The European Side

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European Airlines: Fasten Your belts

by Vincenzo Sciarretta

As an early client of low-cost airlines, I thought that the opening up of the European market would have driven many traditional companies out of business. So I was quite surprised when over the week-end I received a FactSet's study, showing that, on the contrary, our airlines have been thriving.

Of course, there have been a few casualties. Of course, there are a few firms whose position has been deteriorating to the vanishing point. But overall, the performance exceeds most expectations. According to **Jean-Luc Buchalet** and **Pierre Sabatier** – the authors of the report – "European listed airlines were back in the black as early as 2002." This is in stark contrast with the overall industry, which, unlisted companies included, has been loss-making since 2001 and only in 2006 is trying to break even.

The two analysts show that there's a record level of earnings, that the group has been enjoying a slightly out-performance since 2000 in the stock market, and that "the ROE has jumped from 4.1% in 2002 to an expected 13.9% in 2006 and 14.9% in 2007, highlighting success in very difficult conditions."

Yet, some dangers are surfacing. One is named hedging. "European firms – we read – have proved acute hedgers in the fuel market. Many are still benefiting from hedges they put on some time ago."

For example, "Air France -KLM effectively locked in 79% of its fuel costs for 2006 at the equivalent of $48/bbl. This factor limited the increase in its fuel costs to only 24.8%. Unfortunately, some of the hedges were put on two years ago and will roll off before year-end. If they are renewed, they will be so at far higher rates."

Another menace is associated with the cyclical nature of the business. In response to an ever-increasing number of passengers, companies have engaged in an investing spree aimed at boosting their capacity. In 2006, aircraft orders are running at their all-time highs. Lufthansa announced earlier this month it would be ordering around a hundred aircraft just to update its fleets at a total cost of several billion euros. The two analysts are afraid that the new capacity comes on stream exactly when the business suffers from the next cyclical downturn.

So, fasten your belts and make your decisions.

Where is speculation?

Some argue European stocks are in a bubble. But if so, the bubble lacks its main ingredient, massive participation by the public. The out-performance of small- and mid-caps is the consequence of this lack of participation. And the scramble for liquidity makes stocks even more valuable driving interest rates down.

By Vincenzo Sciarretta

Now and then we are told that European stocks are in a bubble or, at least, that they have been going up too far too fast under the impetus of speculation. Well, that may be, however, the mix lacks one of its distinguishing features, gigantic participation by households, retail investors, money managers, and mom and pop.

There is a famous old anecdote: Bernard Baruch - a legendary investor - was having a shoeshine on Wall Street, and the shoeshine boy was giving hot tips to him. He went back and sold all his stocks.

It is the same nature of a boom market that it attracts ever-increasing amounts of money. At some point everyone piles in. But this time, the tendency is moving into reverse gear. People stay on the sidelines. European stocks have doubled. Mid-caps have gone up by 150% and yet this has not exerted the usual attraction on savers and managers.

