

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

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PINK LETTER DAY

Recently, the letters pages of the *Financial Times* have contained several thought-provoking contributions. On Saturday there was one from our own Peter Warburton (who has taken leave of absence from the bulk of this week's Letter), vehemently challenging the *FT's* rosy view of Gordon Brown's "strategic stewardship". Peter maintains that "any developed country... that depletes its savings rate [as the UK has done] can augment its rate of growth for a few years." Quite right, too.

A second letter that caught my eye continued the long-running debate about the UK's potential entry into EMU. The writer (speaking for Britain in Europe) resurrected the old argument that, outside EMU, the UK is exposed to the whims of the currency traders. The writer clearly hasn't noticed the distress being caused in Euroland by the volatility of the Euro. But this stale and sterile debate has suddenly been transformed by events in Spain. While most comment has dwelt on the implications for the 'war against terrorism', a few have noticed that the political landscape in Europe has suddenly altered. Prime minister-elect José Luis Rodríguez Zapatero has already made clear his intention to align himself more closely with France and Germany. One immediate consequence is to reshape the looming re-run of the dispute over the EU constitution. Bertie Ahern, the Irish prime minister and current EU president, has resumed behind-the-scenes deal making with new vigour, confident that agreement can now be reached at the European Council summit in mid-June. Suddenly the EU looks a good deal more Franco-German; and the UK, the European Commission, and anyone who cares about fiscal stability are among those who will be feeling much less comfortable as a result.

The ECB faces a particularly acute dilemma. It will be aware that the balance has just tilted still further away from fiscal discipline, but the impact of the Madrid bombing on business and consumer confidence will make the economic outlook still less encouraging. Against a background of mounting political pressure, which it understandably resents, the ECB may have no choice but to concede a rate cut. Already Jean-Claude Trichet is preparing the ground for a *volte-face*.

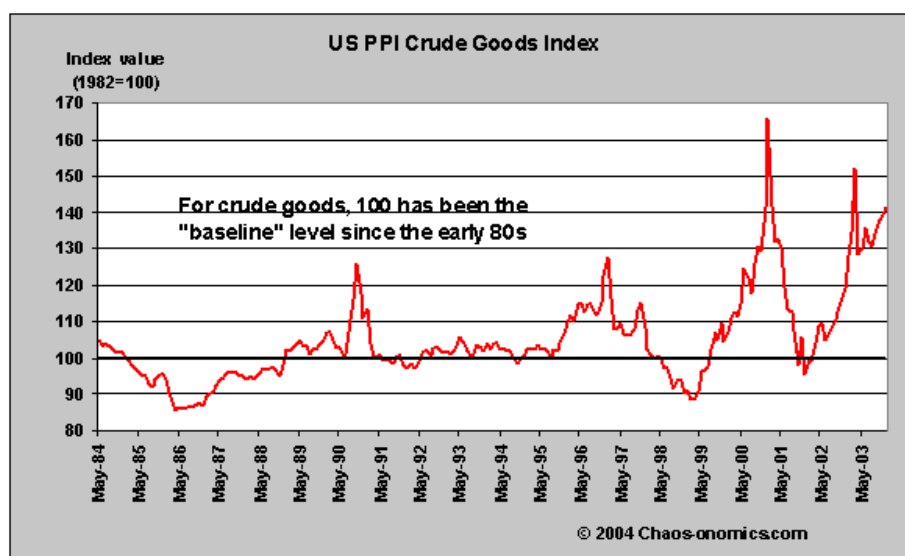
NORWAY: EUROPE'S JAPAN?

At the other end of Europe, analysts of Norway's economy have formed a consensus that it is heading into a deflationary spiral and that there is no alternative to further interest rate cuts. Certainly Norway is in the grip of deflation, but Andrew Hunt (contact: mailto:economist@hunteconomics.com) takes a quite different view. In a typically thorough and provocative analysis he cites several reasons why Norway is nothing like Japan. First, "the recent rise in shipping rates and oil prices will provide a significant boost to the economy. Secondly, the household sector is reviving and... may even expand at too rapid a rate in 2004..." thanks to a rapid run-down in liquid assets "in favour of consumption and less liquid investments." "Thirdly, the central bank's attitude to the currency and its brief, based on 2-year inflation forecasts, make it unlikely to respond. Like many European countries, Norway is stuck with higher interest rates than economic conditions seem to warrant.

