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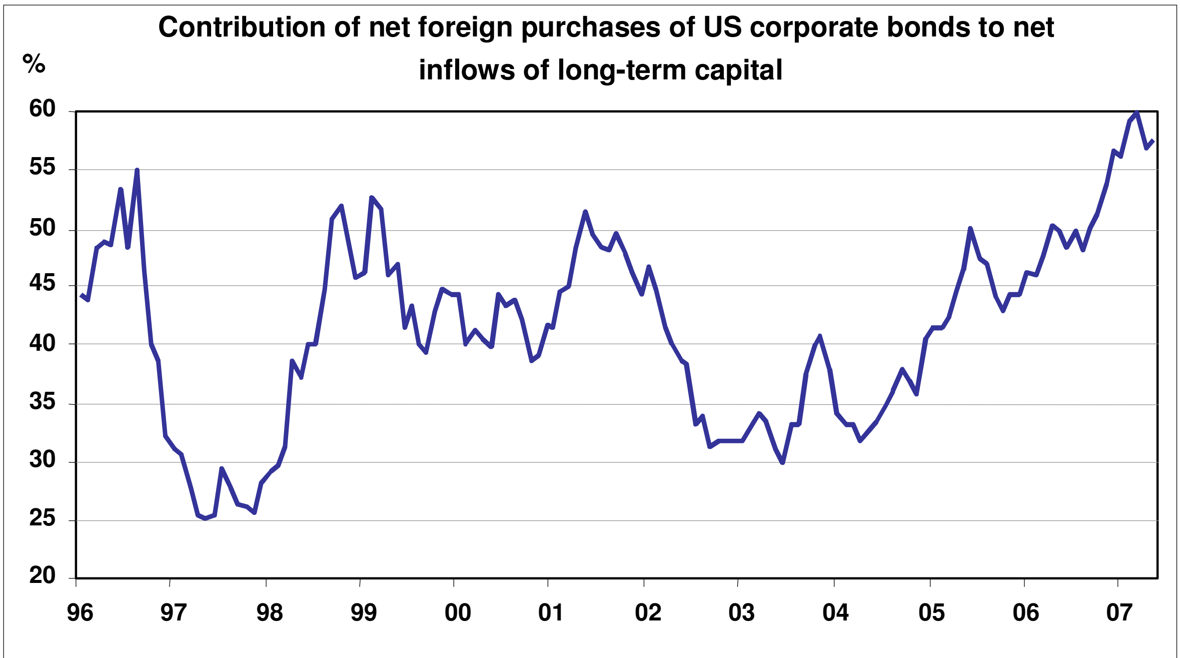
CHOPPY WATERS AHEAD

