The €uropean Side

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The European Side

VIBARO EDITORI S.R.L.
P.IVA 01623730676
C.da Torrito snc
64046 Montorio al Vomano (Te)
Italy

Herr Herbert and the “new economy” portfolio

by Vincenzo Sciarretta

I spent a good part of 2003 in Frankfurt, Germany. Once a month I used to join an investors’ club. The group usually met in a bar named Maximilians in Schweizer Strasse 1 and later in the picturesque Wagner’s Apfelweinwirtschaft in Schweizer Strasse 71. When I arrived the group had already passed its zenith and counted just 10 or 20 active members, but in the bull market’s hot days I was told there was even a sponsor catering for the experts. In other words, the group itself followed its own boom-burst sequence and essentially evolved into a circle of affable and pleasant friends meeting for a drink, although it retained some first-rate analysts, journalists, and the only successful day-trader I have ever met.

Meanwhile, I often stopped by a *Backerei* located in Oeder weg where I met a retired clerk – Herr Herbert - with whom I talked for a few minutes while having our breakfast. After discovering I was a financial reporter, he began to treat me as if I were a confessor with whom he could indulge in confessing his pains. And his pains were essentially the stocks he had bought in 2000 that had completely collapsed.

Last week, I was again in Frankfurt and happened to meet Herr Herbert in the same *Backerei*. I asked about his portfolio; I was convinced that after three years of skyrocketing markets it would have recovered, at least in part. “What?” Herr Herbert yelled. Unfortunately, his portfolio refused to rebound and his losses are still huge. Remember 2000 was the period when buying Technology, Media, and Telecommunication stocks (the so called T-M-T) was the vogue in investing. It was also a time when common people discovered online-trading. All of a sudden, reasonable persons such as Herr Herbert armed themselves with charts and bought “new economy” shares in the Nasdaq.

T-M-T stocks that Herr Herbert bought in continental Europe continue to languish at the bottom and are often 70% below their top. The charts of these companies and those of tech stocks in the 20s and 30s, when superimposed upon each other, show an uncanny similarity. In the US, Herr Herbert had bought Microsoft and Cisco which keep on deflating badly when measured in euros.

Anecdotal evidence suggests that my acquaintance’s portfolio has many of the same features as that of many European savers and explains why the typical household has not benefited in any way from a three-year bull market, preferring to stay on the sidelines and hoping just to recoup their initial investment.

No Inflation, No Bear Market

Tomorrow, Thursday August 3, the European Central Bank ought to push the cost of money to 3%. All in all, monetary conditions remain accommodative. Stocks should recover in a scenario of adequate earnings, low inflation and moderate growth.

By Vincenzo Sciarretta

The stock market plunge that materialized in May had some of the typical features of a temporary correction. "First and foremost," says **Teun Draaisma** of Morgan Stanley "sentiment changed from outright complacent in April to close-to-capitulation in mid-June." It is worth noting that retail investors panicked, setting off a stampede as far as the last 10 years are concerned. Only in September 2001 did equity fund redemptions exceed the May and June outflows in the Euro-zone. In Germany and Spain redemptions were greater than in September 2001. European savers dumped their positions. According to a report by **Ryan Kloster** of Lehman Brothers, "historically such sell-offs have created buying opportunities." In fact, he argues, global equity markets have outperformed on a one- and three-month forward basis after periods of sharp net selling.

No Inflation

Tomorrow, August 3, "we assess a very high 95% probability for an ECB (European Central Bank ed. note) 25 basis points rate hike," affirms **Matthew Sharratt** of Bank of America. This move, consisting in raising the cost of money to 3%, is widely expected since explosive money and credit growth coupled with good economic performance, support the case for additional monetary normalization. Further, the ECB stated in its July meeting that they would "exercise strong vigilance," a code phrase for imminent action and consistent with the decision to reschedule the August 3 meeting from a teleconference to a physical meeting in Frankfurt.

After this action, prevailing expectations and futures markets have been leaning toward a gradual withdrawing of monetary accommodation that leads the refi rate to 3.25% by year-end. Some expect more, namely 3.50%, and some less, namely 3.00%. But the fact is that money markets do not even discount a return to the 3.75-4% "neutral zone."

