The European Side

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A recession early in 2007?

by Vincenzo Sciarretta

There is a little chance that economic activity could stop or even decline a little bit early in 2007. Of course that may depend on a lot of external events such as an oil crisis, a war or a US recession. But there are also some internal circumstances in Euroland one has to take into consideration. Personally, I believe the single most important one is the combination of a tightening fiscal policy both in Germany and in Italy, namely affecting 50% of the euro-zone. Is this enough to precipitate a contraction?

I have asked around, but my worry is not widespread. However, one who has seriously thought about this scenario is Morgan Stanley's economist Eric Chaney. He says that "depending on German and Italian savings behaviour and uncertain cross-country multiplier effects, a short recession in the first half of the year cannot be excluded." In other words, the chances are very little, but the possibility exists.

Mr. Chaney argues that "if the ECB raises the cost of money to 3.5% by year-end and Germany and Italy implement the fiscal reforms they have announced, GDP growth would be reduced by 1 to 1.2% in 2007." This alone is not enough to cause a recession since "in the euro-zone, the expansion is expected to be around 2.5-2.7% this year." And if you lose 1% from 2.7%, you have 1,7% in 2007, which is lower than the trend but not a recession. Instead of this benign outlook, there is also a worst case scenario, although unlikely. "The worst case – explains Chaney – occurs if the 3% VAT hike in Germany shows up immediately in tag prices and German consumers don't reduce their savings rate to counterbalance the price increases. In this case you really have a negative impact in the largest market in Europe, namely the German retail market. The same is true in Italy. The fiscal tightening will be more than 1% of GDP. Again, how will households react? If the savings rate goes down, all would be well. Otherwise, the impact of the tightening policy will be negative for domestic demand."

Mr. Chaney is inclined to be optimistic because he thinks that German and Italian savings rates will go down and the shock will be partly absorbed. But what if the savings rate does not decline because German and Italian people do not trust their politicians any longer?

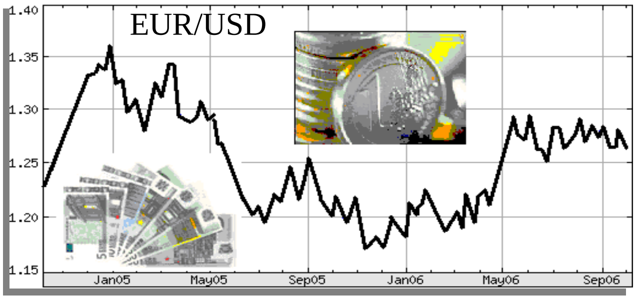
Five Questions on the Euro

Consensus opinion is bullish on the euro. Let's test the thesis.

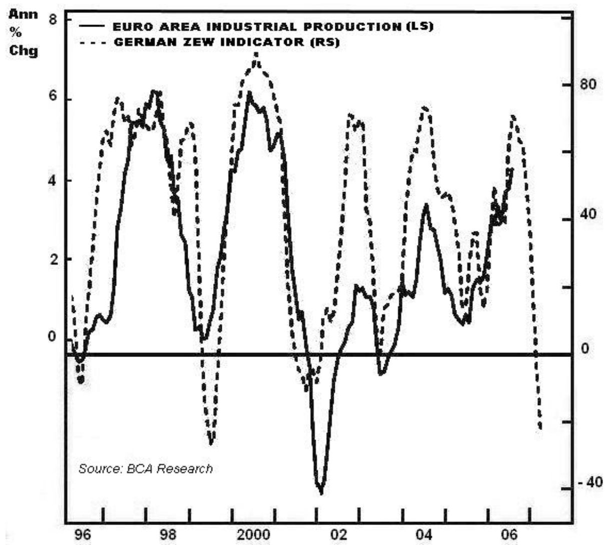
By Ferreo Babbila

TheEuropeanside has asked two experts to linger on five points which in our opinion could cause some weakness in the euro. Their response? Our fears notwithstanding, the euro is likely to appreciate. The two experts are Merrill Lynch's Jason Daw, and Niels Christensen, Société Générale's currency strategist.

For what we hear around, their point of view is representative of prevailing market expectations.