PREPOSTEROUS PRICE INDEX

The flow of *King Reports* resumed just in time to witness it savaging the much-delayed US Producer Price Index. In the end, January's data showed a modest, 0.6%, rise. "Someone has to explain this to us: The PPI of finished goods is +.62% for January but intermediate goods are +.82% and crude goods are +2.76%. Who is eating all those increases along the production trail?" Well, some may be coming out of profit margins, but most of it has been 'eaten' by the statisticians. The BLS itself admits: "Some of the percent changes shown here... may differ from those previously reported because seasonal adjustment factors have been recalculated..." Good old seasonal adjustment; the last resort of the desperate statistician.

The PPI theme is picked up by Dave Lewis at Chaos-onomics. In his piece 'The end of the PPI saga', (<http://www.halkinservices.co.uk/files/PPIsaga.pdf>) he compares the present episode to November 1972, when a jump in the Crude Goods Index presaged the subsequent inflationary surge. He even compares the statistical jiggery-pokery with Thailand's delay in publishing current account data in 1997, which was a major factor in triggering their currency crisis. You have been warned.



MARC FABER: HUNTING FOR BARGAINS

Marc Faber's current concern is to find value in these markets, but he begins the latest edition of his *Gloom, Boom & Doom Report* (<http://www.halkinservices.co.uk/files/GBD0304.pdf>) with a familiar diatribe against prevailing market psychology. "A dangerous consensus view has proliferated among the investment community, which goes as follows. No matter what happens, the Fed will continue to ease... Therefore asset prices can only rise..." Of course he thinks this is dangerous and lists several good and historically validated reasons for his belief. Marc does not rule out a continued feeding frenzy because "fund managers are almost forced to take significant risks..."; but his point is that this will inevitably be "followed by a severe bust and a financial crisis" which will erase most or all of the previous gains. Halkin clients will readily concur.

Understandably, then, his search for value is almost entirely fruitless. Even in commodities (his main topic), he is as concerned about the excesses as the opportunities: "investors... should be aware that significant downside volatility for individual commodities, even in the context of a long-term bull commodities market, is almost a certainty!" Commodities where he believes "overshooting" is particularly dangerous are copper, nickel, steel and platinum. But there is one commodity where he remains firmly bullish: oil. After an extended discussion of supply constraints, Marc concludes that "given the certainty that oil demand in Asia and the Middle East will rise substantially... and the high probability that world oil production will peak out in the next few years, the fundamentals of crude oil as well as oil companies look very attractive." That is now such a strong consensus among Halkin correspondents that it must be true, mustn't it?

Robin Aspinall

CHINA: A SHOCKING TALE

At our well-attended lunch on Tuesday, Simon Hunt elaborated on the bullet points of his recent China visit (<http://www.halkinservices.co.uk/files/SHchina.pdf>). Sometimes we can read a document twice or three times and still fail to grasp the importance of the message. Only when the author speaks it out, does its full import strike home. Simon pulled no punches in his succinct presentation; he believes that the Chinese government has both the will and the means to slow the economy from its 12-13% annual growth pace in 2003 to about 9% this year and 7½% in 2005 and to alter its orientation. Set against the frantic and furious expansion of the past year, this will feel like a recession in some industries and activities. Simon acknowledges that there is precious little evidence of the slowdown at present, but company order books in March were lower than in February (despite the New Year effect) and the inventory situation is worsening. Simon quoted the example of a (metal) connector company whose inventories are 50% higher than a year ago. Similarly, this company's customers were holding 40% more connectors in stock than a year before. Surging materials and energy costs have squeezed profit margins in an environment where pricing power is often non-existent. The attendant pressures on cash flow have reduced some smaller businesses to buying raw materials on a day-to-day basis. In a country that is devoting more than 40% of GDP to investment – more than Japan at the 1980s peak – the accumulation of excessive inventory normally signals the onset of an investment recession. In sectors such as real estate, autos, steel, cement and aluminium, where over-capacity is rife, there is likely to be a spate of company failures. Simon's specialist expertise is the copper market and he has kindly distributed the notes from a recent conference talk (<http://www.halkinservices.co.uk/files/SHcopper.pdf>). "I believe this wonderful bull market in copper is nearing its end, with prices peaking over the next two months. A sharp fall over the summer, a secondary but lower peak should follow in the autumn, after which prices should continue in a falling pattern until the first half of 2007." We are very grateful to Simon for sharing his thoughts and documents with us. As with all our contributors, our desire is to sing their praise, not to undermine their franchise. Simon's detailed analysis is available only through his consultancy, Simon Hunt Strategic Services, and we recommend that you contact him at <mailto:shss1@dircon.co.uk> for more information.