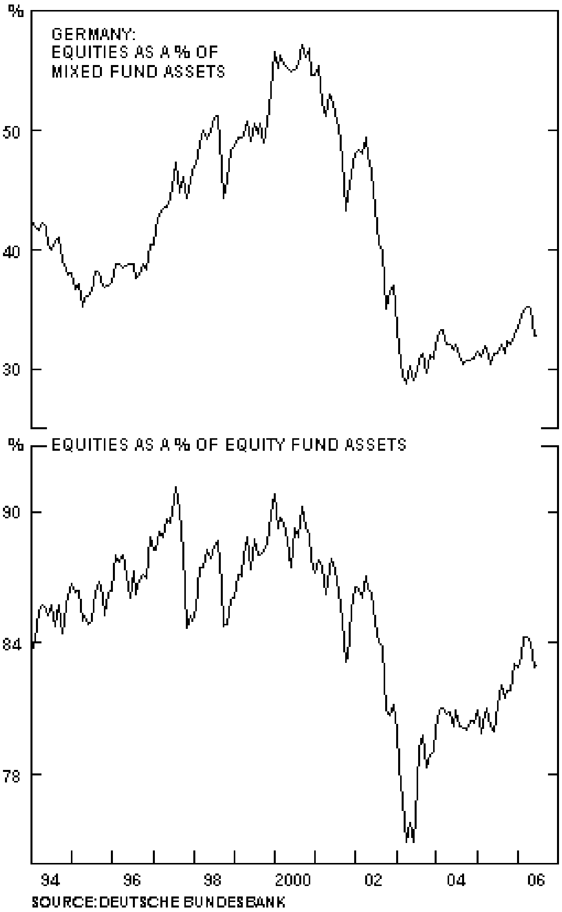
It has been amply recognized that mutual fund flows are the mirror image of the widespread fear felt by retail investors. Until now, in 2006, net redemptions have prevailed in Germany and Italy, while in France money market funds attracted as much as four times the resources channelled into equity funds. When the four largest economies on the Continent (Germany, France, Italy, and Spain) are taken into consideration, these are the figures for the first 8 months of the year: a meager €10 bn went to stocks against €37 bn to money market funds, although the latter group offers a negative real yield if overhead expenses are included.

Mid-caps versus Large-caps: lack of funds causing mid-caps outperformance

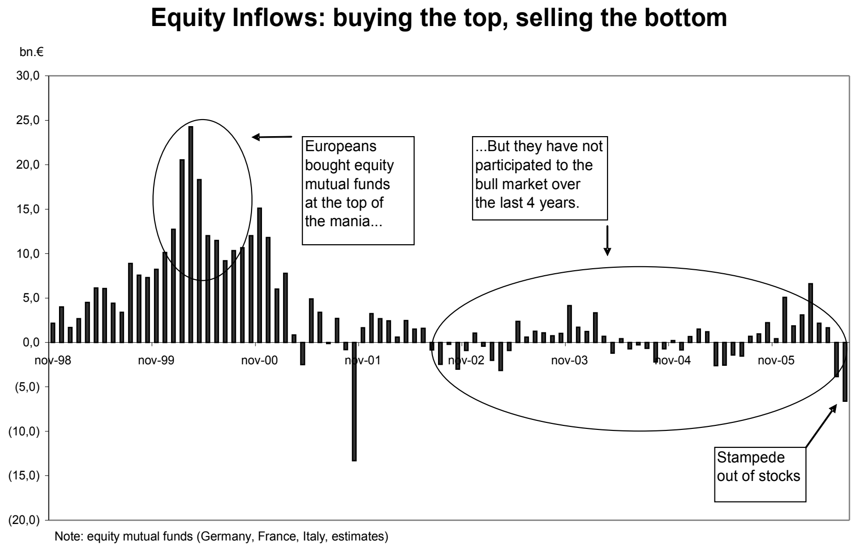
The lack of participation by traditional savers and households is also producing curious results. For instance, most observers claim that if small- and mid-caps have been doing far better than large-caps, this is a clear sign of a market under the influence of speculation. Instead the conclusion may be misleading.

According to a Citigroup's report, the out-performance of small- and mid-caps hinges on the anaemic inflow of funds into listed equities. They write

Managers are not overweighting stocks



German funds had a significantly larger stock exposure during the '90s. Chart provided by BCA Research.