Whilst the rest of the world is on inflation alert, the ECB seems in no hurry to remove its accommodative disposition. "Inflation seems not to be a big problem in Europe," comments **Peter Hoeller**, the OECD's head of Euro-zone studies. "Headline inflation remains at 2.5%, under the impetus of oil prices, and above the ECB's close-to-but-below 2.0% target. However, core inflation has been declining since 2002 and expectations are pretty

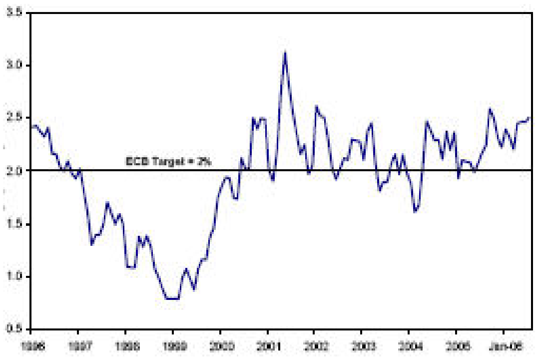
Eurotower -Frankfurt am Main

stable. I can envision a scenario where inflation moves toward 2% again. The dissimilarities with the US situation are centred on the fact that the US economy shows much more dynamism and lower unemployment, and on the fact that in Europe there is still plenty of spare

Eurostoxx 50: recovering its poise

Source:Bloomberg

Eurozone inflation above target



Source:Eurostat
Headline inflation is above ECB's target, but core inflation has been declining since 2002

capacity. In other words, the region can absorb much stronger demand for some time without worsening underlying inflation. We would suggest that the ECB normalizes interest rates, but in a gradual way."

Good value at the right price

Frankfurt Bourse

If professionals are correct that inflation is not such a big problem in Europe, then stock market valuations should be interesting since low inflation and low interest rates make a certain level of earnings quite valuable (for a different point of view read Marc Faber's interview). "Price/earnings multiples are not excessive in relation to the low interest rates that prevail in Europe," claims **Florent Bronès** of BNP Paribas who is in-line with many colleagues. Stocks may be the main beneficiary of the current state of affairs, enjoying a combination of low inflation and moderate growth.

In addition, according to **Ian Scott** of Lehman Brothers, "the European earnings season appears fairly robust." Mr. Scott writes in a report dated July 31: "based on 89 out of Europe's top 300 companies for which we have data, the positive-to-negative surprise ratio has decreased from 2.6:1 last quarter, to 2.2:1. The picture is consistent with still strong, though slowing earnings momentum." Mr. Bronès of Bnp Paribas agrees, "the corporate sector continues to produce excellent earnings." In fact, since wages in most multinational companies can only grow within the limits induced by the opening up of Eastern Europe and the competition of Asia, any pickup in demand goes straight to the bottom line. Moreover, a stable euro is now in the process of relieving pricing pressures. Instead of tightening monetary conditions, the European Central Bank is just gently withdrawing the stimulus and M3 money supply is still running at 8.5%, not exactly a constraint. If the European bull market is to be aborted, the causes will have to be external. A widely recognized menace indicated by the analysts is a slowdown in the US, deteriorating into a recession on account of tightening monetary policy and a collapse in real estate. "Otherwise markets are going up," says Bronès. "Equities are cheap compared to bonds; we are likely to

experience another wave of mergers, acquisitions and buy-backs and rising dividends, and this scheme is presaging that stocks will continue to recover from the nasty break they suffered in May and go up, say, by 10%."

In conclusion, geopolitical tensions could coincide with a new corrective leg in the usual weak September-October period, to be followed by the classical year-end rally. This, of course, is if analysts are right.

An interview with Marc Faber

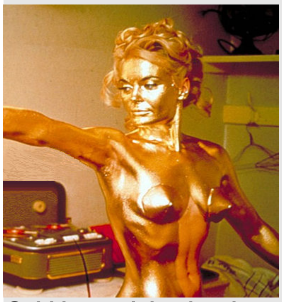
Oil toward $150?