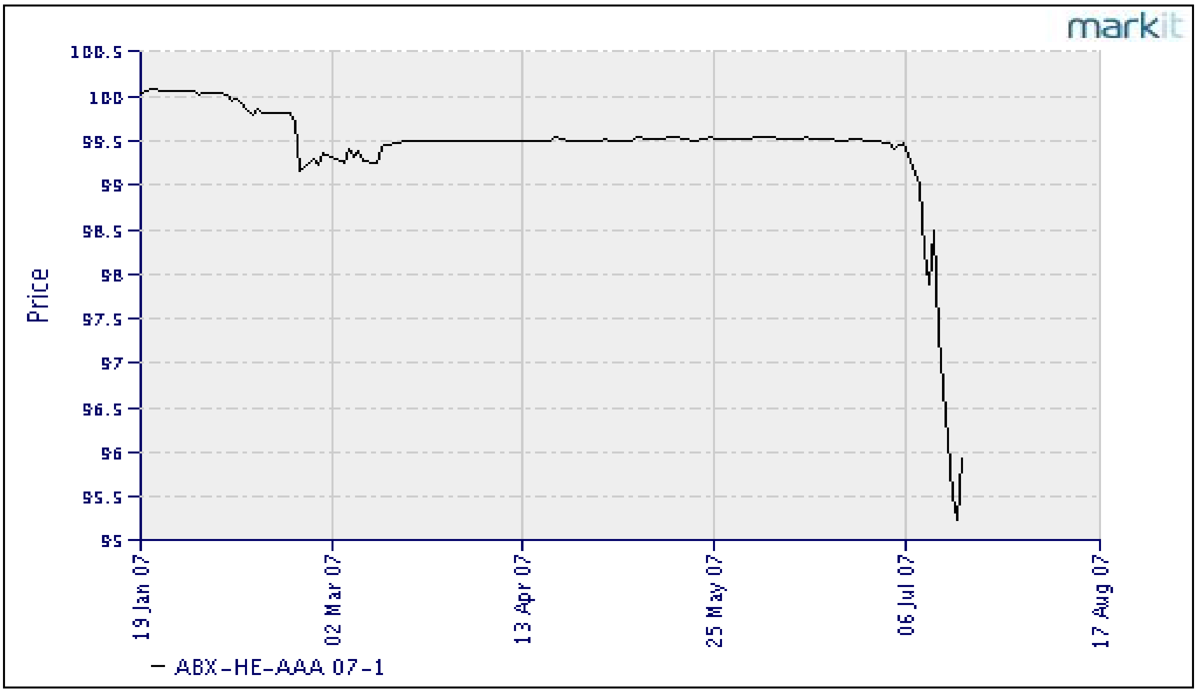
Having left Fed chairman, Ben Bernanke, alone for a few weeks it is time to stretch him across the coals once more. His semi-annual testimony on monetary policy to Congress yesterday betrays a stunning level of complacency. He is resolute in his belief that burgeoning problems in the credit markets will have a negligible impact on the performance of the US economy. He clearly has given no thought to the likely transmission of credit problems from the junk mortgage context to the junk corporate context. He neglects to comment on the uncertainties surrounding the accuracy of the payroll measure of employment gains, which would significantly alter his assessment. (Imputed job creation in small firms accounts for a large chunk of payrolls, yet small business surveys report very weak hiring trends.) He holds up the headline unemployment rate of 4.5% as proof of a tight labour market when almost every other barometer indicates increasing labour market slack. He fails to mention the latest plunge in the pace of domestic vehicle sales that will surely render the US auto sector heavily over-stocked again. He talks about the adjustment in the residential construction market as though the worst is over, yet the NAHB Housing Market Index slumped to a reading of 24 in July, the lowest since January 1991. He makes no mention of the sharp decline in home equity withdrawal or its potential impact on consumer spending. He completely ignores the issue of dependence on foreign capital flows into US corporate bonds at a time when risk appetites for mortgage-backed securities are liable to go into reverse. The May data are the latest, shown below, but it will be



interesting to see the impact of the Bear Stearns fund failures and subsequent subprime revelations on foreign appetites. Apparently, a senior US Treasury official has been in China seeking to market US asset-backed securities! Next week poses some particular challenges for US bond markets that could have important ramifications for borrowers. On Wednesday there is an auction of an estimated US$18bn of 2-year Treasury Notes; on Thursday, of US$13bn of 5-year Notes and on Friday (27th), the first release of the Q2 GDP figure appears. The auctions provide another test of the new-found abstinence of the Asian central banks while the GDP number could well be one from the freak show drawer – a rebound from 0.7% annualised in Q1 to 3% or more in Q2. The instant market reaction is likely to be heavy losses for bonds as the US economic rebound heralded by the ISM surveys, seems to be confirmed. But, hold on. Consumption growth has been slashed from 4.2% in Q1 to little more than 1% in Q2? Yes, the rebound will consist of an erratic inventory bounce and a freakish combination of strong exports and weak imports. Mr Bernanke's assessment will appear to be vindicated, but the next upward shift in bond yields could well be the final straw for borrowers.

SO, THIS WAS THE GOOD STUFF?

The AAA tranche of an ABS CDO was supposed to be immune from problems in the lower ranks, but having held its breath impressively throughout June, the stiff upper lip proved illusory last week. In the absence of the reassurance of an active market with a tradeable price, investors are right to fear the worst in mortgage CDOs. As the Bear Stearns funds are thrown to the dogs, the new worries surround banks' inventories of unsaleable junk bonds. *Serrez les fesses, mes amis*!