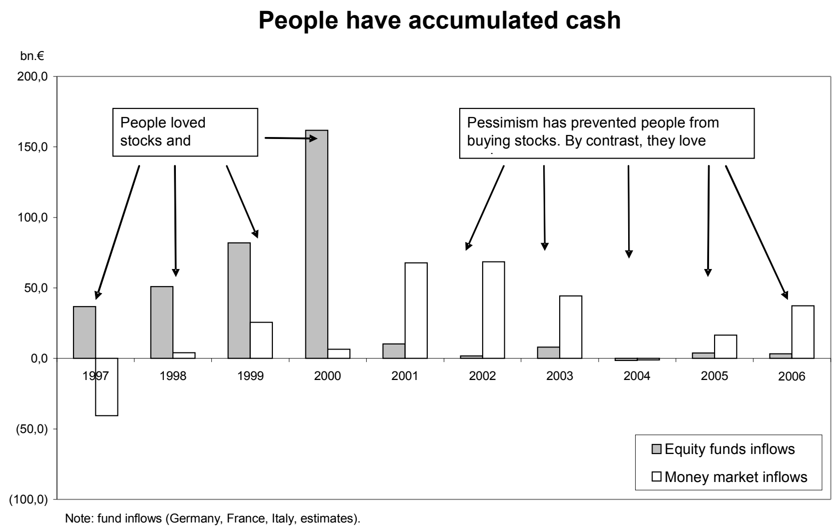


Over the last 4 years, EMU bourses have gone up by 100 percent, but savers are not benefiting, staying on the sidelines. In May and June they panicked again in response to a short-term setback.

that "fund flows have been the single most important driver of performance trends across the size spectrum in the European market. The first point to make about large-caps is of course that they are large. The DJ Stoxx Large-Cap and FTSE 100 indices are both 6 times the size of their mid-cap peers. It takes a lot more capital to re-rate the large-cap stocks than it does to re-rate the mid-caps. There was plenty of money around at the top of the bull market. Institutions were channelling noticeable amounts of liquidity into stock markets. In Europe, money was pouring into equity mutual funds and insurance companies were raising exposure to this hot asset class. The capital needed to be invested in the market, and the most liquid place to put it was large-caps. Back then, large-caps enjoyed a liquidity premium.

However, those heady days now seem a long way off. Fund flows into equities collapsed through the bear market. Saver sentiment remains very fragile. The recent sell-off (in May and June ed. note) provoked the second biggest monthly outflows ever for the European mutual fund industry."

By contrast, the boom has been fuelled by merger & acquisition (M&A) activity which finds its way into mid-caps because they are



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 prices back in line with the fundamentals.

more digestible and tend to be less politically sensitive. Citigroup's report shows that back in 2000 around 7% of both the DJ Stoxx Large- and Mid-Cap indices were acquired, namely the same percentage. On the contrary in 2006 4% of the DJ Stoxx Mid-Cap Index has been acquired, twice the level of the DJ Stoxx Large-Cap Index.

Citigroup's team also underlines another way in which traditional saver caution has favoured stocks without favouring the savers: portfolio flows out of listed companies have fed government obligations, pushing down yields. Flows have also favoured private equity. In turn, the two factors have driven the use of cheap debt to retire expensive equity.

Individual investors remain in the doldrums.

Some also note that a sign of an over-excited market is the fact that many analysts are inclined to be optimistic on the outlook for euro-zone bourses. On the whole, the fact is true, but the optimism is hardly reflected in the behaviour of money managers, whose equity exposure remains significantly lower than during the latter half of the 90's (see chart).

As we mentioned, retail investors and households are still very cautious and, as a consequence, are quite liquid. The primary reason for their dark pessimism seems to be the bitter disappointment they endured with the New Economy mania, coupled with the fact that most of the stocks they accumulated in that period never recovered their poise and still show mammoth losses.

"I was as badly caught as the next fellow," says Francois Lasserre, a Parisian teacher. "I haven't bought any stocks since the Twin Towers attack. From time to time I check the skeletons in my portfolio and they are going nowhere, rebounding only to some extent. Where do I have my money? Essentially in the current account."

"In 2000-2001 stocks were likely around 70% of my financial assets," echoes Mirko Terrenzio, at 38 a salesman in the pharmaceutical sector in Pescara, Italy. "Now the share is probably about 30%. In the meantime I have bought a small flat with the intent to rent it to some students. I admit I don't see many outlets for my money, but I have learned that stocks are risky."

