The €uropean Side

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The European Side

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Transatlantic considerations.

by Vincenzo Sciarretta

Last week, your editor was in Paris to attend a few seminars organized by the Global Interdependence Center or GIC (www.interdependence.org). Businessmen, managers, economists, bankers and a few journalists discussed the outlook for financial markets, the prospects of a soft-landing in the US, the imbalance of the energy market, opportunities in Europe, and other related topics. People were from both the Old and the New Continent.

Foreign participants observed how Paris was very expensive with the euro at 1.33. For instance, the price of a meal – they said – was a little bit higher than in any big American city.

US managers also manifested a vivid interest in our financial markets. I did not attribute any great importance to this attitude because European assets have been outperforming for a couple of years now, for sure in common currency. So that interest was obvious.

I was much more impressed with a chart elaborated by David Kotok of Cumberland Advisor. He argued that "as regards international bonds and notes, the major currency of issue is not the dollar, but the euro." He said that "the US bond market is larger than the euro-zone one, but that since a part is not traded globally on account of tax or regulatory reasons, the international market has a prevalence of the euro." This means that the euro, the ECB's monetary policy and our obligations are becoming a benchmark.

Equally significant was Mr. Dunkelberg's presentation on the outlook for the US economy and the labour market. Mr. Dunkelberg serves as the chief economist for the National Association of Independent Business, namely the nation's leading small-business association including 600,000 member firms.

Take into consideration that in the US 90% of all employers have fewer than 20 employees. Small businesses produce half of the private sector gross domestic product and account for two-thirds of the new jobs. Mr. Dunkelberg regularly surveys these companies and based on their answers he claims that the economy has been decelerating, but remains solid. In particular, "the labour market is tight," he said. "Over half of small business owners continue to try to hire." " Eighty percent of those still report *few or no* qualified applicants for their open positions."

In other words, if Mr. Dunkelberg picture gives an accurate reflection of the current state of affairs, do not bet that the slowdown will turn out into a rout.

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

Where are the opportunities?

Sentiment and market positioning may suggest some profit taking, but good investments still abound in Europe. "Yes" for Germany, Retail, Oil, Telecoms. "No" for Banks and small-caps.

By Sciarretta Vincenzo

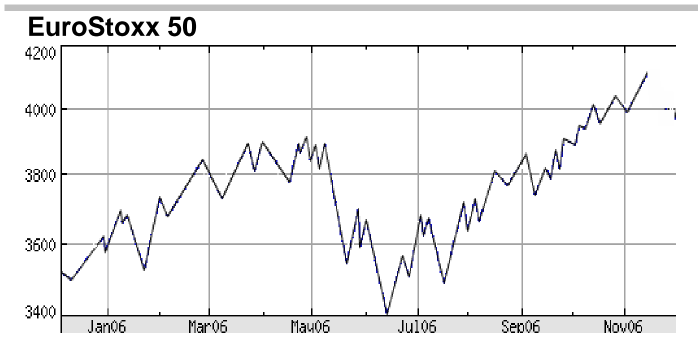
Since they bottomed out in mid-June, European bourses have taken off, gaining about 22%. Therefore, some turbulence is possible. Globally, we record some speculative froth: the ratio of bulls to bears, and the level of selling among corporate executives and directors at companies listed on either the New York Stock Exchange and American Stock Exchange have reached the altitude that triggered a correction in May-June. Also the attractiveness of the continental stock market is beginning to enter investors' consciousness. According to a survey of professionals' expectations, euro-zone equities are now deemed to have the most favourable corporate-earnings prospects, and represent one of the most undervalued regions in the world. Unfortunately, in the fourth quarter of 2005, that diagnosis was associated to Japan, which since then has been less satisfactory.

However, if a setback occurs, it should turn out to be merely a temporary interruption that is due to a short-term indigestion. "Fundamentals are still sound," argues **Tammo Greetfeld** of Unicredit-HypoVereinsbank.

"The dividend yield of the Euro Stoxx 50 based on the dividends estimated for 2006 (and paid in 2007 *ed. note*) is 3.3%. Based on the dividends estimated for 2007, it leaps to 3.6%. The appeal of equities becomes visible in a long-term comparison. The shareholder's average return profits from rising dividends, while on a bond investment, the return is limited to the current coupon, namely a meagre 3.6-3.7% in Germany."

If the experts interviewed by *TheEuropeanside* are right, equity investors have no major reason to abandon ship, but they are advised to adjust their portfolios and focus on some specific themes.