German leading indicators point south



***Argument number 1**: Leading indicators such as the ZEW index have plummeted suggesting a weakening of the dynamism in Continental Europe. Further, starting from 2007, both Germany and Italy (50% of EMU GDP ed. note) will engage in a fiscal tightening campaign. Shouldn't these events reduce the attractiveness of investments in Euroland?*

Niels Christensen: "Yes, slower growth in the Old Continent ought to reduce global investors' appetite for our stocks, which have been outperforming their American and Japanese counterparts. That said, the environment will not necessarily be negative for the euro. The central bank in Frankfurt is expected to keep on moving interest rates up in 2006, while the Federal Reserve is likely to begin cutting the cost of borrowing during the second half of 2007. Hence, the interest rate differential ought to move in favour of the euro."

Jason Daw: "On the whole, German indicators continue to point to above-trend growth into 2007."

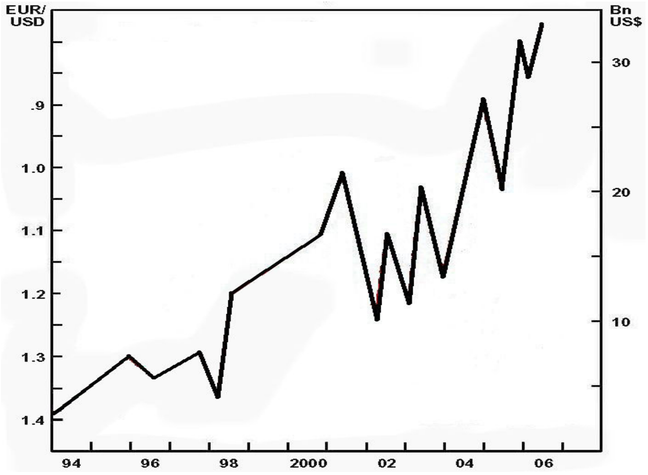
***Argument number 2**: Gold sometimes leads the euro against the dollar and gold has recently suffered from a nasty break. May such a movement carry with it the seeds of the next correction for the common currency?*

Christensen: "I do not see a strong correlation between gold prices and the euro versus the dollar."

Daw: "It is true that in general the greenback is negatively correlated to precious metals. In any case, the performance often diverges from the long-term pattern. In fact we can envision the possibility of a rising euro over the next few months."

Gold has suffered from a nasty break: May the euro follow?

European investors keep on buyng US bonds



***Argument number 3**: Europeans have been buying a lot of US bonds. The interest rate differential may taper off a little bit, but is still likely to remain in favour of US cash and bonds. Shouldn't this preserve the prevailing bias toward US financial assets?*

Christensen: "The numbers reveal that the purchases of US Treasuries are largely from London. And the fact means real buyers can be from everywhere. We suspect a lot of them are located in the Middle East; in other words we are speaking of petrodollars recycled into fixed income assets. In this regard, the spread is not the leading factor".

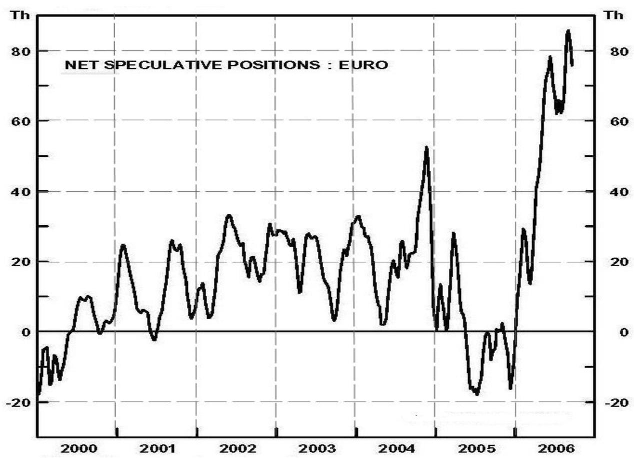
Daw: "Our work suggests that when global interest rates are rising – which is the case today with most monetary authorities in tightening mode – the currencies of countries with high yields and current account deficits tend to under-perform. This would suggest a weaker dollar."