JAPAN SET TO JOIN THE SWF BANDWAGON

It was announced last Wednesday that Takatoshi Ito, advisor to PM Abe, has recommended that the government should set up a sovereign wealth fund with US$700bn of its US$914bn of foreign exchange reserves, investing the funds in Euros, Australian Dollars and emerging market currencies. The authorities need only around US$200-300bn in liquid US Treasuries (an estimate traceable to Morgan Stanley's Stephen Jen, who seems to be the prime mover in the analysis of SWFs), and the rest can be invested in equities, corporate debt and mortgage backed securities, Ito said. "The authorities are effectively engaging in a carry trade with their own citizens", he argued, and "should therefore seek to increase the return on the funds they have borrowed". Although no decision has been taken, Japanese officials have entertained proposals from a number of bulge-bracket banks concerning the possible structure of a Japanese SWF. Stephen avers: "Structural pressures on the budget, particularly in the light of the demographic trend, do not permit Japan the luxury of not maximizing its investment returns today."

GOLD: WE HAVE LIFT OFF!

Alf Field, a past Halkin speaker, has recently updated his Elliott Wave analysis on LeMetropoleCafe website. His conclusion is unequivocal: we have lift off in the bullion price! "Events over the past three weeks have created a situation where an upside catapult of at least US$100 per ounce, without a significant correction, can be anticipated". Qatar obviously agrees, as its government has more than quadrupled its gold holdings since January, to about 9 tonnes. On this happy note, I sign off for a couple of weeks to explore the Norwegian fjords.

FINALLY

Please make a note in your diary that the next Halkin event will be lunch at El Vino on Wednesday 19 September when Dr Ian White will be speaking on the big pharmaceutical stocks. The usual invitation will be sent out in the latter part of August.

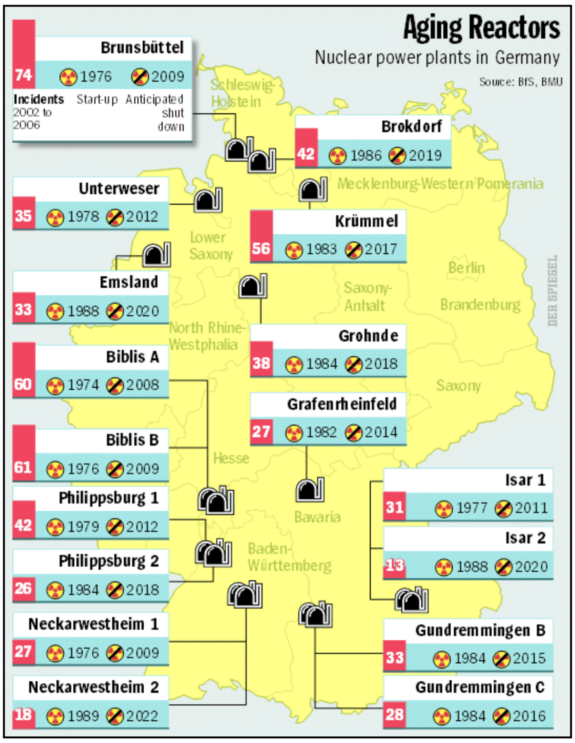
Peter Warburton

CONSTITUTIONAL FRAUD

On Wednesday, under the headline 'Giscard: Treaty changes made to avoid referenda', Euroactiv.com reported that, "Valery Giscard d'Estaing, the 'father' of the EU Constitution … said the draft Reform Treaty agreed at the June Summit only represented "cosmetic changes" compared to the previous version". And on Monday, EUobserver.com reported Giuliano Amato, the former Italian prime minister and "one of the central figures in the treaty drafting process" as admitting that, "The new EU reform treaty text was deliberately made unreadable for citizens to avoid calls for referendum". Both seemed smugly satisfied that, buried in a morass of footnotes, not only the essence, but the bulk of the original Constitution remained intact. The revelation is not a surprise in itself; what is surprising is that two such figures should display in public such a cynical disregard for democracy – and that, by so doing, they risked defeating their aim of smuggling the Constitution through with electoral consent.