"First, you should lighten up on small-caps," says **Alain Bokobza**, head of Pan-European equity strategy at Société Générale. "Small-cap out-performance has been one of the uppermost topic during the advance which began in 2003. For some time they were selling at a discount from large-caps; now, they sell at a premium. I don't see any good reason to maintain generous positions in this area. I also believe selling pressures will continue to push down the dollar. Therefore I would recommend primarily stocks that stand to benefit from domestic activity. For example retail, whose appeal rests on its rapid



German Stocks benefit from tax reforms

Once again, good news are emerging for the German stock market. *TheEuropeanSide* wants to offer a recapitulation of what happened in the last few weeks.

The ruling coalition led by Angela Merkel agreed early in November to change the levy applied to corporate earnings. In the abstract, the reform will cut corporate tax rates from the current 38.65% to 29.8% at the beginning of 2008.

In the most concrete terms possible, since the reform extends the tax base markedly, the real burden would be equivalent to a rate of 35-36%, with a net relief estimated between 5 and 8.5 billion euros.

"The reduction ," explains Tammo Greetfeld of Unicredit-HypoVereinsbank, "will benefit only companies that generate earnings in Germany." "Profits of the Dax stocks should increase by 3-5%. The advantage for MDax companies will be even greater because, on average, they report a much higher ratio of earnings at home." **Ronan Carr** of Morgan Stanley emphasizes that "potential winners have a combination of relatively ...

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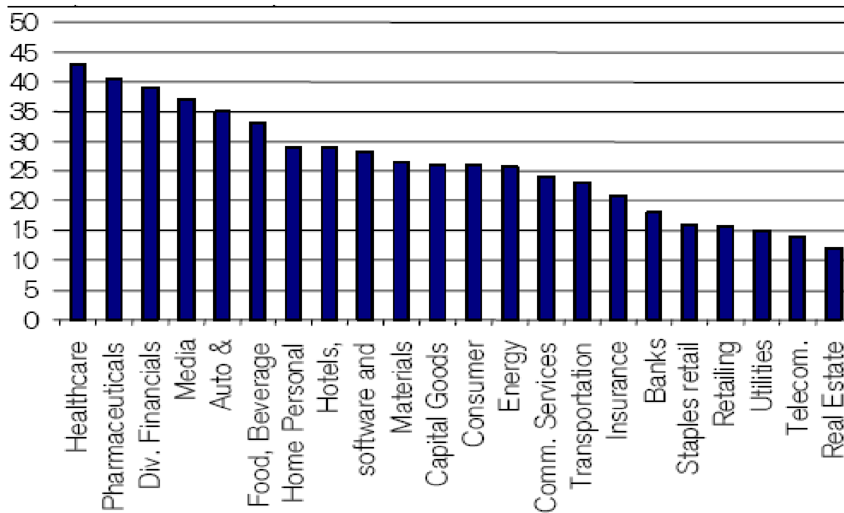
European sector exposure to the US



Source: Credit Suisse

The experts suggest you should accord preference to domestic-oriented companies.

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....low interest and depreciation expenses and a high effective tax rate such as BASF, Stada, Porsche, Solarworld, United Internet and Beiersdorf."

When the effective levy is low and interest and depreciation expenses are high, the advantage decreases and may even become a loss. Potential losers are TUI, Deutsche Telecom, and perhaps Lufthansa, Bayer and RWE.

Finally, in the coming months the German equity market will probably also be influenced by another news. All private investment income is to be subject to a 25% withholding tax from January 1, 2009. Currently, if you hold equities for over a year, capital gains are tax free. The new rule applies to purchases from January 2009. "If, as it seems probable, the withholding tax legislation were in fact to imply that capital gains on equities purchases before the end of 2008 can also be realized tax free after 2009, this would be a strong incentive to buy before the end of 2009", comments Mr. Greetfeld.

restructuring, its inviting valuations and the good dynamism of demand."

By contrast, it may be time "to reduce bank exposure into strength," claims **Ian MacFarlane** of BCA Research. "The banking sector is over-owned and currently accounts for 22% of all earnings in the euro-zone and 20% of the market capitalization. The ratio for broader financials is close to 36% and 33% respectively. The wave of takeovers and the structural change and consolidation in the industry explain and justify some of the increase in earnings importance. But valuations, while below the market norm, are above the historic ratio to the overall market. This is true on both a p/e basis as well as a cyclical-adjusted measure such as price-to-book." Mr. MacFarlane adds that "if one wants to stay in the banking sector, the place to be is probably Germany." " German banks are trading well below regional standards on a price-to-book basis. Moreover, the economy of the Country is still in the early stage of recovery and the real estate market remains very depressed with plenty of upside."

