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Weekly Letter no: 89 **19th August 2004**

THE TRADE TORPEDO

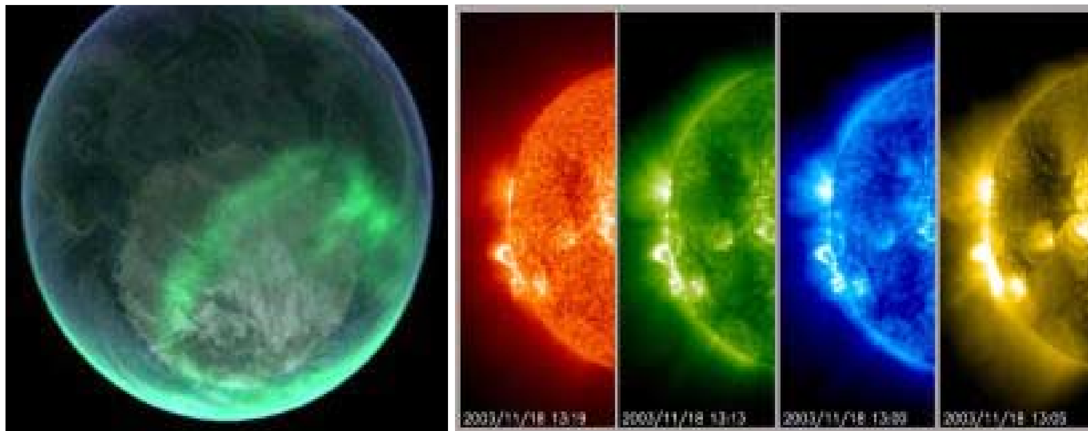
Hurricane Charley has brought devastation to Florida once more and looks as though it will rank second only to Hurricane Andrew in terms of fatalities and cost of damage. Predicted insurance losses are in the region of US$8bn to US$10bn with total economic damage likely to be around double. Ironically, Andrew struck in August 1992 as George Bush senior was campaigning for re-election. ISI reports that “Andrew contributed to weak economic data, declining industrial production, chain-store sales and personal income. Plywood prices soared. Charley will probably impact the August employment report because it occurred during the survey week.”

As if the devastation from Hurricane Charley weren’t enough, the US economy was also struck by a trade torpedo last Friday. Against a market expectation of a June trade (goods and services) deficit of about $47bn, the outturn was $55.8bn. For goods alone, the trade deficit leapt from $51.5bn in May to $60.2bn in June as a result of weak US exports of capital goods and a deterioration of the oil-related deficit. Bear in mind that the first $40bn goods deficit arrived as recently as June 2002. The $60bn goods deficit is composed mainly of $19.2bn industrial supplies (including petroleum), $11.8bn autos and parts, $22.8 consumer goods, and $3.3bn capital goods. The monthly deterioration was almost entirely in industrial supplies ($4.6bn), and capital goods ($4bn). While the immediate impact of Friday’s figures was to knock 1% off the trade-weighted Dollar index, the greater damage might arise from the implied downgrade to annualised Q2 GDP from 3% to about 2%. The June trade data is so different from the values assumed in the construction of the advance Q2 release that it could slice up to $30bn from the estimate of Q2 GDP, measured at an annual rate. These data will be incorporated into the provisional Q2 release on 27 August. Hopes of a swift rebound to lower deficits are probably fanciful. According to the King Report (16th August), the average price of imported oil from the June trade data was $33.76 per barrel. It is 36% higher now! Expect some more grief from the trade figures over the next couple of months.

THE SUN LIGHTS ITS OWN OLYMPIC TORCH

Last Friday, the Olympic flame in Athens was lit after a global torch relay covering 27 countries and travelling a distance of about 48,000 miles (78,000 km) total. NASA reports that “particles from the Sun had to travel a little further – 93 million miles – to light up the skies in states like Iowa, Michigan, California, and New York. The coronal mass ejection (CME) blast that triggered the aurora took place around 10:45 am ET on July 25, travelling at roughly 1300 km per second. It took a day and a half to reach Earth, allowing NOAA to issue warnings to satellite and power grid operators. At 20 times the size of Earth, the originating sunspot was the largest seen since the solar storm onslaught last October and November. The bright auroras (see left hand picture) were the result of elevated activity on the Sun and some unusually large sunspots rotating toward Earth. The aurora, also known as the Northern and Southern Lights, form when solar particles and magnetic fields pump energy into the Earth's magnetic field, accelerating electrically charged particles trapped within. The high-speed particles crash into Earth's upper atmosphere (ionosphere) over the polar regions, causing the atmosphere to

emit a ghostly, multicolored glow.” The right hand picture portrays one of last November’s auroras cycling through four extreme ultraviolet wavelengths. “The area above the active regions seems to be churning with strong, well-defined loops of magnetic field activity.”