MERKEL'S NUCLEAR EXPLOSION

Angela Merkel is very angry, and you can understand why. She knows that Germany's (and Europe's) future energy needs inevitably depend on continued and growing supply from nuclear plants. But public opinion has been strongly opposed to the nuclear option, and legislation passed in the Schröder years requires that it be phased out by 2021. Slowly, she had been winning support, within her own party and beyond, as the harsh reality of Germany's energy predicament became clear. Then, as an article in *Der Spiegel* describes, on 28th June there was not just one, but two disasters at nuclear plants run by Vattenfall – the first involved a fire at its Krümmel reactor near Hamburg, the second a pipeline explosion at the nearby Krümmel plant. To make matters worse, the company tried to cover up the severity of the incidents, fanning a "political wildfire" that has heightened public fears to the point where public opinion now opposes it by almost 2:1. This fact (and the chart opposite) is included in another, extensive *Der Spiegel* feature which, among other things, highlights the aging, decrepit nature of Germany's nuclear power industry. "In short, the incident has made it clear that nuclear energy is by no means the modern, well-organized high-tech sector portrayed until recently by politicians and industry advocates." Selling the nuclear option to the German electorate suddenly looks a momentous task.



Robin Aspinall

JAPAN: SHAKEN

There has been an earthquake in Japan. As of writing, 10 people have been killed in the Niigata area on the Sea of Japan side of the country (about 250 km from Tokyo) and 1,000 injured in a quake that measured 6.8 on the Richter scale. What makes this event different is that the earthquake also damaged one of Japan's nuclear reactors for the first time. All Japanese media are full of the story, but the *Asahi* newspaper gives a flavour of the coverage as all wonder what lessons to draw.

The fault that caused the damage runs directly below the Kashiwazaki Kariwa nuclear power station, a plant built on the assumption that there was no active fault at that site. The plant and its seven reactors were also built to a specification that assumed a maximum potential earthquake of 6.5 (remember that the Richter scale is logarithmic, so an apparently small numerical difference translates into a large difference in power). Small radioactive leaks have been reported at the site, including a leak of water into the Sea of Japan, together with dozens of malfunctions.

According to Tokyo Electric Power, the site operator, the leak was stopped by Monday evening (ie shortly after the earthquake). Nonetheless, as the *Asahi* hints, a review of nuclear power plant sites is likely. In an earthquake-prone country such as Japan, this sort of thing is taken very seriously, so it comes as a shock to discover that the intensity of shaking experienced was two and a half times the cap used in designing nuclear reactors. On a broader scale, any threat to Japan's nuclear power industry must also be a serious consideration for world energy markets. According to the World Nuclear Association, Japan generates 30% of its electricity from its 55 nuclear plants.

P.S. On the subject of toxic waste, the extent of the damage to the Bear Stearns hedge funds destroyed by the US subprime crisis brings to mind experience from another era. *Zaitech* it was called in Japan in the 1980s – great on the way up, devastating on the way down. *Plus ça change*.

NORTH KOREA: ON ICE

Japan is not the only one closing nuclear reactors. The IAEA confirmed on 18 July that North Korea has shut down its Yongbyon nuclear facility. In a brief press release, the organisation announced that five facilities have been shut down and sealed. In return, North Korea is receiving heavy fuel oil from South Korea.

The six-party negotiations now move on to declaration and disablement of all North Korea's nuclear programmes. The South Korean delegate suggests this is a possibility by the end of the year.

INDIA: STIRRING

The India Capital Fund's June newsletter is full of the joys of a rampant equity market. China has been grabbing the headlines because of the way it has tripled over the last two years, but India has also performed spectacularly well. In round numbers, the BSE index has risen threefold over the last three years and fivefold over the last five. According to the India Capital Fund, India is now also the world's eighth-largest IPO market.

There has been a surge of activity recently, with DLF, India's largest-ever IPO, and two others raising a record $10bn in the space of less than four weeks. At the same time there is good news on the fiscal front. The deficit is down 14% year on year, with tax revenue up 35% compared with a government target of 17%.

Robert Brooke

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