The experts also suggest keeping in mind the role of an appreciating currency because the euro is up decisively. Looking at the past, there has not been a consistent relationship between the euro weakening/strengthening and stock market performance. Moreover, there is no sign that a muscular exchange rate is damaging profitability. Over the past 3 years, G6 forward earnings have soared by 78%, on average. But the most brilliant gain (109%) was recorded by Germany, while the weakest (55%) was attributable to the US. A strong euro attracts foreign money as well. According to **Ed Yardeni**'s data, "from January 2004 through September 2006, $303.4 billion poured into US mutual funds that invest overseas, while domestic funds attracted $233.8 billion." An important share is coming to the Old Continent.

By contrast, the impact of currency swings has been higher on a sector basis. **Kevin Gardiner** - HSBC's head of global equity strategy - suggests that "although obvious, investors should accord preference to domestic-oriented companies." As can be seen from the chart above, in Europe, Healthcare Equipment and Pharma have the largest exposure to the US, followed by Financials, Media and Auto. Real Estate, Utilities, Telecoms and Retail have the lowest exposure.

One can also look at single names. Here are a few examples offered by Credit Suisse analysts. On the negative side, "Electrolux sells 35% of its products in the US, plus some turnover in Asian, while ABN Amro's earnings growth is also highly dependent on the US due to its large interest in the US mortgage market." On the other hand, "real estate company Meinl is involved in the development and management of commercial real estate properties in Central and Eastern Europe and has extremely limited dollar positions." Further examples include "German utility E.On with a 4% exposure to North America and Tesco with a 5%." Both the companies have appealing fundamentals, according to **Beat Alpiger** and **Pascal Rohner** of Credit Suisse.

All in all, a market setback may be more an opportunity than a danger.

How consensus are you?

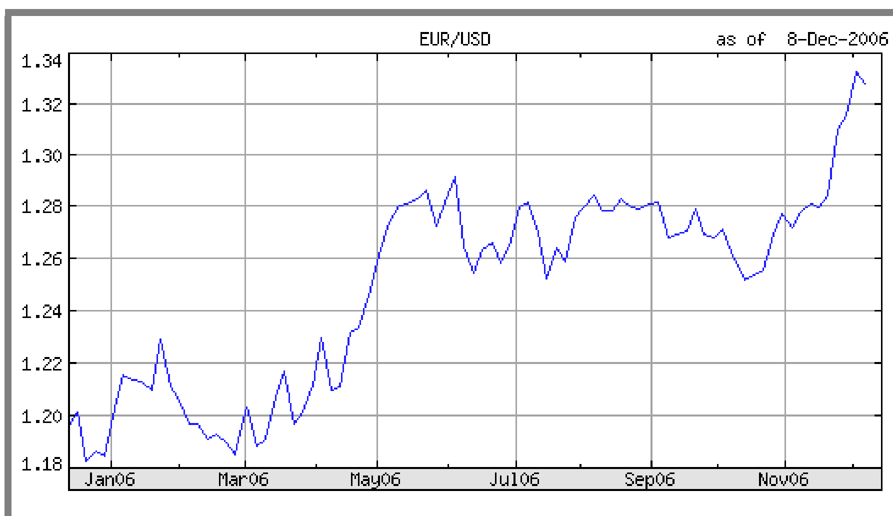
According to a survey by *TheEuropeanSide*, no one is bearish on the euro short-term.

The euro broke suddenly in late November above the 1.24/1.30 range that had been in place for six months, and soared to a temporary high of 1.3365. None of the analysts scrutinised by *TheEuropeanSide* think the cross will fall back into the old band. At least, not in the next quarter.

"Probably the cross is establishing a new range between 1,30 and 1.37," comments **Gavin Friend** of Commerzbank. Your magazine reports a decisive consensus on what is supporting the single currency. First of all, the story is a story of convergence between the two sides of the Atlantic.

Says **Bob McKee** of Independent Strategy: "The US economy will slow to below-trend growth in 2007 while Europe will continue to have a robust expansion. Accordingly, demand for the euro continues to be strong."

At the same time, "the European Central Bank is in a policy tightening mode while the Federal Reserve is on hold.", argues **Philippe D'Arvisenet**, chief economist at BNP Paribas. "the ECB is expected to rise interest rates at least once early next year," echoes **Robert Sinche** of Bank of America. "By contrast, the Fed stays on the sidelines or could even cut the cost of money sometime in 2007. The opposite trends ought to leave the dollar on the defensive."



In short, a narrowing gap on growth and interest rates, coupled with a US current account deficit approaching 7% of GDP, should support a stronger euro. This is the almost unanimous market expectation.

Several experts also mention that the year's end is seasonally a period of dollar weakness and euro strength. Writes **David Woo** of Barclays: "In the past six years, whenever the cross rose in November, it also went up in December of the same year (2000, 2002, 2003, 2004 *ed. note*). The average return of long EUR/USD positions during the final two months of the year since 2000 were just shy of 5%."

