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
R.J. Griffiths

Tel: +44 (0)20 8879 6116
Fax: +44 (0)20 8944 6920

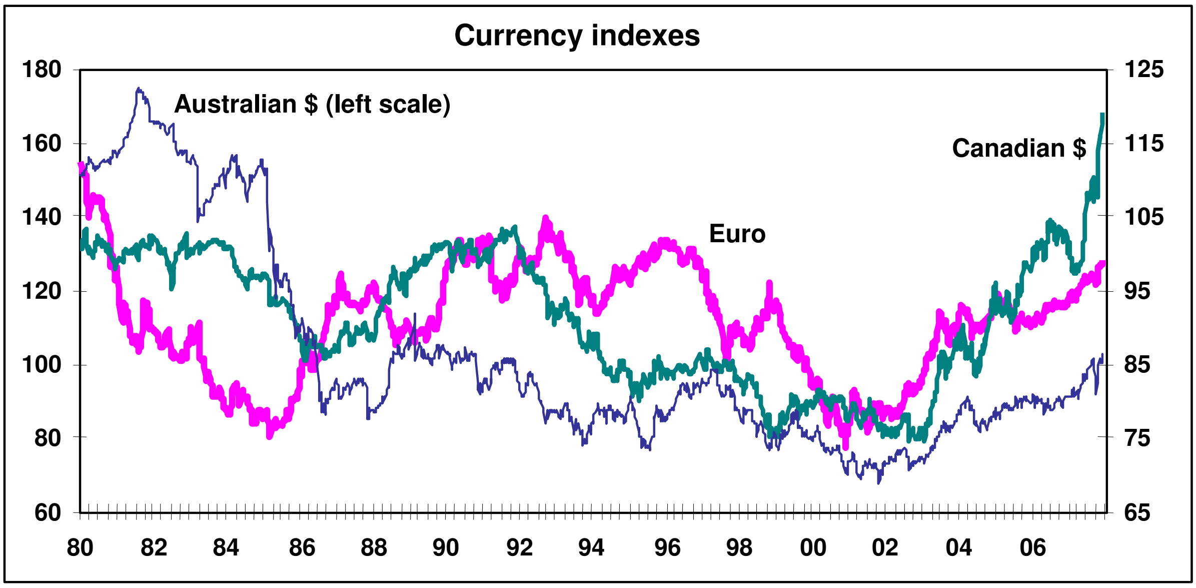
email: halkin@halkinservices.co.uk

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

Weekly Letter no: 247 **8th November 2007**

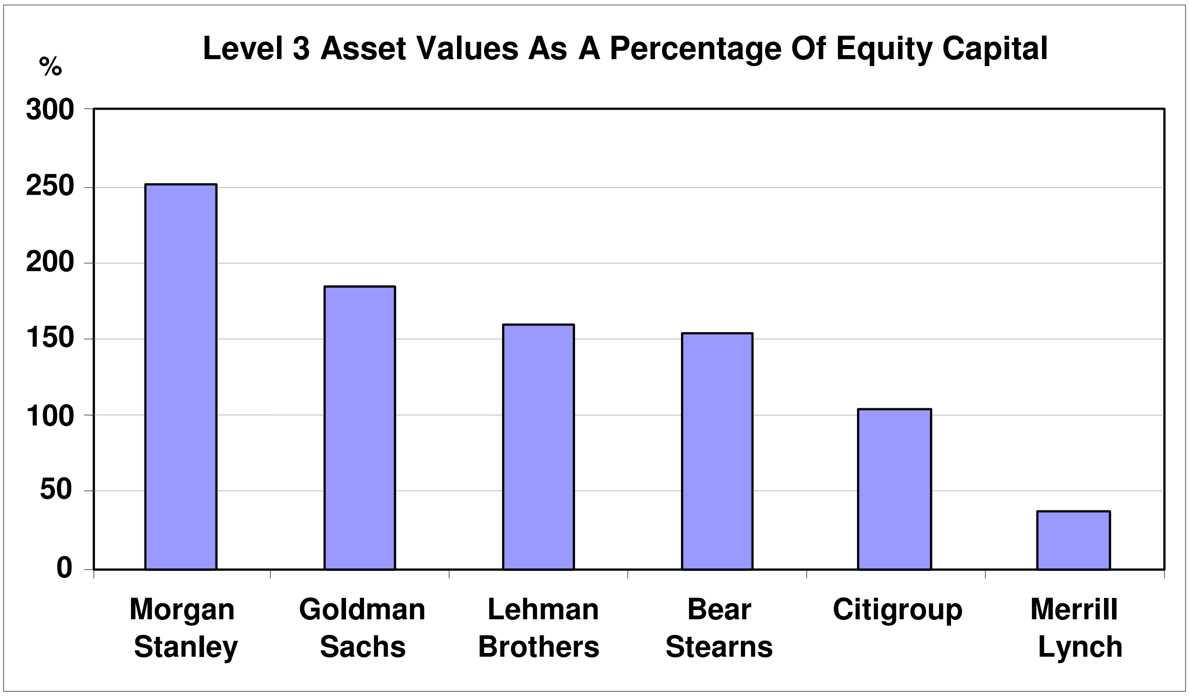
CANADA'S VIRTUOUS CIRCLE

No sooner had the ink set on reports of Alberta's new royalty regime, than Canada's government delivered a mini budget. Billed as a Fall update, finance minister Jim Flaherty announced swingeing corporate and personal tax cuts over the next five years. The biggest surprise was a commitment to cut the corporate income tax rate from its current 22.1% to 15% in 2012. Previously, this rate was set to fall only to 18.5% by that date. That Canada was able to consider the announcement of this C$60bn multi-year package is evidence of a fiscal surplus that has ballooned due to soaring oil and commodity prices. Individuals will benefit from a cut in the General Sales Tax from 6% to 5% at the start of next year and, retrospectively, from higher income tax thresholds and a cut in the tax rate for the lowest incomes. It is estimated that this fiscal relaxation could boost Canada's GDP by up to 1% in 2008. Many will complain that the appreciation of the Canadian Dollar will demolish the competitiveness and profitability of its domestic industries and that a North American strain of Dutch disease will set in. However, in such a large country, it is easy to forget that the population is only 33 million. The unemployment rate is close to a thirty year low and the balance of payments is in healthy surplus. It is possible to argue with Canada's response to its windfall gains, but this generalised tax cut will enhance business incentives and help to create replacement employment. At some point, the Bank