Short-term, most assets are vulnerable. Stay on the sidelines waiting for better prices. Gold is good. Agriculturals are cheap. Industrial commodities may suffer on account of a weakening economy. In Europe he owns some bonds

Marc Faber is accumulating gold whenever it gives ground. He would not be surprised if oil went beyond most conceivable targets, say $150, and would behave exactly as a South American leader in nationalizing his country's energy and mines. And for the short-term? He has adopted the view that most assets are vulnerable and accordingly he has chosen to stay on the sidelines holding two-year bonds. Not that bonds are good or sound, because they aren't, but because they may be a good place where you can protect yourself during the storm.

Dr. Faber, what would be the best move in commodities right now?

"The cheapest are the grains. But aside from the grains, for the typical investor, I would stick to gold, because industrial commodities could come under pressure if there is a global economic slowdown. In that hypothesis, industrial commodity demand will diminish and the Fed will start to ease in response to a weaker economic activity. At that point the dollar is likely to give ground on account of monetary expansion. Gold would benefit from this scenario."



Gold is regaining its charm

Is this your own strategy?

"Well, I already have a lot of gold. I bought gold to hold it. I am not here to sell. However, I would not add meaningfully to my position in this phase. Instead, if the price drops to between $480 and $550 per ounce, I would again accumulate more. I expect a correction in most assets to materialize and in the meantime I hold two-year US Treasury Bills. This is a short-term posture."

You'll tell us about Treasury Bills later. Some readers centred their questions on South America: in that part of the world, many countries have been moving toward communism and the nationalization of their basic resources. The development ought to be bullish for commodities…

"First of all, I think all these countries are entirely right in their policy."

Seriously?

Dr.Marc Faber

Dr. Marc Faber, the cultivated Hong Kong guru, has become the Cassandra of our time. Fortunately he is a positive Cassandra since he not only predicts disasters but is also able to find great opportunities. Dr. Faber publishes a widely read monthly investment newsletter, "the Gloom Boom and Doom" report, universally known in the financial community, which highlights unusual investment opportunities. He is also associated with a variety of funds and a member of the Board of Directors of numerous companies. www.gloomboomdoom.com.

"Why should the workers of a Chilean mine earn $80-100 per month while the mining company is making billions of dollars. I am a director of a mine in Mongolia, so of course I am not particularly happy if the Mongolians want a bigger stake in our business. In spite of that, if I were Mongolia or if I were Evo Morales or Hugo Chávez I would do the same because for the last 20 years, as commodity prices went down, nobody helped these countries."

They have the strength to ask more, you are saying…

"What I am saying is that the rise in commodity prices has shifted the balance of power in the world to resource producers. Mr. Bush thinks he is the most powerful man in the world. It's nonsense. As I said in the past, the most powerful man on earth is Mr. Putin. People such as Iranian President Mahmud Ahmadinejad or Hugo Chávez are gaining greater and greater power. If Iran starts to cut production say by 3 million barrels a day or if Mr. Putin cuts production by 5 million barrels a day then prices will double and what could other countries

Only temporary interruptions for oil

Oil is on its way up: "demand may double in Asia, while I doubt that supply can increase dramatically," says Dr. Faber

South American nationalization of resources

Venezuelan President
Hugo Chávez

Bolivian President
Evo Morales

"If I were Evo Morales or Hugo Cháves," says Faber "I would nationalize my country's resources the same way they are doing." Good for commodities

do?"

Going back to my question: are the developments in South America bullish for raw materials?

"Yes, yes. I believe they are good for commodity prices and may be bearish for the mines. That's why I am telling people: if you want to participate in commodities you may be better off by buying the physical resources, namely physical uranium, physical copper or gold and not the mines because, if prices go up as much as I think they will eventually go, the mines may not get the full benefit because some will be expropriated, some will suffer from excessive profit taxes etc."

Would you be more surprised if 5 years from now oil were around $150 per barrel or if it were at $30?

"I would be surprised if it were at $30 per barrel."

What about $150. Is such a lofty price possible?

