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WAITING FOR A SHOCK

One day the Acer tree has a full complement of Autumn leaves; the next it has none. A gust of wind crosses the threshold of severity and all resistance is ended. After reading the long-awaited summary of [Michael White](#)'s thoughts, I was struck by his insistence that "we are no longer going through a period of evolutionary change, but ... a mutational one." He observes that our institutions are ill equipped to confront either the geonomic challenge (the bursting of the global private sector credit bubble) or the geopolitical challenge (guerrilla war rather than military war). In all walks of life there is a temptation to believe that change will occur gradually and that there will be plenty of time to prepare for it. Yet there are a number of very obvious contexts in world affairs where incremental change has been resisted so strenuously that it has been replaced by the expectation of violent change.

Examples include: the pegging of the Chinese Yuan to the US Dollar; the privileged status of the Government Sponsored Enterprises (GSEs) in the US mortgage market; the delicate balance of power between the US and China regarding Taiwan's status; the risk of [Chechen](#) terrorism spilling on to the international stage (eg US) as a consequence of their domestic frustrations; US foreign policy following the 2nd November presidential election. This pretence of serenity, not least in the assertion of rapid and sustainable GDP advances, may soon be over. Michael summarises the situation as follows:

"Most politicians are relatively honest in the light of their times. But in an age of materialistic hedonism, they pander to their electorate in order to be re-elected. Thus, financially indulging the electorate becomes the order of the day; and the more this is done, the more they desire, making the politicians more demagogic than ever. This used to be done by pork (special fiscal favours) legislation that benefited a particular solon's district. But with the government's debt explosion, the only way the consumer can be taken care of is through the Federal Reserve's ever expanding monetisation of the credit economy. As long as the government did this fiscally, the damage to the credit system was not too great as this represented government debt. But when this was done through monetisation this spurious economic growth – (enabled) by the mounting debt of the private sector economy – is dangerous as it must be paid off by the private sector (bankruptcy) rather than public debt which is paid by the use of the printing press (inflation)."

Michael's leading candidates for a serious exogenous shock are war between US and China over Taiwan and a trade war involving retaliation between the US and EU.

ALL PEGGED OUT?

Marshall [Auerback](#)'s article, entitled 'Guess Who's Coming to Dinner', contains some helpful insights into the Chinese dilemma over the revaluation of the Yuan in the light of the recent purchase of Canada's mining giant, Niranda, by Minmetals, one of 53 state-owned enterprises administered by Beijing. While some have interpreted the move as China's "increased readiness to spend some of its

stash of US\$480bn in foreign exchange reserves to alleviate the country's dependence on foreign-owned resources", others doubt whether this marks the beginning of a new trend. Marshall quotes Simon Hunt who "ascribes most of the noise surrounding the purchase (concomitant with talk of revaluing the renminbi) as symptomatic of the usual speculative frenzy that one sees at the peak of commodity bull markets." Simon draws attention to the sharp real-time decline in the Chinese housing and automobile sectors this year: "If the USA had seen a 60% to 70% fall in housing starts between the start of the year and August and a 38% fall in auto sales, markets there would be shaking. And yet markets appear oblivious to the facts." China's dependence on export growth, not least in its more immediate benefit to corporate cash flow, is a powerful deterrent to anything more than a token widening of the exchange rate band.