***Argument number 4**: Speculation is still short the dollar, long the euro: if some operators lose their conviction and cut back their exposure, might the euro correct of its own accord?*

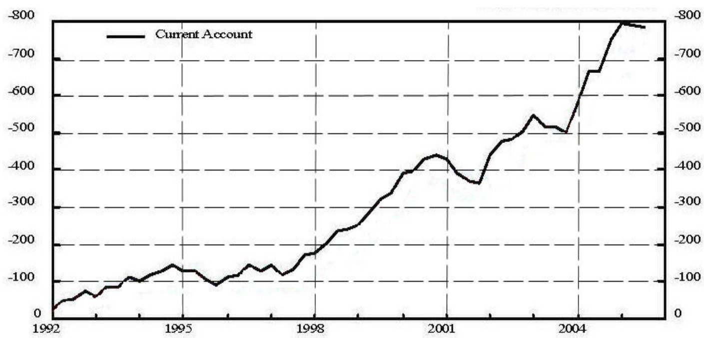
Christensen: "Sure, as long as the exchange rate moves sideways, a reduction in the speculative positions may cause a fall in the euro. It would be short-lived. I expect investors to enter the market and buy the single currency on the weakness because the fundamentals would not change."

Daw: "Market positions have been pared back recently. The futures data shows that net euro long exposure has been declining since the 15th of August. It is our contention that positioning is not stretched."

Euro: speculation is already long



US ever-increasing deficit:
If there's a slow down, shoudn't the deficit decline?



***Argument number 5**: If the US economy slows down, shouldn't the current account deficit go down? And since the US deficit is mirrored by trade surpluses around the world, if the US slows down decisively, shouldn't other countries suffer as much as North America?*

Christensen: "Yes, in the abstract one would expect the US trade deficit to narrow. In the most concrete terms possible, I think the slowdown will be moderate, or very moderate, with no major relieve to the twin deficits."

Daw: "Merrill Lynch economists see a consumer-led slowdown in America with GDP growth dropping sharply from 3.4% to 1.9%. The good news is that there are strong sources of growth outside the United States, including consumer demand in China and India, European demand in general, and business investment in particular, and demand from commodity exporters. The demand emanating from all these sources ought to slow non-US global growth only from 5.7 in 2006 to 5.2 in 2007."

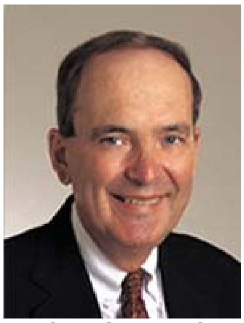
A conversation with Edward Boehne, former president of the Federal Reserve of Philadelphia

Don’t be surprised if US bonds rally

The central bank has succeeded in taking the “froth” out of housing and may be succeeding in containing inflation. This should help government obligations.

By Sciarretta Vincenzo

Many economists did not expect 10-year US bond yields to decline from a top of 5.25% last summer to the current level of about 4.7 per cent. On the contrary, Dr. Edward Boehne thinks that the drop was quite reasonable. And would you like to know something? Yields are likely to go down even further, conceivably reaching 4.25% in the next few months. Why? Because the economy is cooling and the outlook for inflation is improving. As far as monetary policy is concerned, the “Fed-is-done” consensus is very reasonable. And, yes, in the long-term, the path of least resistance leads to a lower dollar.



Edward G. Boehne

Mr. Boehne joined the Federal Reserve Bank of Philadelphia in 1968 and subsequently was promoted to Vice President, Senior Vice President, and President and CEO in 1981. He retired from the Federal Reserve Bank in 2000. He was active in determining the nation's monetary policy as a member of the Federal Open Market Committee.. He currently is a director of several corporations. Mr. Boehne is a graduate of Indiana University in Bloomington, Indiana, where he also received an M.B.A. and Ph.D. in economics.

The return on 10-year US bonds has come down to around 4.7 per cent. How do you judge this level and the fact that the yield curve is mildly inverted?

“What’s happening here is that the markets are anticipating forward downward pressures on inflation and a weakening in economic activity. Further, the Fed’s credibility on the cost of living front is fairly high and this is pushing long-term bonds on the upside. My hunch is that yields ought to decline more, say, toward 4.25% in the coming months as increasing signs of a slowing economy emerge.”

Skyline of Philadelphia, Pennsylvania

FED Philadelphia

Prevailing professionals’ expectations are that the slight inversion of the yield curve is not presaging a recession. Would you agree?