"Well, oil could be anywhere. I am not sure if it will be in 5 years. It could be in 3 years or in 10 years. One thing I do know is that currently in Asia we have a daily demand of 22 million barrels and this amount is likely to double. We don't know whether it will take 5 years or 10 years or 15 years, but it will double. On the contrary I am inclined to doubt that supply can be increased dramatically. The path of least resistance leads to higher prices."

At a certain point, you suggested dumping all assets, including commodities, and even selling short copper. What in hindsight and what for the future?

"A lot of asset markets have overshot in some way, under the impetus of liquidity-driven buyers. And liquidity is not expanding at the same rate as in the past and may even decelerate. This is the reason why I am not so keen on asset markets."

Let's change the topic: a few readers asked whether you have any money in the Euro-zone?

"Yes, I have some bonds."

Do you have strong convictions about this investment?

"I am bearish about bonds by and large, but I think they may rally a little bit in the expectation of a softening economy. Long-term I am not optimistic."

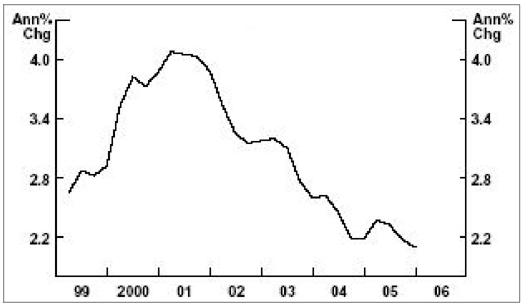
Are you referring to both US and Euro-zone bonds?

"In particular to US bonds. I can envision the possibility that a decelerating economy would tend to lift bonds for a couple of months. Thereafter, bonds, especially US bonds, ought to decline again."

What about stocks?

"All in all, the market I like the least is the US and the markets I like the most are the Asian markets. Europe is in between. I like Asian markets because economic prospects are relatively good and whereas in several Western nations we have witnessed a debt multiplication, in Asia the debt level and the leverage of corporations have come down very substantially and government debt as a percentage of the economies (with some exceptions such as China) has come down as well. Thus I am rather positive."

Wage inflation under control in Europe



Source: BCA Research 2006

Labor cost: wages and salaries

Shanghai Traffic jam

Oil demand is soaring in Asia

In core Europe we have strong disinflationary forces in the fact that workers suffer from the competition of their counterparts in Eastern Europe and Asia. Do you share this diagnosis?

"It depends on what kind of inflation. Basically, I don't expect significant wage inflation in Europe because of the inclusion of some new countries into the Euro-zone that have lower price and wage levels than Western Europe. In addition, wages and salaries are much lower in Asia."

Where do you see inflation?

"For instance in real estate or in the service sector. For instance, nobody can tell me that Italy is a bargain. If you go to Milan, it's one of the most expensive cities in the world."

Is it possible that we experience an earnings boom in continental Europe because revenues don't go to salaries but find their way into profits?

"Corporate profits have already expanded a lot. Industries which are exporting to emerging economies, say luxury goods and capital goods manufacturers are already doing pretty well."

Is the trend likely to go on or not?

"The earnings trend is probably favourable, but this does not mean that stocks will go up."

Why not?

"Because you may have a tightening of monetary conditions and

Shanghai building site

It is well acknowledged that China is absorbing a lot of commodities for its urbanization

because the international boom may drain money from financial markets into the real economy. This has happened in the Middle East: stock markets went down by 50% in a few months. Bourses are often driven by an increasing rate of monetary ease. Liquidity is still there, but not at an increasing rate."

Analysts often mention that p/es in Europe are low at 12-14 and this makes equities irresistible compared to bonds…

"Senselessness. Securities Exchanges don't move according to p/es. Otherwise US homebuilders would have not plunged by 50%. The experts who argued last year that homebuilders' p/e was low have lost 50% of their clients' money. The fact is that stock markets are discounting mechanisms and perhaps most of the good news of the global economy is already in the price since everybody knows we are in a global synchronized expansion."

Finally, there is a question regarding currencies: when looking at any survey, one notes that everyone is bullish the euro and bearish the dollar. This is confirmed by large speculative positions in the futures arena in the same direction. Shouldn't this imply that being short the dollar is not without risk?

