some gold."

Let's change topics. 10-year yields have broken out on the upside, reaching quickly 5 percent. Is that a temporary high or an uptrend?

"I have been forecasting a raise in Treasury bond yields for quite some time and eventually they have started to increase. And would you like to know something? I'd not be surprised if they moved higher, say to 5.5-6 percent."

What are the main implications for financial markets?

"I can envision the possibility of a shift from stocks to bonds to some extent. People like me love higher interest rates because I am a saver and I am now getting 5 or 6 or 6.5% on my life savings and I love it. And money market funds, where wealthier Americans, especially older persons, used to hold their savings are yielding 5% compared to 1-2% earlier. Going forward, fixed rates will be exerting their fascination."

Mr. Greenspan stated in mid-April that "asset prices will fall eventually." Do you agree?

"The first asset which comes to my mind is real estate. In the past, Greenspan denied there was a housing bubble. He spoke of *froth*, like when you shake your beer and a lot of little bubbles materialize. One thing I do know is that there's definitely a bubble in some of our major markets, like San Diego, New York, Boston and, I'd say, in the coastal areas. Prices have been increasing at 20% per year. It must stop and it will stop. And it is stopping right now. Sellers are having to cut their prices for the first time in a long time. Yes, we shall see some asset price deflation in certain real estate markets."

And what about stocks?

"Stocks are not crazy as they used to be in 2000-2001. There are perhaps some crazy cases like Google, but it's not the overall situation."

Mr. Greenspan also said that current imbalances in the global economy could be corrected if high-growth countries allowed their currencies to strengthen. Do you see that happening?

"I do not want to indulge in fantasies. It will be a slow process."

Many claim that the US trade deficit is a big problem for the US. But given the fact that the deficit is mirrored by surpluses all around the world, is it accurate to say that it is a US problem?

"I share the view of people like Milton Friedman who say, the deficit is not so much the consequence of the fact that our exports are uncompetitive; our deficit simply reflects the fact that all you foreigners love to invest in the US, buying our Treasury securities, companies, ports. The fact that savers want to invest bids up the price of the dollar and causes the trade deficit to go forward. This is what is keeping the dollar up, according to the other point view, the one I share."

Staff

A Buyout Fever in Gold Stocks?

Futures players call it "contango," a strange word describing a situation in which distant futures prices are well above spot prices. In the oil market, this has encouraged inventory-building so that, ironically, oil prices and inventories have been rising in tandem. In gold, some are now saying, contango may lead to a leveraged buyout spree. The idea was first advanced by ***John Tumazos*** *of Prudential about Newmont Mining, and then elaborated by* ***John Doody***, *the author of the outstanding newsletter The Gold Stock Analyst. Circumstances for a leveraged buyout are favourable, according to Doody, due "to the current contango in the gold forward market, where the metal's price increases approximately $3/oz each month into the future and hedging is possible for 15 years out." A buyout could be financed by borrowing from a banking syndicate and selling forward Newmont's 6.5 mil oz/yr production for each of the next 12 years. Doody thinks that "this analysis could likely apply to other big non-hedging gold miners, namely Freeport or Gold Fields." Leveraged buyouts: another by-product of the commodity boom?*

NEXT APPOINTMENT WITH YOUR MAGAZINE ON TUESDAY 30, MAY

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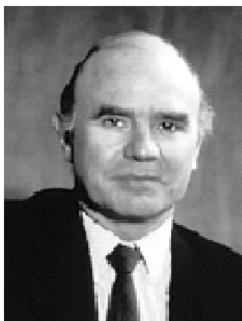
Ask the GURU



Marc Faber,
the famous Hong Kong guru

What's the probability that Asian central banks will start to accumulate gold?

Fabrizio Motalbano
Milan

TheEuropeanSide was in doubt whether to accept this question since we have dealt with the topic of diversification at length in this issue. But we also received a lot of inquires, so here is an answer:

"It's not a possibility, it's a certainty. But the question is the quantity and, of course, I hope they are not that stupid to make a great announcement saying 'hey, we are going to put 20% of our reserves in gold.' They are likely to keep it quiet in order to prevent the hedge funds from front running them. Now, you may observe that a few central banks, say Russia and South Africa, have made such announcements. But it's different because they are gold producers themselves. China, Singapore, Japan, and Taiwan are in a different position. In any case, if I had been the head of the central bank in Russia or South Africa, I would not have behaved that way except in one case: namely, the case in which I wanted to get the precious metals really moving up, providing the market with a catalyst able to force the Asian authorities to buy gold as well."

Marc Faber
www.thegloomboomdoom.com

The German conundrum

Conrad Mattern

The German economy continues to send mixed signals. I have heard many commentators mentioning that the Ifo leading indicator has been soaring to multi-year highs, but retail sales and economic activity do not look brilliant. Do you have a good explanation?

Michael Schenk,
Vienna

"I think the media have been misleading on the interpretation of the Ifo index. Let me make this point clear. The Ifo institute sends its questions both on the present state of affairs and on the outlook. To keep the explanation simple, let's say that the questions on the current conditions are the following ones: in your opinion, is the business situation good, satisfactory (typical) or bad?

Then the institute goes on to assess the outlook, asking: over the coming six months, is the business environment supposed to improve, remain the same or worsen?

At this point, you have to focus on a structural change we have experienced in Germany. From 1992 to 2002, the average growth rate was 1.8%, but from 2002 on, the average plunged to 0.6%. Now, back in the '90s, confronted with a 1.5% growth rate, German businessmen would have answered that conditions were satisfactory or bad. Today, they would associate a positive judgment with that level of economic activity. Here is the difference. You can't compare recent levels of the Ifo index with past figures. The direction suggested by the index is correct, but the levels are misleading.

In accordance with my comment that the potential of Germany has declined, I guess we may have a growth of 1.5% in 2006. In other words, I do not share at all the idea that we are on the verge of a boom as some may be inclined to think when they compare the Ifo index today with that of the past. I diverge from this opinion. I believe the potential growth rate in Germany is 1-1.5%. For similar reasons, I diverge from the consensus opinion that the European Central Bank will push the cost of money to 3-3.5% by year-end. I believe 2.75-3% is more likely, especially if the euro stays high."

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