SEASONALLY ADJUSTED, WE’RE ALL DEAD

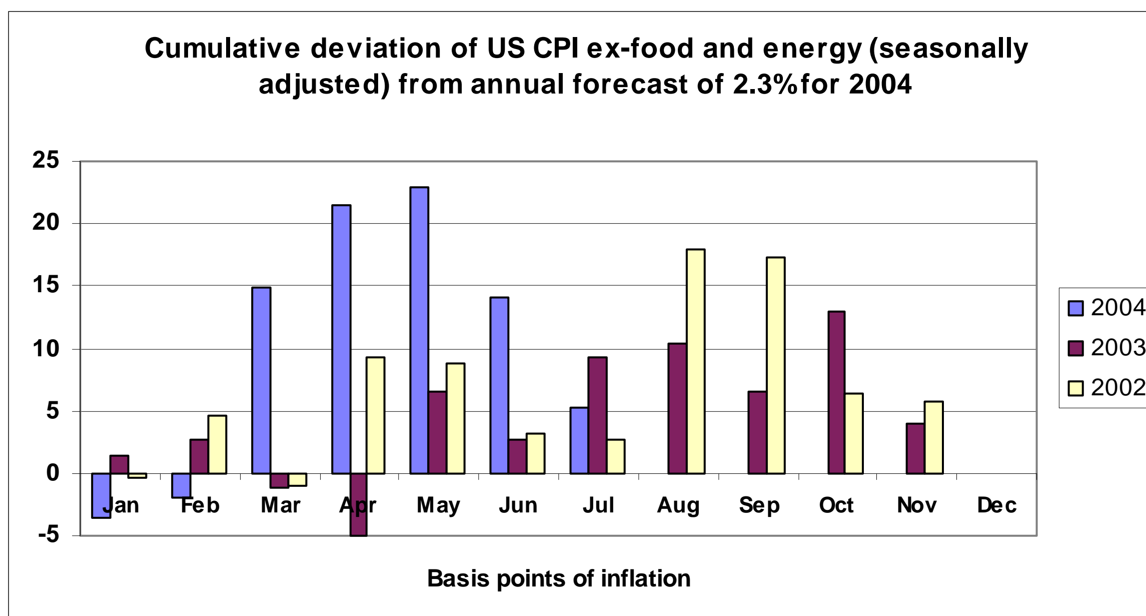
In its ‘Special Report on Global Warming’, *BusinessWeek*, 23rd - 30th August, elaborates the conventional wisdom on climate change. “What scientists do know is that carbon dioxide and a number of other gases act like the roof of a greenhouse. Energy from the sun passes through easily. Some of the warmth that normally would be radiated back out to space is trapped, however, warming the planet. With no greenhouse gases at all in the atmosphere, we would freeze. The earth’s average temperature would be a cold -17C, not the relatively balmy 14C it is today.” However, it is clear even from the caveats in the article that “it’s just too soon to tell if greenhouse gases will significantly change the climate.” But caveats don’t make good headlines, so the bold type is reserved for a series of charts that purport to demonstrate that carbon dioxide emissions correlate with global temperature deviations. As an empirical economist with thirty years’ experience I have to say that the statistical evidence presented would get a mauling in a staff seminar, let alone a conference. There doesn’t seem to be a convincing explanation of the severe temperature shifts 5,000 and 12,700 years ago when man-made carbon emissions weren’t much of a problem. And then there’s the small matter of the variability of the sun – could the climate change model be mis-specified? The overriding issue seems to be the significance of human activity: by taking responsibility for global warming, we assert our self-importance.

ARE CENTRAL BANKS TO BLAME FOR HIGH OIL PRICES?

Wednesday’s *FT* carries a report of a piece of research from an acquaintance of mine, Eric Barthalon, chief economist at Allianz Dresdner Asset Management, to the effect that the over-expansion of central bank liquidity (alias foreign central bank holdings of US public debt) is fuelling the recent surge in oil prices. “Whenever you print money in excess of the needs of the real economy, you create a situation where people try to spend it, to get rid of excess liquidity. We are in a situation where the US current account deficit is not financed by foreign private savings but by global (central bank) money creation – money is being created out of thin air. The markets that are most likely to react the fastest are commodities markets.” Eric reckons that the annual average price of oil could rise by 15-20% over the next two years. Point well made, but, as Jeffrey Frenkel points out in the same article, the speculative demand for oil and commodities is more likely to be influenced by very low short-term real interest rates. ‘Commitment of traders’ data for 10th August show large speculators to be net long 36,000 crude oil contracts (versus a 1-year high of 82,000 and 1-year low of -51,000). Either way, we can still blame the central banks.

