HALKIN SERVICES LIMITED

INTERNATIONAL
RISK ANALYSIS AND ASSET ALLOCATION
SERVICE

DIRECTORS:
Dr P.J. Warburton
R.M. Aspinall
A.N. Brewer
R.J.W. Catto

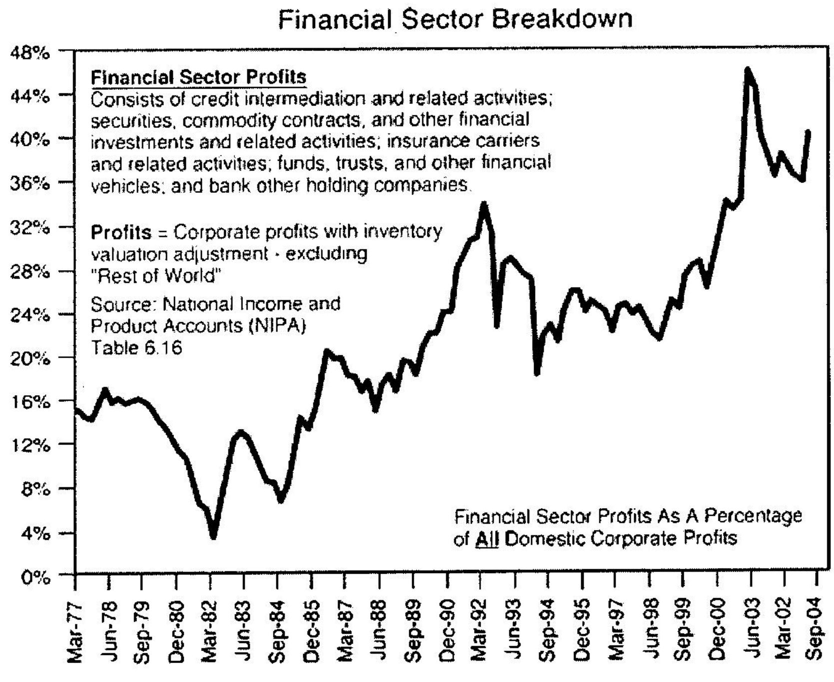
Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920
email: halkin@halkinservices.co.uk

Company secretary:
Mrs P.A. Ranken
21 Vineyard Hill Road
London
SW19 7JL

Weekly Letter no: 84 **15th July 2004**

RICHEBÄCHER'S REALITY CHECK

About seven years ago, when visiting a senior official at the US Treasury, I made the mistake of mentioning Dr Richebächer's name in the course of a conversation about domestic economic achievements. This man's amiable disposition transformed in an instant to one of irritation, as if a personal insult had been delivered. The Dr's longstanding critique of American economic management has had to withstand more than its fair share of derision and ridicule from officialdom and its close relations, the business economists who purvey conventional wisdom. US Treasury officials have come and gone. But the Dr, now well into his eighties, is as adamant and as animated as ever in his denunciation of the US economic 'miracle'. His July Letter prods and pokes the defenders of the miracle to answer his perennial criticisms about the sources and foundations of US economic growth. He is a self-contained Reality Check. As the second quarter corporate earnings season gathers momentum, the Dr repeats the charge that non-financial company profits are a pale shadow of their former selves. At an annual pace of $410bn, using the national income and production accounts, domestic non-financial profits are 29% higher than in 2001 but still 20% lower than in 1997. Manufacturing profits are 53% lower than seven years ago. Computers and electronic products remain in loss and the information sector has reported a widening loss in Q1. The Dr dismisses the notion that booming profits will stimulate a corporate hiring and investment boom.



Source: Bianco Research, L.L.C.

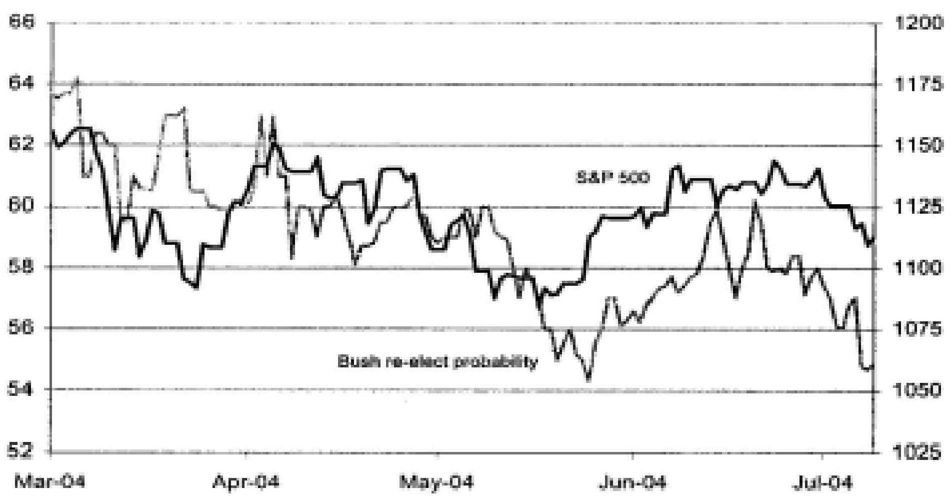
"Since we do not see the booming profits, we are understandably more than doubtful about the hiring and investment effects. Yes, non-residential business fixed investment has recovered from its slump in 2001-02, but it is a weak and extremely lop-sided recovery. Its rise has been entirely in high tech. Investment in industrial and transportation equipment has remained flat. This is definitely not the kind of investment recovery that could possibly become the economy's new driver."