Nobel prize winner **Robert Mundell** has also stated in a recent conference in Venice that " the euro has benefited from an acceleration in productivity gains compared to the US."

If in the short-run, the analysts surveyed by *TheEuropeanSide* lean vigorously in favour of the euro, mid-term opinions are much more variegated.

Essentially, the magazine has recorded two schools of thought. The former says that a weakening dollar will persist all year long in response to the large current account deficit and the narrowing gap on growth and interest rates.

The latter says that the US will show more dynamism in the third and fourth quarter of 2007 and therefore the greenback will rebound from a bottom touched in May or June.

This is the consensus opinion and yours?

Ferreo Babbila

How Consensus are you?

Largest Banks on the Continent	Analyst	3-month target	12 month target
Unicredito	Roberto Mialich	1.32-1.35	1.26
UBS	team		1.35
BNP Paribas	Philippe D'Arvisenet	1.35	1.35
Credit Suisse	Team	1.31-1.35	1.25-1.29
Société Générale	Carole Laulhere	1.32	1.32
Crédit Agricole	Oivier Bizimana	1.34	1.37
Fortis	Karel De Bie	1.34	1.40
Deutsche Bank	Team	1.32	1.35
Commerzbank	Gavin Friend	1.35	1.30
Selected international players			
Merrill Lynch	Alex Patelis	1.34	1.33
Morgan Stanley	Stephen Jen	1.35	1.24
Bank of America	Robert Sinche	1.33	1.25
Independent Strategy	Bob McKee	1.35	1.45
Barclay	David Woo	1.30	1.35
HSBC	Paul Mackel	1.32	1.40

Fonte: TheEuropeanSide

If conventional wisdom is right, the euro may appreciate a little bit more.

A story of wine

Whether real estate or tourism, whether luxury or novel-cuisine, Europe is the main beneficiary of the increasing number of wealthy people around the world. A light article for the Christmas season.

Take wine for instance; not because it is necessarily the best investment asset or the most suitable vehicle for savers, but because it provides the paradigm of what's going on in the upper range goods market: on the back of changing lifestyles and rising supply from New World, low and middle class wines are in a prolonged crisis. However, the case is totally different for exclusive bottles: here demand is significantly rising in response to population's enrichment and jumping purchases in Asia. By contrast, supply is limited.

Vin de table disappoints

Writes **Hervé Prette**, a Credit Suisse analyst: "Viticulturists in Australia, the United States and South America have significantly improved the quality and quantity of their wines and are able to produce middle range wines at much lower costs compared to European producers. Over the past 10 years, Australia has increased its exports fivefold to 500 million litres, Chile jumped fourfold to 350 million, South Africa reached 200 million." The rapid raise in production has gone hand in hand with the collapse in consumption. Globally, it fell from 46 million to 33 million hectolitres from 1960 to 2005.

Great Wines for great profits

Runaway appreciation on selected Bordeaux wines (in GBP)

	Vintage	Release Price	Market Price	Annual Return
Lafitte	1982	300	7950	14%
Palmer	1983	130	1650	10%
Clinet	1989	165	2640	16%
Montrose	1990	155	2520	18%
Petrus	1998	3800	12320	16%
Margaux	2000	1440	3600	16%

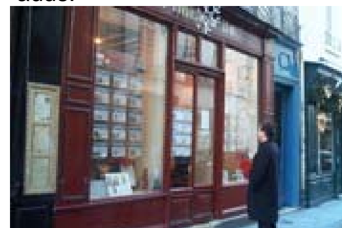
Source: Credit Suisse July 2006

The environment is much more constructive for prices when it comes to the upper-grade area of the wine market. First of all, supply is limited; the production has not increased in decades. In France, accounting for 90% of this sector, volumes have been in a downtrend since 2000. On the contrary, "demand benefits from higher incomes, changing lifestyles and ongoing consumer interest in the potential benefit attributed to moderate consumption of quality wine," says Mr. Prette. He also emphasizes that "the strongest growth in demand for upper class wine comes from emerging countries such as Russia, India, China and Korea." A new business elite has become able to pay exorbitant prices for dear goods. "This enlarging number of wealthy people," continues

Mr. Prette, "in conjunction with the adoption of western living styles opens up new markets for luxury goods. In the next five years, wine consumption in Asia is forecast to increase by 46%, representing 4% of world consumption. China is seen as the jewel in Asia's crown with growth in consumption rising 20% in the four years to 2004 and set to rise 48% in the next three years, according to

Paris:
Housing is still good

"So, how's business?" we ask. "Very good", he answers. The gentleman is Mr. **Richard Bluoit**, a real estate agent located in Rue Saint-Louis-en-l'ile, in the very heart of Paris. He says that 80% of his clients are foreigners. "Probably 50% from the US, many from Northern Europe and Italy." "I have seen no decline in my business", he adds.