Mr. Terrenzio and Mr. Lasserre give a good reflection of the current state of affairs. They bought a lot at the top of the bubble and have stayed on the sidelines since European bourses bottomed out in 2002-2003. And the fact that many individual investors are very nervous about stocks is perhaps proved by mutual funds data. Last February and March, equity fund inflows started to show some modest signs of dynamism in response to three years of a booming market. But as soon as the May-June correction materialized, sales took off. In reaction to a short-term crisis, retail investors panicked. There was a stampede. Morgan Stanley's equity team reports that for the six countries they track, that is Spain, Germany, UK, France, Italy and Sweden, there was a record outflow in June. More than after 9/11.

In the meantime, it looks like 2006 will be another year by +10%.

The Fed may cut rates sooner than later

A conversation with Nobel Price winning professor Lawrence Klein and former central banker professor William Ford.

Over the last few months, each and every time we have talked to European specialists about the risks for continental markets, they have indicated an external cause, that is to say the possibility of a recession in the US brought on by excessive monetary tightening and the housing sector contraction. Accordingly, this week *TheEuropeanside* has decided to focus on this eventuality, reporting the point of view of two outstanding personalities: Nobel Prize winning professor Lawrence Klein, and professor William Ford, who, early in the '80s, was the chairman of the Federal Reserve of Atlanta and has therefore first-hand experience with the logic of monetary policy. Their verdict? The economy is below potential, but is unlikely to deteriorate into a recession. Moreover, the Fed may cut rates sooner than later.

Prof.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 also served as Executive Director and Chief Economist of the American Bankers Association.

What's your appraisal of the US economy?

"It looks like a soft-landing is coming up - we hope – for all the good reasons which have been largely debated over the last few months."

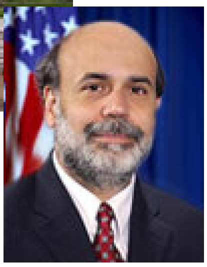
What about Fed policy?

"At the next meeting on October 24-25 the Federal Open Market Committee will probably not raise rates and may even start to think of lowering the cost of money in December or early next year, depending on what kind of data comes in."

You were a central banker yourself; do you try to associate any probabilities with those scenarios?

"Based on what we know now, I would say that

Federal Reserve Board Building

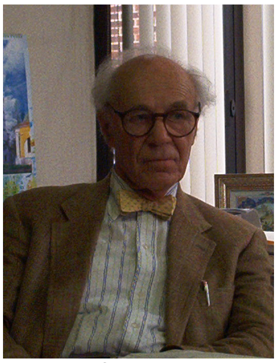


Ben Bernanke

the odds are 90% that they don't change their monetary posture in October. In December, if the economy keeps weakening, the odds of lowering the rate on federal funds go up to maybe 20-25%. And in January the odds become considerably stronger, perhaps 50%. Of course, this is true under the hypothesis that the soft tendency goes on."

Professor Klein, as far as the US economy is concerned, should we expect a soft-landing, a hard-landing or no-landing?

"My primary point is that – soft-landing or not – the average performance of the US is below potential."



Prof.Lawrence Klein

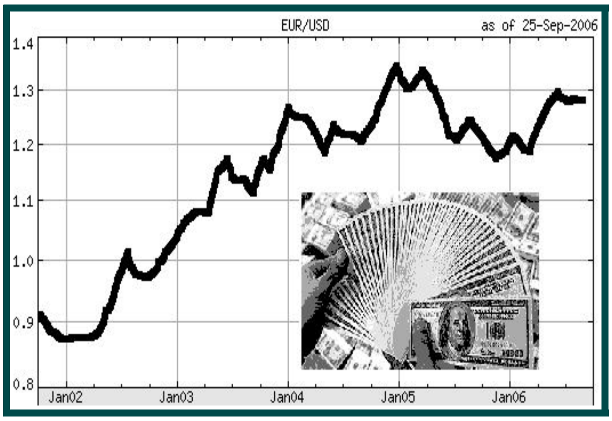
Prof. Klein graduated from the University of California (Berkeley) in 1942 and acquired a Doctor's degree at MIT in 1944. He is one of the drafters of the World Economic Development Declaration. Since 1968, he has been a professor at the University of Pennsylvania. In 1980, Prof. Klein won the Nobel Prize for Economics.