Doug Noland, in his latest Credit Bubble Bulletin, makes some stark observations about the recent earnings report from General Electric under the heading 'US Financial Sphere Bubble Watch': "General Electric reported Net Income of $3.924 billion, up 3% from the year ago quarter. Revenues were up 11% y-o-y to $37.0 billion. "Cost of sales, operating and administrative expenses" was up 21% compared to second-quarter 2003. Total Assets expanded $35.0 billion (21% annualized), up from the first quarter's $14.6 billion and the largest increase since the second quarter of 2002. Consumer Finance Revenues were up 26% from comparable 2003 and Healthcare Revenues were up 40%." The orientation of corporate profits from operations to financial transactions is illustrated not only by the rising share of financial sector profits in the total (as shown in Jim Bianco's chart above), but by the financial content of profits in the non-financial sector. Bianco observes that financial sector profits have correlated strongly with the spread between 2-year and 10-year US Treasuries. The steeper the yield curve, the higher the concentration of financial profits. In a nutshell, he reckons that the Fed has "kept the yield curve steep for so long that financial firms have been gorging themselves on it to the point that they are now supporting the entire stock market's valuation." What is true for financial firms is surely true for many others whose principal business activities lie elsewhere. A flattening curve threatens to expose the fragile nature of the US profits boom.

MICHAEL WHITE: BUSH IN TROUBLE

Michael is convinced Iraq-related issues have the capacity to undermine president Bush, notwithstanding the hand-over on 28th June. The key question is whether the violence in Iraq represents ongoing hatred of an occupying power or whether it is the precursor to a civil war. If there is one thing worse than being an occupying power more or less in control of the situation, it is to be an occupying power in the midst of anarchy. The potential for US casualties to rise sharply is clear for all to see. While the accelerated withdrawal of US troops may be an acceptable strategy in the context of an uneasy truce between rival factions, evacuation in the context of chaos is quite another matter. With the slow drip of reports and testimonies discrediting the basis of going to war in Iraq, Bush (and Blair) are happy to take any opportunity to re-focus attention on the domestic economy, healthcare or indeed anything else. Michael laments the sub-par quality of political leadership, sparing only Sarkozy, the French finance minister who has attacked the 35-hour regulation, and possibly Schroeder, the German chancellor.

Maybe The Market Is Paying Attention To The Election



Intrade.

THE DEVIL WE DON'T KNOW: BIRD FLU

Courcy's Intelligence Review, July edition, highlights the far greater scale of threat to human life from epidemics than from international terrorism. The report links the outbreaks of the H5 strain of bird flu in Vietnam with a similar strain that is having a lethal effect on ducks in China. "From mid-December 2003 through to February 2004, there were outbreaks of H5N1 in Cambodia, China, Indonesia, Japan, Laos, Thailand and Vietnam." "The 2004 outbreak led to 34 officially reported cases in humans, of which 23 were fatal. This was the third occasion since 1997 that the H5N1 strain had passed to humans, and there is no vaccine to provide protection and no specific treatment once illness sets in." "The point about health crises is the *scale* on which they can occur. The 1918-19 Spanish Flu epidemic killed between 20m and 40m people, and while a crisis on that scale has not been seen since, the Asian Flu epidemic of the 1950s and the Hong Kong Flu epidemic of 1967-68 killed 4.5m people between them."

INDIAN BUDGET: SPINACH NOT SWEETS

Jon Thorn, writing in his latest report for the India Capital Fund, reckons that the Indian Budget was clever and well thought out. "From the negative side, the Budget did not give away the economy to subsidies and handouts and the political Left did not have the field day many had feared they would." "The market got spinach rather than sweets, in the form of reduced short-term tax on capital gains, from 30% to 10%, and, of huge importance, a 0% rate long-term capital gains tax, down from 10%." "This makes the stock market much more attractive to long-term and to institutional investors." On the other side of the equation, there were some promising noises made about eliminating the fiscal deficit over the next four years through privatisation, the raising of FDI limits and the national introduction of Value Added Tax from 1st April 2005. "This means for the first time that all Indian citizens become potential taxpayers." Lucky them!