Your editor looking for a flat

We walk along Rue Saint-Louis-en-l'ile and then turn on the left in Rue des Deux Ponts, where Mr. **David Amanou** has got his agency. We repeat our question: "How's business?" Mr. Amanou says he has two agencies.

One on the Ile Saint Louis (the island in the heart of Paris *ed. note)* and the latter in 7th arrondissement, also a luxury area.

"Yes, most clients are foreigners. And most of them are looking for a flat where they can live for 2-3 months per year. ...

L'Ile Saint Louis

Continued on page 6

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.... Others want to invest their money and rent the apartment. Here, on the Ile Saint Louis, the average price per metre squared is about €10,000, up, say, 30% compared to 2002. I see no contraction. Prices and transactions are now stable; all in all it is a good market."

One of these lucky people who live for a few months per year in Paris is Mr. **Paul Horne**. Mr. Horne joined Smith Barney in 1975 in Paris as chief international economist. He retired in July 2001, and now divides his time between Virginia and Paris. He says: "I think there's a bubble in some American cities, but not here in Paris. Of Course, prices are expensive, but they must be expensive. Supply is limited while an enlarging number of wealthy people want to live here."

In the early days of the internet, a lot of outstanding experts predicted an urban revolution. They said there was no reason to live in our chaotic cities since the internet allowed many professionals to work from wherever they liked. Their reasoning was right, but it looks like many of us, especially affluent people, want to live in beautiful places such as Paris.

Once again, Europe has a competitive hedge here.

Performers at Pont Saint-Louis: The small bridge that connects Ile Saint Louis with Ile de la Cité is a popular spot for street performers, be it jazz bands, jugglers or mimes.

Vinexpo."

As a consequence of the favourable combination of an increasing demand and a stable supply, upper range wines have been performing fabulously. Since 2001, when the first publicly traded index on wine was developed, the LIV-EX 100 Fine Wine index (linked to a basket of first-class brands) has significantly outperformed equity and bonds asset classes, as represented by MSCI World and JPM Global Bonds indices.

China loves luxury	9 months to September
Wines & Spirits	+24%
Fashion & Leather Goods	+20%
Perfumes & Cosmetics	+24%
Watches & Jewelry	+18%
Selective Retailing	+8%
Total	+17%

LVMH: Year to Date Organic Sales Growth

Source: LVMH and Merrill Lynch

Luxury

What's happening in the wine market is the mirror image of what's happening in the luxury section of several goods and services where Europe has a competitive hedge.

For example, the apparel industry has been suffering from a general price decline caused by the opening up of Asia.

Many small businesses were literally wiped out.

But the story is different when it comes to the upscale fashion producers and retailers. Here players are gaining ground and the outlook is particularly encouraging. Deflation is replaced by inflation and losses by profits.

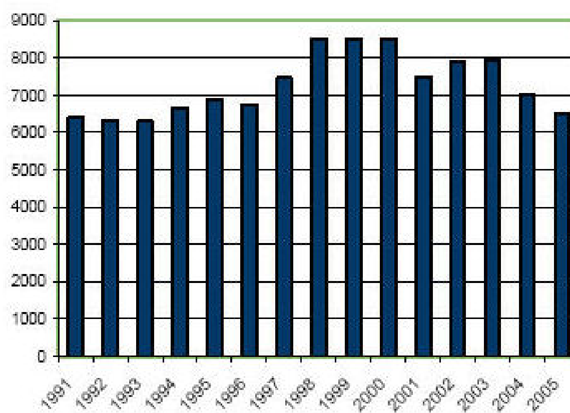
According to Forbes Magazine, "the cost of living well index" - a basket of expensive items - is running much faster than

the overall consumer price index. The former is up 7% in the last year, the latter is up 4%. "Being rich has never been so expensive", loves saying **Louis-Vincent Gave** of GaveKal Research. Again, part of the boom is in response to population's enrichment and jumping demand in Asia. Again, Europe is the main beneficiary of the current state of affairs.

In the 9 months to September, "Fashion & Leather Goods" have soared by 20% in non-Japan Asia. "Perfumes & Cosmetics" by 24% and "Watches and Jewelry" by 18%.