"My reasoning can be articulated as follows: I am particularly negative on the greenback compared to the price of gold. I have always maintained that the US dollar not necessarily declines against other paper currencies; it is likely that it will go down somewhat, but it will weaken along with other currencies against gold. Accordingly, at this point I have no short position. Further, if I take into consideration that my business is denominated in dollars, then I may be net long in dollars."

Dr. Faber, thank you for your time.

V.S.

European Oil Majors enjoy a record quarter

If oil does not collapse, the chances of outperforming the market are high.

Perhaps the greatest problem with oil companies is that their investment merits are well recognized. According to a recent Merrill Lynch survey, European managers continue to aggressively overweight the energy sector and believe it to be the most undervalued segment of the stock market in the Old Continent. In particular, a net 49% of respondents overweight the energy sector and a net 32% are inclined to think it is undervalued.

The other problem is that if it comes to a choice between oil companies and oil itself, the latter may enumerate more advantages. This is the investment thesis formulated by the famous investor **Jim Rogers**, whose interview with *TheEuropeanSide* will be featured in our next issue. Jim has proven his ability to think years ahead of the financial community so his viewpoint deserves particular attention. He says, "with stocks you have to worry about the management, the government, the risk of nationalization, the balance sheet, pension plans, the greens, the environmentalists, the unions and many other things. Further, the problem with most oil companies is that they are losing their assets. Most of them have reserves which are in decline. If you buy an oil stock with 10 years of reserves right now, you may find that after a while it only has 5 years of reserves. Accordingly, if you can find an oil company which is increasing its reserves, that's probably a good buy. However, most are not, they are losing their reserves and wasting their assets."

After talking with analysts and experts, it seems that the decision to invest in oil companies or not is relatively easy after all. If one thinks we are in a period of high and even rising commodity prices, then oil companies are cheap and their outlook should be good. Otherwise one would be better off looking elsewhere. For example, **Aymeric de Villaret** of Société Générale argues that "Oil prices are likely to suffer a contraction this winter. The sector is implicitly pricing in a average what is required to see valuations reflect current equity prices. But Merrill's analyst expects "crude and refining margins to remain well supported." For crude the focus will remain on the potential for supply disruptions on heightened Middle East tensions and Nigerian civil unrest, while in refining he sees strong

European oil giants have been outperforming the stock market and distributing substantial dividends

crude oil price of around $40/b, compared with less than $20/b in May 2004. This leaves no room for appreciation relative to our long-term assumption of $40/b." Therefore Société Générale has an underweight recommendation.

On the opposite side **Mark Iannotti** of Merrill Lynch contends that "he sees good value in oil shares on an absolute, market relative, historic or distribution basis." His investigation reaches the same conclusion as that of Mr. Aymeric de Villaret that $40/b is on demand from the US and Asia keeping global refining capacity stretched to the limit.

The second quarter of 2006 is a record quarter for the European Majors. The sector is on a 2006 p/e of around 9.2, a 0.71x market relative PER, which is a 29% discount to the historical average over the last decade.

An interview with Laurence Meyer, former member of the Fed

Only a slowdown in the US

At the upcoming FOMC meeting to be held on Tuesday, August 8, market expectations are set for a pause. Uncertainty remains because the Fed could hike rates in reaction to inflation figures. However, Dr Meyer thinks that by year-end the cost of money ought to be at 5.5% (from current 5.25%).

When TheEuropeanSide interviews managers and experts about the risks of the European financial markets, we often get answers which begin illustrating the possibility that a downturn in North America engenders a contraction in Europe as well. The reasoning is sound since the huge size of the US external imbalance allows other countries to maintain a level of production well in excess of domestic consumption. If that source is aborted other outlets have to be found. TheEuropeanSide will assess the prospects for the US economy with the assistance of Dr. Meyer.

Dr. Laurence H. Meyer

Laurence H. Meyer served as a member of the Board of Governors of the Federal Reserve from June 20, 1996 until January 31, 2002. He was widely recognized as an influential member of the Federal Open Market Committee and built a reputation for independent thinking and straight talk about monetary policy.