“Yes, I think it is suggesting we are entering a period of below-average growth, but the curve is not inverted enough to point to a period of contraction.”

Some say the Federal Reserve has succeeded in taking the “froth” out of housing and may be succeeding in containing inflation. What is your view?

“Certainly the housing market is cooling and the steps are in motion for inflation to be contained, although the tendency is not entirely reflected in the current figures. As it typically happens, you need a deceleration in growth, and then, after a while, you get a diminution in the price dynamics. All in all, I believe the Fed has succeeded in doing its job.”

Are you saying the Fed is done raising interest rates?

“Yes, I am.”

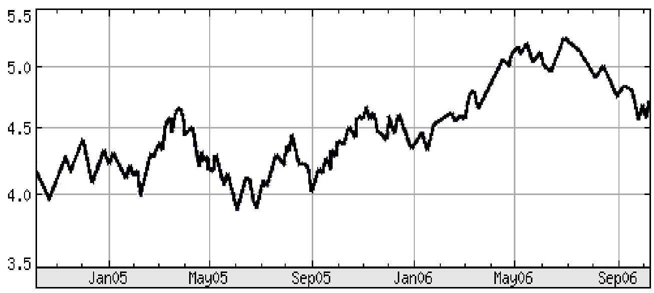
Is the central bank about to lower the rate on federal funds?

“Probably market participants are a little bit ahead of the Fed on this, which is typical after all. In my opinion, the Federal Reserve is not yet ready to cut the cost of money and will not be at that point until, I would say, the second quarter of next year.”

Do you think it possible that the US economy reaccelerate in response to lower oil prices and declining long-term and mortgage rates?

“I suppose it is possible, but not likely. Observers widely recognize that one of the main factors weakening the economy is the cooling of the housing market and the housing market is not clearly dependent on interest rates at present. It is true that borrowing is historically cheap enough for helping real estate, but what’s happened here is that supply has got ahead of demand. There is excess inventory. It has to be worked off. Buyers now believe that prices are likely to fall, and, accordingly, they are waiting. In conclusion, lower interest rates will not turn the housing market around.”

US bond yields could fall further
%

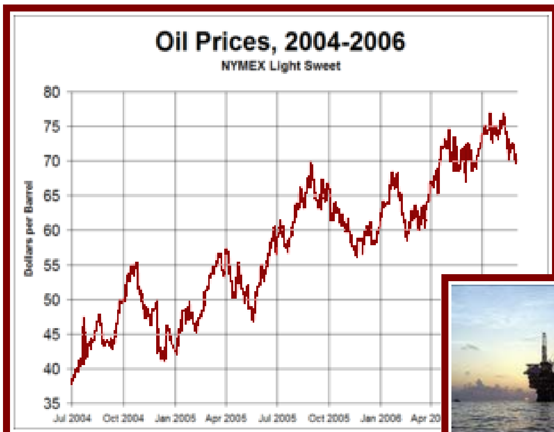


Ten-year government obligations

Out of curiosity:
Lobby of the Federal Reserve Bank of Philadelphia. The lobby features a 25 foot (7.6 m) tall tower filled with shredded U.S. currency.

Thus, no re-acceleration in sight?

"I would put the probability of a re-acceleration of the US economy very low at the moment. It is a scenario for the latter part of 2007."



Can you summarise your general assessment of the current state of the US economy?

"The growth rate is lessening from around 4% to possibly 2% or under. As it has been amply discussed, the housing sector is the weakest, and still deteriorating. Consumer spending is holding up, even if it shows a more moderate pace. Business investment is enjoying a good growth. Inflation remains at an elevated altitude, but, if historical patterns prevail, while the economy decelerates and the time goes on, inflation should ease."

The press has stressed the possibility of a consumer-led recession caused by falling home prices. Can you elaborate a little bit on this?

"It is my contention that the influence of housing on consumer spending was probably exaggerated and declining housing prices and their influence also are exaggerated. Clearly, falling home prices have a negative effect, but the negative effect is dwarfed by the good trend in wages and salaries coupled with low unemployment. Therefore I don't see housing as a dominant factor for consumer spending."