JAPAN STILL TOPS THE HARD WORK LEAGUE

If you ever wondered which country's employees work the longest hours per year, then the answer was Japan in 1980 and still in 2003. At an average of 1,828 actual hours worked per employee per year (equivalent to 38 hours per week, 48 weeks per year), the average Japanese works 3% longer than an American, 11% more than a British worker, 20% more than an Italian, 36% more than a Frenchman or a German and 40% more than a Dutchman. Just think how much more they could achieve if they worked a full week.

US PENSION LIABILITIES START TO BITE

Business Week, 19th July issue, cites a report that 85% of the defined benefit plans in the S&P 500 don't have enough assets to cover their pension obligations. "Together, the underfunding equals 15% of their 2003 cash flow." "According to CSFB analyst David Zion, the companies in the S&P 500 have contributed $88bn to their pension plans over the past two years. They're likely to have to add another $31bn over the next two years." For some old-timers, the pension deficit threatens to take the whole company down: Delta Airlines $5.7bn pension deficit represents 379% of the company's market capitalisation; for Ford, the figures are $11.7bn and 69% and General Motors, $8.6bn and 29%. This year, Delta is slated to spend $1.1bn in shoring up its pension fund.

GOLD MAKES A QUIET ASCENT

The gold price has made a quiet recovery over the past two weeks to US$403, largely a reflection of a weakening Dollar. However, Adam Hamilton, writing for Zeal LLC, believes that the uptrend has firmer foundations. "For the first time since last year when gold was in a major and immensely profitable bull-market upleg, we are now seeing the early evidence of a new uptrend. If I am right, then enormous profits will be earned by gold investors and speculators in the second half of this year." Wishful thinking? We hope to explore this and many other related topics at lunch with Alf Field next Tuesday, 20th July at the offices of Williams de Bröe in Broadgate. Please contact Patricia for further details, although the lunch is almost full.

Peter Warburton

JAPAN: THEN THERE WERE THREE

It is quite an event when a Japanese business news story features on the front page of newspapers on opposite sides of the world on the day it breaks (14 July), then in editorials in those same papers the following day. The event in question is the proposed merger of MTFG with UFJ. The former is third-largest and strongest mega bank in Japan. The latter is fourth-largest and struggling to survive on its own. The merger would create the world's largest bank by assets and leave Japan with just three majors. The *FT* is the more sceptical: "The proposed merger would be fraught with difficulties". It is also unequivocal in its assessment of the reason: "[UFJ's] decision… is the latest sign that it is unable to survive in an environment of intense scrutiny". By the time of the editorial comment, the *FT* was a little more emollient, reflecting the current mood of optimism, but not overwhelmed. "Is this deal about getting bigger rather than getting better?", the paper asks.

The *Nikkei* was very excited, sending out a rare e-mail alert about the news. Its report was straighter though, contenting itself with relaying the facts. One sentence stands out however: "The FSA is believed to be supportive of this merger because it considers the rearrangement of megabanks to be the final chapter of Japan's financial system rehabilitation." With only three big banks left, one would hope so – except that the regional banks, which account for about 40% of deposits and lending, still have to go through the wringer that money centre banks have experienced. The paper's editorial view was more considered, commenting on "UFJ's desperate attempt to secure its survival" and acknowledging that taking on UFJ's bad loans would inevitably damage MTFG's health. Nonetheless, the paper agrees with the general view that this is the end of the great banking crisis. I wonder.

CHINA: FEEDING THE ONE BILLION

Top story in the *People's Daily*, by contrast, was as domestic as they come. It reports on a State Council (cabinet meeting) chaired by Premier Wen, which set China ten economic goals for the second half of the year. Three features stand out. First: top target is "more grain, more income, less damage". For all the excitement over China'a growing manufacturing power, the top consideration is feeding the populace and rewarding farmers.

Second: it is not clear what some of these targets really mean. "A clean sweep of fixed assets investment" and the "clear-the-decks campaign in the land market" are sufficiently vague to be both reassuring and threatening. Something is to be done, but the details are left to the imagination. Third, despite the uncertainty of the translation, it is clear that growth and progress remain on the agenda, particularly in the private sector: "Studies and formulation of policies and measures should be sped up to prop up and lead the economic sector under non-public ownership." For the full article, click People's Daily website.

Robert Brooke

Registered Office: 91 Gower Street, London WC1E 6AB. Registered in England: 04559723. **www.halkinservices.co.uk**