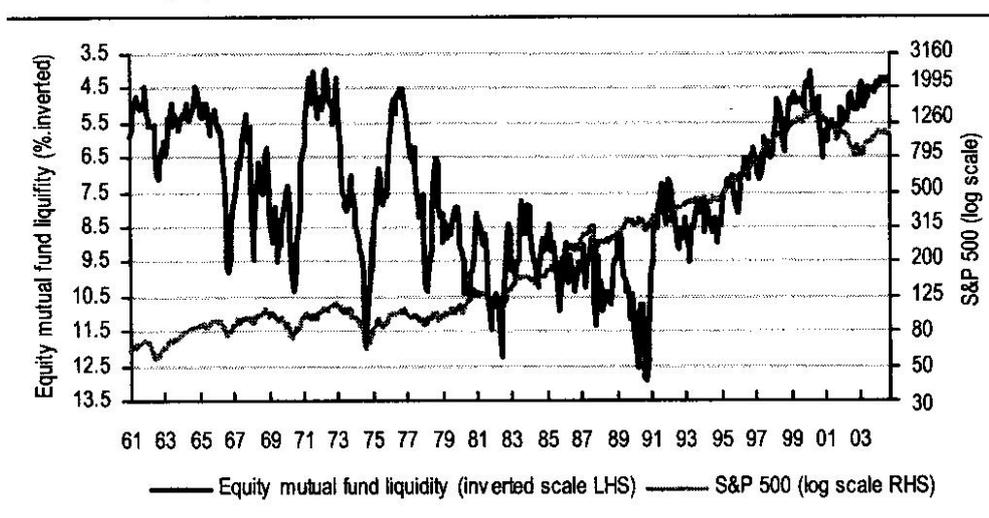
POWER SHORTAGES TO INTENSIFY IN CHINA

Last week UBS issued a report warning that the recent reduction in the number of overstretched power grids in late Summer was unlikely to continue. Alice Hui notes that "the shortage could intensify this coming Winter and Spring due to the tight coal supply and the seasonal factor for hydro-electric power." Power output rose 14.8% on an annual basis in the first 8 months of 2004 with power consumption biting hard at its heels. "In terms of installed capacity (2003: 391,000MW), China is the largest in Asia and the second largest globally (after the US). China's additions of new capacity in the next two years (2004-05: 102,800MW) are greater than the total installed capacity of the UK (around 70,000MW in 2004).

THE LATENT RISK OF MUTUAL FUNDS

According to Jens Johansen, also of UBS, US mutual funds are more heavily invested in the markets than at any time for the past 40 years, beating the low liquidity reading in March 2000. "There are parallels in fundamentals between the early 2000s and the early 1970s. There are also parallels in mutual fund liquidity. In 1973, mutual funds raised liquidity sharply, having bumped along the bottom of the liquidity range for over two years. But in 1973 mutual funds held just 9% of US market capitalisation. Now they hold around 33%, so liquidity raising need not be as severe to affect markets as long as it is sharp." Nevertheless, Jens fears that fundamentals and sentiment could drive mutual funds into a bout of selling.

Chart 1: US equity mutual fund liquidity since 1961



Source: UBS (using ICI, Bloomberg, Datastream data)

IMPROVING CREDIT QUALITY IN INDIA

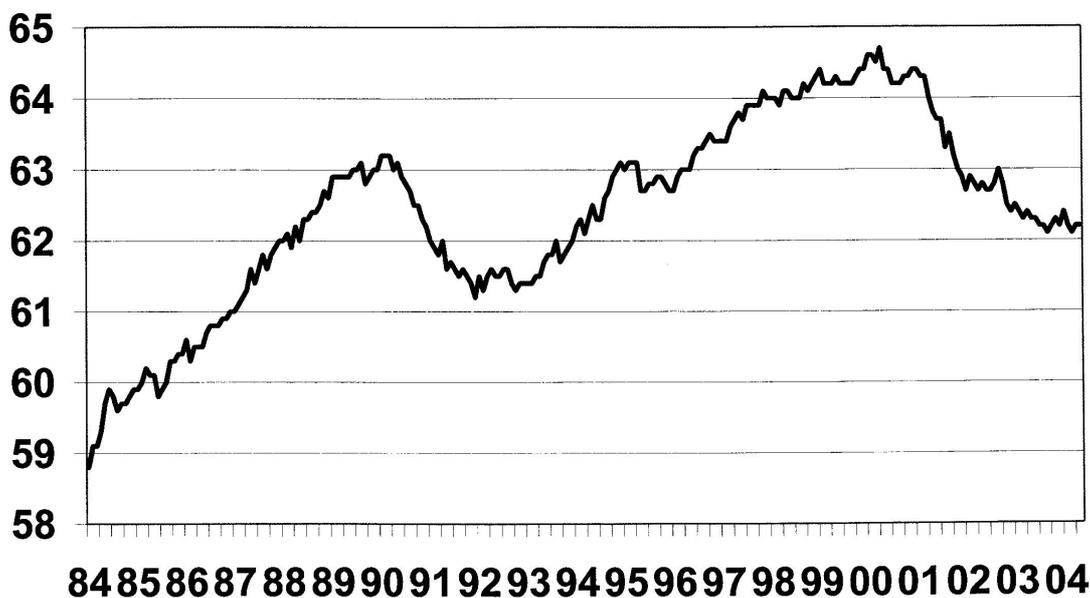
The latest [India Capital Fund](#) newsletter highlights an absence of credit downgrades and defaults for the first time in 10 years. Indian corporates are, in a benign context of volume growth, increasing efficiency and a high level of capacity utilisation which all point to sustainably higher earnings per

share. The quoted agency, CRISIL, draws attention to the “aggressive financial and operational restructuring over the last few years that has improved the manufacturing sector’s competitiveness across a broad spectrum of industries. This year’s upgrade list shows companies from the packaging, plastics, automobiles, pharmaceuticals, fertiliser and other diversified industries.”

