

To: Oakmont Corporation

From: Damon de Laszlo

DABERIAM XXIX

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Global Economic Indicators

World Economic Growth (World Bank figures)	2005	3.60%	2004	3.40%	2003	2.90%
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Base rates: 29 Dec 2006	USD	5.25%	EUR	3.50%	GBP	5.00%
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MSCI World Equity Index	29/12/2006	235.243	31/12/2005	203.143	YTD %	15.80%
Gold (PM London Fix \$ per ounce)	29/12/2006	635.70	31/12/2005	513.00	YTD %	23.92%
Oil (WTI Crude \$ per barrel)	29/12/2006	61.06	31/12/2005	61.04	YTD %	0.03%

Christmas is a time for reflection but December already seems a long time ago. At the end of December a number of economic statistics came out that indicate there could be a tipping point in 2007 that might disrupt the “more of the same” economic trends that carried us through 2006.

The US economy seems to be slowing down gently; but the Fed looks poised to raise interest rates as the new Democrats are threatening to interfere with the Fed’s carefully balanced thought processes which are grappling with the problem that incipient and imported inflation is rising.

In Europe and the UK money growth is still rising rapidly, compared with economic growth. Rising food costs, partly as a result of grain being diverted to alternative energy, the rise in German VAT and rising energy costs are creating inflationary pressure. Here again this must tilt the probability of the BoE and ECB increasing interest rates.

In China, financial managers of the economy are pushing up domestic costs at the same time as encouraging domestic consumption; the latter in order to try and rebalance the economy in favour of domestic rather than export driven growth. A series of policy straws indicate that quite significant changes that are taking place: big salary increases for some 120 million employees of state companies and civil servants; increasing prices for domestic oil, gas, electricity and water; further reductions in tax benefits to exporting companies; and measures to discourage exports of some raw materials. Fiscal measures to encourage state owned companies to pay Dividends will further encourage domestic consumption at the expense of capital investment. These various measures will push up the cost of Chinese consumer goods to the rest of the world with the related inflationary consequences.

An interesting comment in the FT just before Christmas from a strategically minded Government:- *China Curbs Corn Ethanol Production*. The Government is worried about the effect of growing ethanol production on the price of food. To quote further from the FT: *The growth in US Ethanol production is the key feature behind the 75% rise in US Corn Futures to a near 10-year high of \$3.76 a bushel.*

There is also appearing a new wildcard in the global banking sector. While the general increasing concern about a financial crisis in the low grade bond sector gathers pace, pushing up interest rates and reducing liquidity, the possibly unintended consequences of Basle 2 could precipitate a credit crisis.

The Bank of International Settlements, Basle 2 rules are a formulaic process for judging banks capital adequacy standards. The F.T. mentioned in December that Japanese banks as a consequence of the new rules coming into force in March '07, were liquidating holdings in Hedge Funds and Funds of Funds as a consequence. The formulaic nature of the Rules could have other bizarre consequences on large sectors of industry. For example, in the materials processing industries, where raw materials are a high percentage of the cost of sales, companies' turnover rise faster than profits as commodity prices rise. Under the Basle 2 rules this would make them less credit worthy and consequently less able to finance their turnover, creating a potential liquidity problem throughout the sector. The knock-on effect into manufacturing and food processing is difficult to anticipate.

In 1994, a confluence of different phenomena created an unanticipated credit crisis. With the re-rating of low-grade debt, rising interest rates and Basle 2, a similar explosive mixture could be brewing.

My apologies for casting a little cold water on the prospects of a benign year ahead.

Damon de Laszlo
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