of Canada will have no further reason to raise interest rates, but, until that time, the Canadian Dollar has scope to set new records having broken through the 1957 high *versus* the USD last week. Canada has positioned itself as the natural resource currency par excellence and a prime candidate to benefit from the re-deployment of official reserves into Sovereign Wealth Funds. Commodity-related setbacks are inevitable, but Canada's fiscal strength allows scope to mitigate its worst effects.



MARK TO MYTH WILL NOT STAND THE TEST OF TIME

In *Letter* 238 we alluded to the esoteric US accounting standard known as FASB 157, which is due to be adopted on 15th November. However, some financial institutions adopted early and have shovelled billions of Dollars of illiquid assets into the Level 3 bucket during the course of the year. As Nouriel Roubini has argued in his 5th November posting, new regulations will limit the ability of financial institutions to continue this practice. The unfolding mortgage crisis has created many contexts of thin trading and wide price spreads. For the owners of such assets, it is highly convenient to regard these as distressed markets in which a fair price cannot be observed. However, this interpretation looks certain to be challenged by the SEC. To gauge how significant it would be for Level 3 valuations to be replaced with more accurate valuations based on comparable assets, the chart shows the importance of Level 3 assets relative to the equity capital of the leading Wall Street firms. Morgan Stanley raised the absolute value of its Level 3 assets by 37% in the third quarter of 2007 to US$90bn. Professor Roubini reckons that the credit-related losses will run into hundreds of billions of Dollars and that the on-going credit crunch will get much worse in the year ahead, spreading to Europe, Asia and beyond.