Fuels have given ground noticeably. If you were still a central banker, would you indicate the drop of energy prices in your communicates?

"No, I don't think so. Crude oil has declined in reaction to two major factors: one, some compression in demand on account of a softer economy, and, second, some hedge funds pulling out of the speculative arena. However, oil prices are so volatile and hinge on so many unanticipated influences that it is largely unpredictable in the short-term. What I am saying here is that as a central banker I would not emphasize the drop in energy prices because next week they might be higher again."

Do you have an opinion on the prospects for the dollar?

"Well, I am not a speculator, of course. But if you ask me whether in 3 or 5 years I see the dollar higher or lower, my answer is that it will be lower. As long as we have the kind of trade deficit we have, the forces will tend to push down the greenback."

Some argue that your current account deficit is the consequence of the fact that we Europeans, Asian people and people in the Middle East want to invest massively in America…

"I am not inclined to buy this line of reasoning because, in my opinion, the single most important reason driving our deficit higher is centred on US consumption, which has been one of the strongest elements in world economic growth, attracting imports. In other words, our deficit is the result of uneven growth around the world. If we had more dynamism outside the United States, we would see the phenomenon moving into reverse gear."

Dr. Boehne, many thanks for our conversation.

Mining for M&A nuggets in the basic resources sector

By Juergen Trojan*

Five years ago, I was working as an analyst for Deka Investment Management. I decided to take a position in a company called Arbed, a producer of steel, iron and related products. It was trading at just two times earnings and had good prospects for growth. The same was true for another firm, Salzgitter, a manufacturer of steel and associated goods. Despite the give-away valuation, the recommendation found only scepticism. Why? The sector was out of favour at the time.

But this story had a happy ending. The stocks went up nicely and they really took off when the merger and acquisition (M&A) wave finally hit the basic resources sector.

How times have changed. We have seen an upsurge in takeover activity in the mining, oil and steel sectors and that has helped this area of the market to be one of the best performers in the past year. Now the question is, are there any attractive takeover candidates left for the prudent investor?

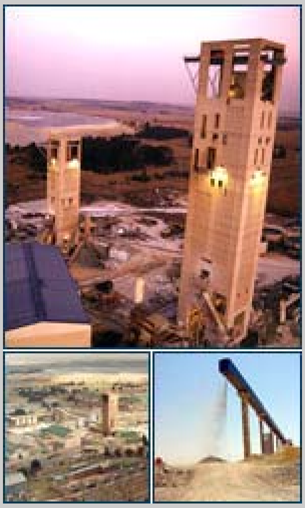
I'm afraid to say the easy gains are probably behind us. However, all is not lost as there are definitely some unpolished gems still out there.

A tug of war

I think a great example is the Gold Fields bid for Western Areas.

The logic seems obvious. The main asset of Western Areas is the Southern Deep Deposit, the biggest deposit in South Africa. However, it's also South Africa's deepest mine and therefore mining there is technically complex. Finally, the company was poorly managed and due to high investments and years of losses the balance sheet needs strengthening.

Adjacent mines are run by Gold Fields and Harmony – well known rivals as Harmony once made an unsuccessful offer for Gold Fields – and, interestingly, each of them own 20% stakes in Western Areas.



South Deep mines

For various reasons, both companies need to grow their reserves and resources. It was no surprise to me that the more financially sound Gold Fields began the battle by acquiring the other half of Southern Deep from Barrick Gold and is now offering 35 of its own shares for 100 Western Areas shares.

I would not be surprised if we saw an increase in the offer or if Harmony entered the battle.

The worst case scenario is that Western Areas' management claims the offer is too low and Gold Fields withdraws the bid. Taking into consideration how deeply Gold Fields is engaged in Southern Deep, this outcome is unlikely. If my analysis is correct, there's a good chance that the management asks for an increase in the offer by, say, 10%, and the offer is accepted.

Jürgen Trojan

A very big deal

Interesting rumours surfaced recently that Anglo American, the world's second-biggest mining company, could be broken up if a rival such as Rio Tinto or Xstrata bought the company. I'm not sure these specific rumours deserve merit. However, they reminded me that we have to consider Anglo American as an eventual takeover target. In the current investment environment, I can see a scenario in which Anglo American's shares appreciate, as the company's outlook remains fundamentally sound.