INFLATION SURPRISES TURN POSITIVE

About three months ago, we warned that the US consumer price index is only partly adjusted for seasonality. While there is a great deal more to say about the authenticity of the CPI and its coherence with breathing reality, as an artificial construct it has certain properties. One of these is that increases



in seasonally adjusted 'core' CPI (excluding food and energy) are more likely to occur in the April, May, August to October than in the other seven months. Bond scares emanating from the CPI frequently occur in conjunction with the release of April and May data, only to give way to a more relaxed frame of mind by the summer. Come September and the inflation data regain their negative market bias.

EUROPEAN TECH SECTOR FACES PAINFUL OPTIONS

Barron's, 16th August, highlights the imminent adoption of a new accounting standard, IFRS2, covering the treatment of employee stock options. "In summary, IFRS2 will require firms to account for options as an expense, charging the income statement with the fair value of the stock options. This is planned to take effect officially with 2005 results, for options granted after 7th November 2002. But it also calls on companies to begin disclosing alongside 2004 results what the books would have looked like if the IFRS2 standard had been applied." The new rules bear heavily on the computer hardware and software sectors because of their heavy dependence on options as employee compensation. DKW estimates of the effects on 2003 earnings suggest an overstatement versus the new standard of 17% in the European software sector, 11% in hardware and 7% in pharmaceuticals.

IS INDIA BOUNCING BACK?

As usual, Jon Thorn, ICF, has some interesting insights into the Indian corporate economy and his latest letter concentrates on the merits of the over-weighted banks and metals sectors. "… Indian banks offer the best upside of almost any asset class that we are aware of. They are the clear winners from strong GDP growth, significantly rising credit off-take to enterprises (20% year-on-year growth) and consumers (30% year-on-year growth and less than 3% debt to GDP) and have low non-performing loans (net 0% to 5% and falling fast). Where those three trends are clear, along with stable inflation and large low-cost deposit bases, good banks cannot help but increase their EPS, some by a lot. Our attraction to Indian metals companies has nothing to do with whatever kind of landing China has … but rather with Indian metals companies' capacity expansion – by far the largest in percentage terms in the world, and they are also among the cheapest metals companies in the world."

LUNCHES

As many of you are away on vacation, this is a reminder to sign up for either or both of the September lunches, 7th September with Dr Brian O'Connor on Russia, oil and Yukos and 28th September with Richard Fulford-Smith, chief executive of Clarksons, on a shipping topic.

Peter Warburton

JAPAN: STEADY AS SHE GOES

First the Japanese government upgraded its assessment of the economic outlook, then the IMF followed suit. Among the adulatory comments from the press was a leader in the *Financial Times* (13 August). It notes the "discordant" nature of data released since the official optimism, but opines that there is no need to panic. The article then concludes that the Bank of Japan should refrain from planning a quick exit from its quantitative easing strategy while the government should defer talk of tax rises to plug its fiscal holes. "The authorities should keep their fingers off the policy triggers and hope it continues".

This is a commonly-held view, but is it right? The argument is that artificial stimulus – both fiscal and monetary – is essential to enable the economy to stabilise. Those supporting this view point to the lack of serious economic damage since the bubble burst (compared with the Great Depression, for instance). The imbalances will sort themselves out when recovery comes along. The opposing argument – to which I subscribe – is that they will not correct themselves until and unless steps are taken first. The probability is greater that one of those imbalances – most likely government debt – will become not just unsustainable but unmanageable, leading to widespread disruption, rather than that it will fade away. Wishing is not enough; actions are needed. The imbalances are not just extreme, but also continue to grow. Crises never blow up as a result of a single event, they are caused by multiple influences. In Japan there is no shortage of complicating causes.

KOREA: SHOCK THERAPY

Investment in fixed assets in China grew by a staggering 28.7% in the first half of this year, but then accelerated to 31.1% in the first seven months (the July figure alone has not been released). Little surprise, then, that central banks around the world are well into the rising part of the interest rate cycle. The Bank of Korea has just flouted the trend by cutting rates. The one quarter point cut takes the overnight call rate to 3.5%, a record low.

The move took commentators by surprise since headline inflation was running at 4.4% in July and the economy is on course for 5.2% growth this year. The *Korea Times* notes that this reflects how seriously the monetary authorities view the slump in the domestic economy and how determined they are to rescue it. The paper sees considerable dangers in this shock therapy, however, questioning whether it will achieve its aim. Article at: Shock Therapy.

Robert Brooke

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