Nicolas Hayek, executive chairman of the Swiss watchmaker, Swatch Group, has found the most appropriate words to describe the investment thesis: "Chinese dream to have luxury goods. The original Swatch is a success in China. We sell 1 million units per year there, and the pace is fastening. Concerning the wealthiest consumers, they want the prettiest watches. I think the Chinese economic development is a real chance for us. You must see that way: 10% of Chinese having the same standard of living as Europeans, that represents 150 million further consumers of our watches, jewels, wines, and Airbus planes…If we continue to innovate, there will be no European decline." We agree.

Vincenzo Sciarretta

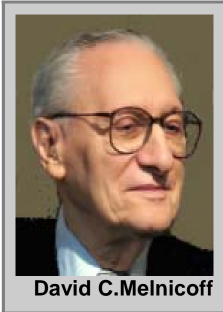


ABROAD

Talking to David Melnicoff, an economist at the Federal Reserve from the mid '40s to the mid '70s

The US housing recession may cause a financial crisis

The burst in real estate is not over. It is unlikely to trigger a recession, unless it sets off a financial crisis. In that case, yes, you have a recession



David C.Melnicoff

If you are looking for experience, David Melnicoff is the right person for you. He was hired by the Federal Reserve in the mid 1940s and covered several positions within the central bank till he became chief of staff under chairman Arthur Burns in the first half of the 1970s. "I don't think the United States is on the verge of a recession", he says. "However, there's the possibility of a financial crisis engendered by the huge amount of derivatives associated with the housing market. If that happens, then, yes, you have a recession."

In the last few weeks, we had a spate of statistics indicating a sharp contraction in the US housing sector. What is your verdict?

"Well, it's likely to go further. It's impossible to say how far it could go, but no doubt it's going a little bit worse. Because once it starts, it develops its own momentum, sometimes beyond the intrinsic value. There's not only the valuation, but also the usual psychological boom-burst cycle."

Some argue that the economic slowdown is going to deteriorate into a recession on account of the housing sector…

"Not necessarily. It certainly will contribute to a slowdown. The only thing that will precipitate a recession is the possibility of a financial crisis. A lot of fancy borrowing has been done in housing and of course a lot of the mortgages that were made in the last few years have been securitized. Then all those mortgages are now through out the market. We don't know a lot about who holds them. We know they are very widespread. It's possible that the internal mechanisms of those securities could cause a lot of defaults that might lead to a crisis. It is the financial aspect of the housing market that could create more difficulty. But we don't know that either. How far that will go."

You have a lot of experience. How likely is that crisis?

"I would say it is less than 50%. Not likely to occur, but certainly could."

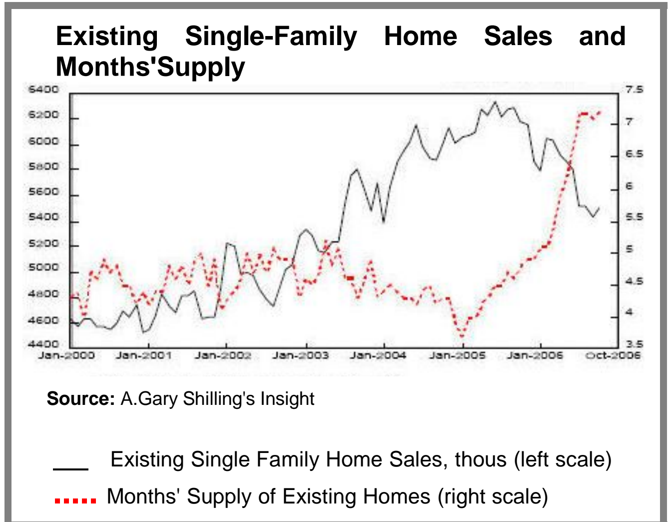
You said 'less than 50%', that looks enough…

"It's enough, yes. Over the ten years and more, the mortgage market, which is the largest part of the debt market, has been transformed and consists mostly of securities. The system has not been tested in bad times yet."

What is you central scenario for the US economy?

"A slowdown. That is the consensus view and that is what I feel is likely to happen. Consumer spending ought to slow down. It hasn't yet, but it will occur."

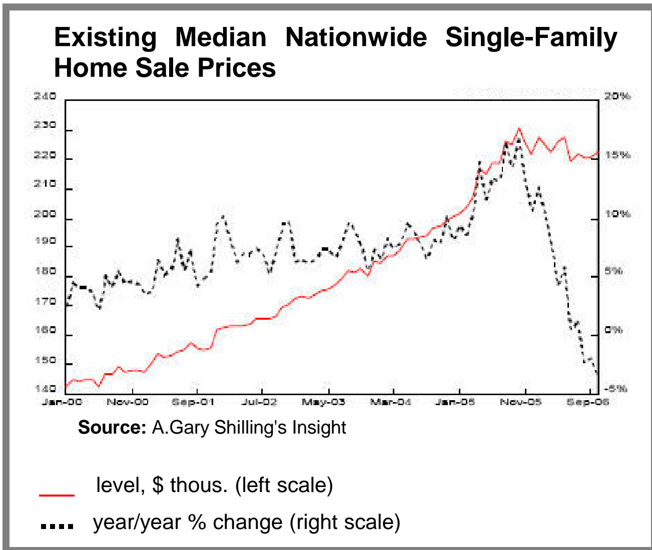
Vincenzo Sciarretta



Source: A.Gary Shilling's Insight

Existing Single Family Home Sales, thous (left scale)