INDIA'S CONSUMER BOOM

Towards the end of the lunch, Jon Thorn, proprietor of the India Capital Fund, gave a short update of his thoughts on India. His upbeat remarks provided a stark contrast to Simon's warnings about the Chinese economic and corporate outlook. India is experiencing a credit-driven consumer boom that looks, at first sight, to be a banker's dream. Housing loans are rising 30% per annum, but householder equity is typically 60% of the purchase price! Sales of two-wheeler scooters are up 40% on a year earlier. India's residential housing boom is the biggest in the world, at present. Unlike China, there is no over-arching economic plan, nor the same degree of concern over oil and power supplies. Jon reminded us that 20% of the world's generic drugs are now made in India. After thrilling us with his cement story last year, his enthusiasm has been transferred to laminated tubes. For the annual reports of the ICF and his monthly newsletters, contact Jon at <mailto:jon@indiacapitalfund.com>.

Peter Warburton

ASIAN POLITICS 1: LANDSLIDE

A week after turmoil hit Korea when its president was impeached, there have been contrasting elections in two other Asian countries. Comments are attached from various newspapers to show differing reactions. In Malaysia, Abdullah Badawi won an unexpected landslide victory. A factual *FT* article reports how, having succeeded Mahathir Mohamad in October, Mr Badawi has cemented his own authority, halted the rise of fundamentalist Islamists and built a position of strength to limit links between government and business. Article at: <http://www.halkinservices.co.uk/files/Landslide.pdf>.

The *New Straits Times* (<http://www.nst.com.my/>) captures the self-congratulatory mood with a sycophantic article praising Mr Badawi for, of all things, not declaring a public holiday to celebrate his party's massive win. The article is at: <http://www.halkinservices.co.uk/files/NoHoliday.pdf>.

ASIAN POLITICS 2: UPHEAVAL 1

How different things are in Taiwan. Presidential elections over the weekend ended in the narrowest of results since the hanging chads of Florida and have thrown the country into turmoil. In a tale full of drama, President Chen and his deputy, Annette Lu, were both shot on the eve of polling but proceeded to win by 30,000 votes out of 13 million. Turnout was high, believed to have been boosted by a large sympathy vote. Mr Chen's pro-independence stance has annoyed the US and angered China, but his victory has also stirred up the opposition with thousands taking to the streets of Taipei to protest. The latest state of play in this complicated story, as reported by the *FT*, is that the losing candidate, Lien Chan, has challenged the results with two court cases as well the street protests, while his supporters question whether the president staged the shooting. Mr Chen meanwhile has offered an amendment to the election law to allow a swift recount, but only if Mr Lien withdraws his suits claiming the results invalid. The article can be found at: <http://www.halkinservices.co.uk/files/TaipeiRecount.pdf>.

Contrast this sober and informative article with a more emotional and personalised version from the *Taipei Times* (<http://www.taipeitimes.com/News>). This reports in direct speech what Mr Chen had to say, his protestations of innocence and his invitation to Mr Lien to agree to a recount. He puts the ball firmly in the opposition court by demanding that Mr Lien take his supporters off the street and claiming the government has no right to be involved with the legal demands for a recount unless Mr Lien withdraws his cases. The article is at: <http://www.halkinservices.co.uk/files/RecountCall.pdf>.

ASIAN POLITICS 3: UPHEAVAL 2

It was Korea that started this series of political dramas and the country's own drama is approaching its *dénouement*. With three weeks to go before parliamentary elections, the *FT* reports on a gamble by the Grand National Party (GNP) to restore its fortunes. It was the GNP which voted to impeach President Roh but that success has seen the party's opinion poll rating slump to 15% compared with 45% for the losing Uri party. The GNP has now chosen Park Geun-hye as its leader to try to rebuild its popularity for the election. She is the daughter of President Park who seized power in a coup in 1961 and transformed Korea from an agrarian into an industrialised society. The scale of Uri's opinion poll lead still suggests that the GNP is going to reap a whirlwind having sown the wind in the unpopular impeachment. Article at: <http://www.halkinservices.co.uk/files/DictatorsDaughter.pdf>.

Perhaps reflecting its political leanings, the *Chosun Ilbo* (<http://english.chosun.com>) is more measured, simply reporting as fact Park *fille's* appointment. It does however carry a leading article reflecting on the lessons for Korea from Taiwan. The paper makes clear that it thinks relations with China should be a central issue in the region's politics. The article ends rather tamely but this puts into even greater focus the one emotive paragraph that links Taiwan directly with Korea: "Our interest as onlookers is that before Taiwan's internal divisions grow deeper and they become a justification for outside intervention, they must be dealt with so that they do not become a new tinderbox that can light Northeast Asia aflame". The article is at: <http://www.halkinservices.co.uk/files/TaiwanLessons.pdf>.

Robert Brooke

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