GOLD PRICE HITS THE HEIGHTS

The price of gold, particularly in US Dollar terms, has entered its parabolic phase with $850 per ounce in its sights. Analysts have begun to address the extent and timing of a correction, but Adrian Douglas believes that no major correction is imminent. He believes that the prices of gold and silver are in equilibrium with their market dynamics and are not overbought. On this analysis, the rallies in both metals look very young and healthy.

IS THE BALTIC ROLLING OVER?

I am indebted to Geordie Kidston, senior research officer at J M Finn, for an analysis of Baltic shipping rates. The Baltic Capesize Index fell 9% last week in the first hint that the China boom might be flagging. This index has risen from around 6,300 in late June to a peak of over 15,000 last month. Geordie reckons that the recent 10%-plus hike in domestic fuel costs in China may have triggered the correction. The JP Morgan global manufacturing PMI fell by 1.4% in October to a 2-year low. The combination of softening US-driven Asian growth and significant additions to freight capacity out to 2009 will weigh on freight indices for some time. According to Clarksons, new build will add 29 million tonnes to bulk shipping capacity next year and over 130 million tonnes in the following years, with 2009 as the peak.

DIARY DATES

We commend to you our lunch with Jonathan Chew, managing director of Imara Asset Management on Monday 19th November at El Vino. Jonathan led the team at GT that launched the first African mutual fund in 1995 and has developed strong expertise in the continent. Charles Morris of HSBC comments that Africa is the place to "find uncorrelated, high-return equity exposure". Please sign up to broaden your investment horizons and hear what Africa has to offer. Names to Patricia, please.

We are delighted that Derek Musgrove, managing director of Northern Petroleum, has agreed to be our speaker at a dinner on Tuesday 4th December at the Draycott Hotel. Derek will speak on an oil-related theme.

Peter Warburton

EUROPE'S POLITICAL DISARRAY

The Reform Treaty has been the focal point of EU activity for months, and will continue to be so as it treads the rocky path to ratification. The treaty is important in its own right, but the ratification process highlights other, fundamental issues confronting the EU, most importantly the political cohesion of its membership. Political volatility within the eastern fringe of the EU's newer membership is understandable – these countries are learning how democracy works. What is more surprising is the disarray apparent in countries closer to the EU's core. Belgium, the totemic centre of the EU, has not had a government for five months and, as EUobserver says, "a quick solution remains unlikely". The story is headlined 'Belgium government difficulties could endanger EU treaty ratification'. That is because, "Legal experts now fear that if Belgium fails to have a new government by 13 December, the outgoing government … will not have the powers to sign the document."

In Denmark, a snap election has been called for next Tuesday, with an increasing likelihood that this, too, will produce a political stalemate. *The Economist* (November 1st edition) examined the likely outcome under the headline 'A new centrist party may complicate coalition-building after November 13th': "the emergence of a new force in Danish politics: Naser Khader, a Syrian-born 44-year-old ["secular muslim"], who set up a new party in May with the aim of emasculating the Danish People's Party. Polls suggest that Mr Khader's New Alliance might capture 10% of the vote, enough to make it a potential king-maker between left and right."

Denmark does not currently plan to hold a referendum on the EU treaty (although that might just possibly change after the election), but Ireland is different: it, alone among the EU's 27 member states, will hold a referendum in the early summer of next year. Another EUobserver story highlighted the surprising fact that the 'Irish [are] largely undecided on EU treaty'. That conclusion was prompted by a survey conducted for *The Irish Times* which showed only 25% in favour of the treaty, with 62% undecided. A similar survey conducted in March 2005 found 46% in favour and only 12% against. The reason for the shift is not hard to identify: Ireland has enjoyed an enormous economic/housing boom, largely attributed to its EU membership, but that bubble is now bursting. Naturally, the EU is seen as the culprit. Consequently, as EUobserver says, "Ireland is expected to become a battleground for pro- and anti-EU campaigners". And the outcome is far from certain.