A platinum-plated opportunity

I also think Impala, the South African platinum producer, is a good takeover candidate. The shares are widely held with few big shareholders. The main problem is that due to anti-trust constraints, only a non-platinum producer will be able to acquire the company.

Interestingly, the price of its shares does not reflect the hypothesis of a takeover. Some observers argue that with a price/earnings multiple of 20, the firm is not cheap. However, I believe that Impala's earnings should improve in 2007 in proportion to the decline of the South African rand.

All in all, if commodities benefit from another bullish leg, the sector should enjoy another wave of takeovers. Until then, though, we will keep digging for the few opportunities that are left.

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

The EuropeanSide's Selection of Fine Wines

by Angela M. Boskovitch

Driving through Piedmont, Italy, the beauty of this diverse landscape bordering France and Switzerland was striking. The fertile valleys and hillside vineyards produce famous varietals like Barolo, Barbaresco, and Barbera. These grapes find their way into wines served in New York, Moscow, and Tokyo restaurants. This part of Italy along with Tuscany, the Veneto, and Bordeaux produce some of Europe's best wines. *TheEuropeanSide* seeks to provide you with our pick of some of the continent's premier wines.

Although such a list is by no means inclusive, it is a list of five great wines that will increase in quality and value. Europe produces over two-thirds of the world's wine. The emerging economies of "New Europe" are all producing some excellent competitors with good price-quality ratios. For Europe's best wines, as a former sommelier in American and European restaurants, I'm loyal to the traditional producers.

When trying to compile such a list, one must consider the producers, vintages, and ability of the wine to keep and improve with age. Such a list includes rare wines, produced in small quantities with extreme care. This standard remains largely unmatched by the leaders in Italy and France. I enlisted the help of fellow Frankfurt sommelier, Alsatian Pascal Schmidt, to help me round out the choices.

Château d'Yquem, Sauternes Grand Premier Cru, 2001, France.

This white wine from the Sauternes in southern Bordeaux is one of the superior French classics. Characterized by its complexity and sweetness, this wine is meant to last decades, and does not fully mature before at least 15 years. When cellared properly, it can even be enjoyed up to a century later! The grapes are individually picked; each vine averages only a single glass of wine. Recent exceptional years included 1967, 1971, and 1990. The 2001 vintage was awarded 100/100 by famed Bordeaux critic, Robert Parker.

* €€€€€€

Romano Dal Forno, Amarone della Valpolicella Monte Lodoletta DOC, 1998, Italy.

Romano Dal Forno is considered the "King of the Amarone" and deservedly so. The resulting product is one of painstaking work from generations of vintners. It's an elegant ruby color, with an intense nose and whiffs of coffee and tobacco. The taste is extraordinarily long and is best appreciated with smoked meats and cheeses.

* €€€

Château Lafite Rothschild, Bordeaux Pauillac, 1982, France.

Anything from Château Lafite Rothschild is superb, but this particular vintage resulted from an outstanding production year similar to 1985 of hot, dry conditions from July to September. The resulting grapes had very thick skins and condensed tannins. The elegant wine produced has an intense aroma and velvety texture; it has an especially long shelf-life and is very rare.

*€€€€€

Villa Antinori, Tignanello, 1998, Italy.

The Antinori family has been producing some of Italy's finest wines since 1385. The now legendary Tignanello "Super Tuscan" blend was first produced in Tuscany in 1971, violating the Chianti regulations. Despite its spectacular quality, its retail labeling was the humble Vino da tavola until 1982. It's recipe of Sangiovese comprised with lesser parts Cabernet Sauvignon and Cabernet Franc remains unaltered. It's an outstanding accompaniment to any Mediterranean meal.

* €

Angelo Gaja, Barbaresco, 1997, Italy.

This Barbaresco has been produced from 14 historical vineyards from local Piedmont communities since 1933. The grapes are matured in classic oak barrels for 12 months and in smaller, varied ones for another 12 months. This procedure allows a more complex, nuanced wine with less direct oak flavor.

* €€

Remember that fine wines benefit from decanting and proper glassware suited to their type and age. ***À votre santé, Cin Cin, Cheers!***

*** (€ → €100)**