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June and July have continued to produce stock market confusion. There seems to be an aggregation of worries that don't on the whole relate to underlying trends.

In May I commented that the Fed's long-expected indication that interest rates were going to rise sooner rather than later produced bizarre market gyrations. We also had the news that the Chinese Government was taking measures to restrain the unsustainable economic growth. This has since produced a rush of predictions about hard landings, crashes etc. Again these predictions seem to be based on nervousness or perhaps a desire for a crisis.

The general good news is that a marginal slow down in global economic growth has stabilised most commodity prices, yet worries still remain. The US, in particular, seems to be beset by paralysis caused by the extraordinary polarisation of politics around an intense dislike or like of Bush. As a President he has managed to generate more odium than any other President in my living memory, both in the US and around the world.

Further worries in the market about terrorist risk and the confusion generated by the reporting of Government warnings on terrorism add to the general market uncertainty in the short term, while the macro economic and global world seems to be on the whole good. Even the WTO has managed to get some sensible conclusions in the last round of meetings in Doha. Developed countries have for the first time agreed that subsidising their farmers and then subsidising the export of non-required product is extremely damaging to the developing world.

Among the building blocks of the wall of worry that the markets are hung up on, perhaps oil is the most intriguing. It is probable that supply and demand is nearing balance, i.e., there is little surplus. The result of this is commodity traders, particularly in the hedge fund area, heavily influence market prices. While recent production figures are exceeding consumption, the price continues to rise on a fear of terrorist disruption. I suspect that if there were an oil related terrorist incident, there would, perversely, be a rapid drop in the price of oil as speculative positions were unwound and demand dropped. Rising oil consumption is a problem a few years out but at today's prices it is not a significant drain on the world GDP.

The good news, starting with **China**, is their economy is slowing, a bit, and is therefore probably now expanding at a sustainable rate without major dislocations. This growth is enormously helpful to the world economy, Asia in particular. It is also “a good thing” that Chinese poverty is diminishing and the country as a whole has an interest in world stability. As with oil, China raises some major problems for the West in perhaps four or five years’ time. Their rate of technological advance is prodigious and much of their industry is at the forefront of production techniques. Their manufacturing capability is likely to increase at a far faster rate than in the Western world, particularly (as reported in 13D Research) China will graduate 325,000 engineers in 2004, five times the number of the US!

Virtually all global companies have manufacturing facilities in China and inevitably R & D will follow. In practice R & D can not for long be far away from production facilities in most manufacturing sectors.

India too is broadening out its economic growth. The development of the Internet and the mobile telephone network is not only providing economic growth in the software industry, but also seems to be having an extraordinary political impact. India is a proud country with a great heritage and the Indian people have regarded themselves as a cut above the rest of Asia, if one is allowed to make this sort of comment in a Politically Correct world. The impact of greatly reduced cost of telephone communications and Internet facilities is bringing a realisation to middle class Indians that they are being overtaken by developments in China and Korea. This discovery seems to be galvanising political opinion into resisting bureaucracies that stifle economic and industrial growth. The globalisation effect at its best?

The most fascinating recent development in **Europe** was the announcement some two months ago that two Siemens factories in Germany had agreed to extend their working hours from 35 to 40 hours a week for no extra pay. This is deeply significant as it must be the beginning of the new trend in both Germany and France. Both countries’ Governments have failed to sort out their labour problems and at last companies are beginning to take the matter into their own hands. The alternative for European corporations is either to move manufacturing to Eastern Europe or Asia, which would be an economic disaster for Central Europe. The introduction of the ten new member States is producing huge strains as the regulatory burden in “Old Europe” greatly encourages companies to relocate to take advantage of more sensible labour regulations and, as importantly, lower tax rates. Economic performance in Europe will pick up and the renegotiation of working hours could have a dramatic effect on corporate profitability, as the efficiency of European manufacturing is by and large competitive, particularly with the US. The major worry in Europe, apart from the bureaucratic overload, is the potential political instability caused by the disparities in the Euro zone and the inability of the Commission to enforce its own rules on national Governments.

Britain is still marching somewhat out of step with Europe and it is unfortunate that one has to observe that, the Government in Britain is doing its best to create the equivalent bureaucratic burden that hampers European industry.

More worrying is the propensity for British Ministers to undermine the legal system. Complex modern economies require certainty that their actions comply with the law and that the law doesn't change arbitrarily. Last month the Treasury announced that 'in their opinion' companies were not paying enough tax. There is a blurring by the Treasury between tax avoidance, which is legal, and tax evasion. This blurring makes long term capital investment and planning more uncertain which is not good for economic growth.

In the same vein, the Department of Transport has decided that the Banks made too much profit financing the railway companies that were set up after privatisation. The new train operators had to raise huge amounts to replace the rolling-stock that the Department of Transport had failed to do prior to privatisation; this funding was provided by the big banks at relatively high rates of return, as the risk of this finance was high. The problem was exacerbated by the short duration of the train operators' franchises – seven years against the economic life of the rolling-stock of some thirty years. Contracts entered into by sophisticated lenders and borrowers are now, many years later, being challenged by the Government, who of course can make up the rules as they go along!

Having started with the peculiarities of the **US** market and its present bizarre behaviour, it is worth reviewing the good news. Corporate earnings continue to grow at a good rate. The corporate sector is very liquid. Employment is rising. The institutions appear to be underweight in Equities, and the Hedge Funds appear statistically to be heavily short. While interest rates are likely to rise rather than fall, which may slow down consumer expenditure a bit, the economy as a whole looks very solid. It seems that the general nervousness is being sustained on a relatively rickety wall of worry. As every month goes by with earnings rising and the market going nowhere, the stock market looks a better and better bet.

The risk, I believe, is the market could move rapidly upwards and in quite a short period, leaving little opportunity to buy into the rise. Funds that are short or in cash or bonds are far more risky today than being in the equity market.

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