Dr. Meyer is a Senior Adviser to Macroeconomic Advisers .

www.macroadvisers.com

Dr. Meyer, could you kindly set out the basic framework for the US economy and monetary policy in the quarters ahead?

"We have to recognize that powerful crosscurrents are at work. Economic activity appears in the middle of a period of below-trend growth, which is likely to persist at least until the turn of the year and probably will extend into 2007. That's the prevailing expectation and the one shared by the Federal Reserve as well."

And what about inflation?

"Of course, the cost of living has been running somewhat higher in recent months. In my opinion, it should trend a little bit higher between now and the end of the year before softening. The focus of next week Fed meeting will be on these two issues…"

Namely?

"The key question for monetary policy is centred on a typical challenge: how significant and how persistent the slowdown in growth is likely to be and how persistent inflation running above the upper end of the comfort zone is likely to be. It's a challenge. The Fed is certainly close to a pause; it may be at 5.25% or at 5.5%, but we have to be aware that the Fed is facing a lot of uncertainty. Next week meeting could be one of those rare cases when the decision has not been taken well in advance."

Let's go back to the economy. The first quarter was very strong, growing at 5.6%, while the second suffered a deceleration at 2.5%. What's the trend?

"The strong first quarter was in part a rebound from the weak fourth quarter of 2005 (when the economy grew at 1.8% ed. notes). If you average the two, you may find a growth of 3.6%, or something like that and close to the underlying trend. But I do believe that the second quarter showed the signs of a fundamental slowing relative to the trend of the previous quarters and presages further below-trend quarters."

Many financial operators have been focusing on the yield curve as a predictor of growth. Since the curve is inverted, some fear a sharp slowdown or even a recession. What do you think about this? Do you fear a recession?

"Not at all. Remember that the inverted curve has not been such a good tool in the last decade or two. Back in the 70s and 80s it had a better record. But I want to stress that the rate on federal funds fluctuated at higher levels. Therefore, I would say this: if the Fed had to push the real rate as high as 6%, then we would have a recession. Instead, the current situation is consistent with a slowdown."

If it comes to a choice between a sharp slowdown and inflation, the odd are in favour of what, in you opinion?

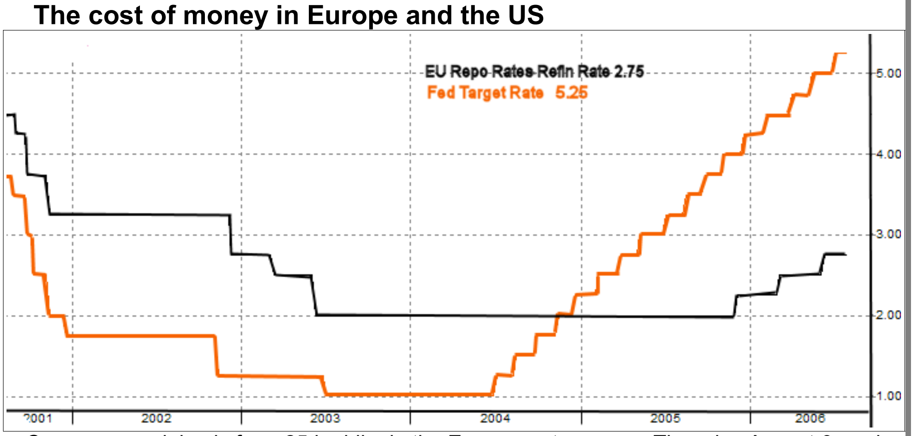
"I can't answer in the abstract. For instance if the choice is between a recession versus inflation staying at 2.25%, then the odds are that the Fed would take the 2.25% inflation rather than a recession."

Where do you see fed funds rate by year-end?

"Probably at 5.5%."

Staff

The cost of money in Europe and the US



Consensus opinion is for a 25 bp hike in the Euro-zone tomorrow, Thursday August 3, and for a pause in the US when the FOMC meets next week on August 8. In any case, the fate of the Fed meeting remains to be seen.