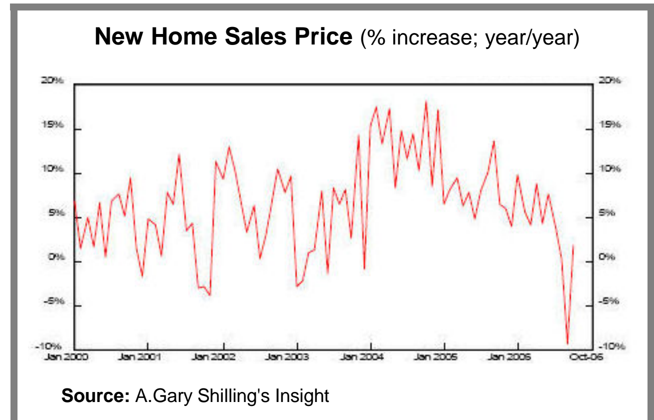
Months' Supply of Existing Homes (right scale)



Source: A.Gary Shilling's Insight

level, $ thous. (left scale)

year/year % change (right scale)



Source: A.Gary Shilling's Insight

LETTERS

Dear Editor,

I keep on reading that both the political and economic outlook in Italy are terrible and that the new premier – Romano Prodi – is failing to reform the country. I read the same things when the government was led by Mr. Silvio Berlusconi. Is the country without hope?

Juergen Wolf, Frankfurt

Dear Mr. Wolf, I am not here to plead Mr. Berlusconi's cause, but take the following into account: when agricultural prices go down, South America usually goes out of business, and when oil prices collapsed, the Soviet Union actually disintegrated. So, it should not come as a surprise that when China opened up and the price of textiles, clothing, leather goods and in general consumer goods plummeted, the Italian price-sensitive export sectors suffered. Add a strong euro, and you have the picture. It took a few years for restructuring; thousands of small businesses disappeared.

Romano Prodi
Silvio Berlusconi

Berlusoni's main fault was that he did not cut taxes as he promised at the time of the electoral campaign. He said he could not because there was a war. Of course, that was nonsense.
Said a book from historian Will Durant: "In the last 3,421 years of recorded history only 268 have seen no war." So if one has to wait for peace on earth to cut taxes, he may have to be patient.

Then came Mr. Prodi's government. The international press – especially the Anglo-Saxon press - expressed optimism and confidence. At least, until recently. In his first budget – which will be enacted in a few days – Mr. Prodi has increased taxes and spending simultaneously and the pressure of taxation will rise by 2 or 3 percentage points in 2007. Pessimism has surfaced again.

Now, what should you expect from Mr. Prodi's government? I'd say, all the worse. And the reason is simple: his coalition has two very influent communist parties. Nine out of twenty ministers are communists or ex-communists. With great intellectual and moral clearness, they call themselves "communist". And as far as business is concerned, I don't know of any case where communism has enriched a Country. In 2006, the Italian GDP growth ought to approach 1.6% compared to 2.6% for the euro-zone. Expect a continuation of the trend. Italy is going to lag behind.

What about the markets? For several years, rating agencies, analysts and newspapers have been warning us about the precarious situation of the Italian debt. This notwithstanding, bond players have refused to be panicked. And till now they have been right since the spread between German and Italian bonds has remained quite stable. The fact is that the debt of the public sector is high (about 107% of GDP), but it is counterbalanced by great financial strength in the private sector. The ratio between wealth and GDP in Italy is the highest in the world (together with Spain). About 80% of the inhabitants are owner of their house, and the level of consumer and mortgage debts is very low. Sure, the private and the public sectors are two distinct entities, but if it comes to a choice Italy is likely to pay its debt. We are not saying you should be optimist about Italian bonds, yet foreign press is probably too pessimistic

What about the stock market? The story is the same as in the rest of Europe: the market is attractive because price/earnings multiples are low, dividend yield is 3.9%, and bond yields are not so competitive.

THE EDITOR

The greatest gaffes in 2006

Dear international investor,

You believe it has only happened to you, and it strikes you as an odd thing that you over-weighted Japan in your portfolio and are now under-performing decisively both for the currency and the stock market. But do not worry, if you have made this mistake, you are now just expiating one of the several sins households and the financial community have committed in 2006.