When you speak of below potential growth, what is the life span you are referring to?

"The underperformance has been going on for a while and ought to continue for another year or two."

What is the potential growth, in your opinion?

"I'd say 4% and my estimates now are for a pace between 2 and 3 percent. Do not forget that they played around with the consumer price index. I am speaking of the *hedonic adjustments* or *quality improvement adjustments*, which have lowered inflation and pushed up the GDP figures. I am a critic of the way the innovations were embodied. For instance, since the terrorist attacks many services have been reduced in quality. The most obvious case in point is airlines transportation.



The yield curve has been inverting. Any implications?

"The market is really anticipating a downturn in interest rates. Furthermore, it suggests that participants in financial markets have been gaining conviction that the Fed will keep inflation under control."

Yet, the pessimist camp argues that many recessions since the end of the Second World War have been introduced by the Federal Reserve tightening the money supply, causing an inverted yield curve to appear at some point along the line…

"Yes, most of the time it forecasts a recession, but I don't think that's necessarily true this time. First, the curve is more flat than inverted. Second, the level is low. The time when an inverted yield curve caused a recession was for instance when I was on the Board of the central bank back in 1980 and we had short-term rates as high as 15-20% and long-term rates at 12%. That was really an evilly inverted curve which carried with it the seeds of a recession."

In the present setting, figures are not so extreme, you are saying…

"We are talking basically of a flat curve around the 5% level; this is not necessarily forecasting a recession. Mortgage rates for example are still very low, say at 6% for a 30-year loan. It is slowing housing down, but should not kill it. Back in 1980 when it was 14%, it really killed housing. The current cost of money is not likely to prevent people from buying their cars or consuming in other ways."

Every professional economist seems to focus on housing.

What's your point of view?

"You know, housing starts are still at a pretty high level, up around a million and three quarters, which is historically not a bad level. And the slowdown is above all on the two costal areas. I am inclined to think that the slackening is not going to turn into a rout."

Both energy prices and long-term yields have declined substantially, relieving the pressure on the economy. Do you think this line of reasoning makes sense?

"Well, it is certainly relieving pressure on President Bush – he says, laughing – Whether oil prices are staying around 60 dollars per barrel remains to be seen. We have passed through the driving season and this reduces demand and we are not seeing any important disruptions from the main producers, which could happen any time. So it's good news for America, for our consumers, but I suspect oil prices may start to raise again."

The quality has worsened, but there have been no adjustments in the price indexes for the deterioration of quality in air travel. Thus, in my opinion, inflation and GDP figures don't quite tell the right story. This notwithstanding, if you accept the figures, the potential growth is higher than most people think."

Some claim that a 4% growth rate today would be a 3% growth rate under the old rules. Would you agree?

"Roughly speaking, yes, I would agree."

Long-term bond yields have come down over the last few weeks. What's the message?

"I am in the consensus opinion that government obligations have been responding to the housing slowdown and that people's inflationary expectations are going down. You can see this by computing the spread between the non-inflation protected bond yields and the protected yields."

Gas prices have come down, relieving the pressure on the economy

Do you think Fed policy is in line with the current state of affairs?

"It's not bad. They moved to the sidelines in two meetings. Their reasoning is that they want to drive the economy toward a soft-landing. I say that pausing is the right thing to do because growth is below potential. So our diagnoses are a little different, but the therapy is the same."

Professor Klein, you have been bearish on the prospects of the dollar for several years. What for the future?

"I think our government is doing bad things with our twin deficits, namely the fiscal and current account imbalances. Therefore the US currency will remain under pressure. There are some positive days and some negative days, but look at the trend. The trend is down for the dollar. Other countries aren't performing well, and that is the reason why the decline of the dollar does not deteriorate into a debacle. However, the persistent current account deficit and the persistent fiscal deficit exert a downward pressure on our currency over the medium-term."

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