US JOBS REPORT FAILS TO SET THE WORLD ALIGHT

Far from supplying the final boost to his campaign, the September non-farm payrolls were downbeat with little sign of a meaningful hurricane impact and a big fall in manufacturing employment. The loss of momentum in job growth was underlined by a lower-than-expected 238,000 estimate for the benchmark revision. Relative to the growth of the adult population, net employment gains are failing to match those in previous recoveries. This chart says it all.

US civilian employment to population ratio (%)



UK TRADE DEFICIT WIDENS AGAIN

In the three months to August, the deficit on trade in goods and services worsened to a record £11.2bn from a £9.1bn shortfall in the previous three months. Most of the deterioration appears to be in visible trade outside the EU and, predictably, the bilateral deficit with China is growing by 20% per annum. Even UK trade with the US is faltering. Despite a recovery in the oil trade balance for August, the monthly figures worsened as manufactured goods slipped to a record monthly deficit of £4.3bn – equivalent to £51.6bn at an annual rate. The UK is following hard on the heels of the US in terms of its proportionate external deficits.

FORTHCOMING LUNCHES

Please note that we have postponed the lunch with Ian Simm, joint MD of Impax Ltd, until Tuesday 2nd November, when it is hoped that we can build a longer list of attendees. To those who had accepted for this coming Tuesday, please accept our apologies for the late change and we do hope that you can make the new date. Due to a different set of logistical problems, Michael White has agreed that it would be better to visit London in January of next year rather than next month. We will advertise the dates of the dinner and lunch in the very near future. Finally, we are hopeful that Robin Griffiths of HSBC will address a December lunch (or dinner) to update his roadmap after he has completed his Atlantic sailing expedition.

Peter Warburton

JAPAN: RESTORATION

The 12 October edition of the *Financial Times* included a six-page special report on Japan. Twin themes of the review were: to what extent Prime Minister Koizumi has broken the mould; and whether the economic recovery is different this time. There are divergent views on both topics, and the *FT* reflects this ambivalence. Mr Koizumi's supporters make reference to the Meiji Restoration of 1868, a reference the *FT* regards with scepticism: "The claim [that Koizumi's reforms amount to a Heisei Restoration] is a wild exaggeration given the comparison with the profound social and economic transformation that swept Japan at the end of the 19th century."

On economic recovery, the article is more hopeful, pointing in particular to the restructuring which has enabled companies to translate top-line growth into profits. Nonetheless, a short paragraph in the middle of the article manages (whether deliberately or not is unclear) to summarise the hopes and doubts about whether the recovery really marks the economy's escape from the grinding pressure of the banking crisis: "The Financial Services Agency has forced banks to write off bad loans more urgently, a task made easier by improving economic conditions that have turned would-be defaulters into sounder borrowers"... which tends to imply that if economic conditions were to deteriorate, they would turn these sounder borrowers back into would-be defaulters. Scarcely a resounding endorsement.

CHINA AND TAIWAN: PEACE AND HARMONY

Despite opposition to his Iraq policy, John Howard has been re-elected in Australia. In fact, peace and harmony are breaking out not just in Australia, but all over the Pacific region. Even the Taiwan Straits, the hottest spot of all, has seen what looks like a *rapprochement* this week. As ever, however, there are differing views. The *Taipei Times* reports that the Taiwan government expects to see direct air links between the island and the mainland by next spring, "provided China is willing to send appropriate personnel to negotiate the issue". This is remarkably different in tone from the premier's recent desire to have missiles that can strike Shanghai. Article at: [Direct Flights](#).

Well, almost harmony. The *People's Daily* does not reply in kind. "Facts have fully shown that Chen Shui-bian [President of Taiwan] puts on shows of trying to ease tension, but what he is really doing is to promote 'Taiwan independence'," according to an official at the Taiwan Affairs Office. He went on to accuse Mr Chen of escalating separatist activities both in Taiwan and internationally. It takes two to have a *rapprochement*. Article at: [False Remarks](#).

Robert Brooke

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