Gaffe 1. Perhaps, the most bitter disappointment has to be ascribed to European families and traditional savers. Immersed in their dark pessimism, they failed to recognize that a wonderful bull market in stocks was weaving its magic. They have remained on the sidelines all the year long, as anaemic mutual fund inflows show indisputably. And how did they react in May and June when a temporary setback brought back our bourses by 10 per cent? Not with a profit, the correction set off a stampede: just in the three larger economies on the Continent – Germany, France and Italy – there were net redemptions for €3.9 bn in May and €6.6 bn in June. Since then, the market is up by about 22%.

Gaffe 2. It may have been Winston Churchill who once said: "an economist needs to be able to forecast what is going to happen in a week, a month, and a year, and then be able to explain why it did not." In fact, you can count on the fingers of one hand the number of professional economists who predicted the upward surge which the Euro-zone economy is enjoying with a GDP growth around 2.6% in 2006. At the turn of the year, prevailing expectations were far more gloomy.

Gaffe 3. Another blunder? That inflation would have built up in reaction to a run-away commodity market, ample liquidity on the Continent, and a worldwide boom. On the contrary, the European Central Bank is doing a great job in maintaining price stability.

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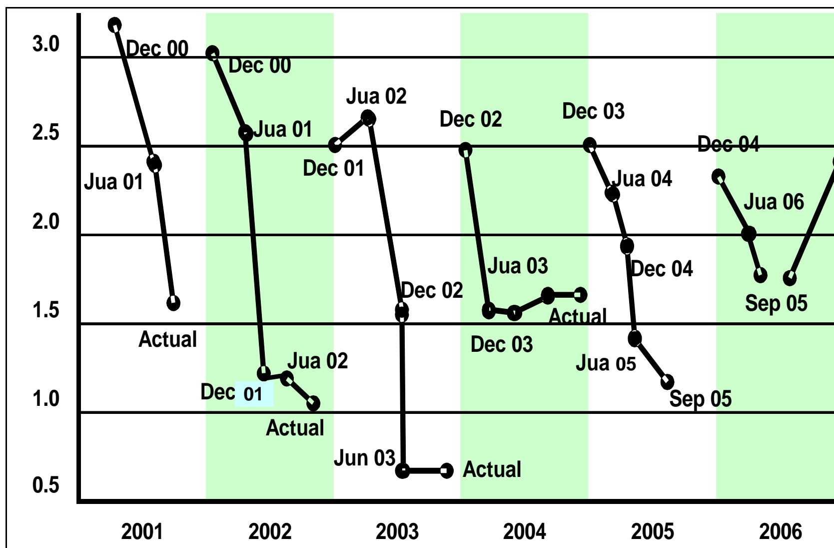
Out of curiosity

The ECB: What a poor track record!



Developments of the ECB's euro area GDP forecasts

Please, do not misunderstand our words. The success of the European Central Bank in assuring price stability and the acceptance of the euro has been excellent. But what a surprise when we read a recent report prepared by Gavekal Research, presenting the chart above. It seems that 2006 will be the first year since the creation of the euro that the ECB's growth forecast was not undershot massively by realities. What a profession being a professional economist!

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The trend in core inflation is down and headline inflation has recently plunged well below the target of 2% (the October figure was 1.6%).

Gaffe 4. By reading Merrill Lynch's monthly survey among investors and managers you get a feeling of what consensus opinion may be. And of what is wrong. For instance, in the December 2005 issue, European specialists were largely over-exposed to the energy sector. That was the time when oil prices were on automatic pilot to the moon. A net 30% of professionals declared to have a bigger than usual position. Only insurance companies got a higher approval. Were they right? Well, not so much, at least till now: the Oil & Gas group is antepenultimate (out of 18 sectors) in 2006.

Gaffe 5. By contrast, the performance of some areas of the stock market has exceeded most expectations. Retail was under-weighted by 47% of the experts interviewed by Merrill Lynch but is now the sixth better segment of the transcontinental bourse. Utilities were disliked by 45% and are the fourth better-performing sector. Basic Resources and Automobiles, which were widely disliked as well, are classed second and fifth in 2006.

Gaffe 6. On the international front, one thing we do know is that the mother of all blunders has been over-weighting Japan. If you are located in Europe, you have lost 10% on the yen and about 12% because of the underperformance of Japanese stocks against European ones. Yet, at the start of the year, a net 26% of respondents considered the Nikkei as the index with the highest potential. Add that another 40% of respondents considered the yen undervalued and ripe to rise. In short, the best combination turned out to be the worst, and you would have been better had you remained at home.

Staff