Meanwhile, the cracks are beginning to show in Germany's 'grand coalition'. There is no threat to the EU treaty there, but the policy inertia of the last 18 months is gradually turning into a U-turn as the left wing of the CDU competes with the SPD in its determination to unravel Schröder's hard-won labour market reforms. It almost makes France look like an oasis of political stability and resolve…

FRANCE: FISHING FOR SUPPORT

… except that France seems to be up to its old tricks again. There is a long tradition in France that disgruntled farmers and fishermen take strong (often violent) action to protect their 'right' to a livelihood. There is an equally strong tradition that the government eventually caves in to their demands – which is exactly what Nicolas Sarkozy has done to appease the fishermen who have been blockading the ports of Normandy and Brittany. €21m of fuel subsidies was instantly forthcoming.

Robin Aspinall

CHINA: BUBBLING

Now it's just silly. PetroChina tripled in price on the day it listed, giving the company a market value of more than $1 trillion and turning it into the world's largest company by market capitalisation (worth more than ExxonMobil and Shell combined). There may be details and disclaimers – not the least being that only a tiny proportion of the shares were on offer – but this is absurd. China is a big and fast-growing economy, worthy of respect for those facts both today and in anticipation of even greater achievements in future. Nonetheless, financial values are becoming as distorted as they were in Japan in 1989, when the Emperor could theoretically have sold his palace in central Tokyo and bought most of California.

Edward Chancellor, writing in the *Financial Times*' FTfm supplement on the same day that PetroChina was listed (5 November, 'Bursting China's bubble could hurt'), noted that "current trading volumes on the Chinese exchanges are so large that broking and stamp duty charges actually exceed the total profits of listed companies". As if this were not enough: "The reality is even worse because a growing chunk of profits comes from companies reporting gains from playing the market." In Japan, we used to call that *zaitech*. It wasn't good news then, and it is hard to believe it will be now.

As if to emphasise the fact that the day's news should be treated as a cautionary tale rather than a reason to celebrate, Hong Kong was experiencing excitements in the other direction. The market has surged this year in anticipation of a Chinese plan to allow mainland Chinese to invest directly in the HK market. This was known as the 'through train' approach. With the news that the train has been pushed off into sidings indefinitely, the market fell 5% on the same day as PetroChina was beating records. This is a modest fall compared with previous gains – since the proposal was announced on 20 August, the HK index had risen by almost 50% – but it is a reminder of two things. First, the market is priced for perfection. Failure to deliver perfection causes exaggerated disappointment. Second, such anticipation of an impending 'wall of money' is another reminder of Japan in the late 80s. Walls of money have a disconcerting habit of being more anticipated than real.

All in all, it is time to be very sceptical about Asia's hyper markets.

JAPAN: YES, NO, MAYBE

Meanwhile, in Japan, it is confusion that rules. Economic headlines are full of gloom as the leading economic indicators hit zero in September, for the first time in a decade. Could there be a greater contrast between China, so full of fizz, and Japan, whose bubbles went flat a long time ago? On the other hand, I wonder whether we shall still be saying that a year from now? Japan stands as a reminder that hubble bubble is followed by toil and trouble.

Political headlines speak of the resignation and unresignation of Ichiro Ozawa, leader of the opposition DPJ (Democratic Party of Japan). As of writing, he is full of contrition and back in charge again, having resigned in a huff over the weekend. This is a curious state of affairs, given the DPJ's success in the summer upper house elections. A majority in that house has given the party a veto over policy, which should have left Prime Minister Fukuda with the real headache and Mr Ozawa smiling.

The incident is probably best seen as jockeying for position, with both leaders trying to find a sustainable way to manage the situation (it's not obvious there is one). Meanwhile, the direct impact on economics or finance is likely to be limited. It is the imperative of managing the government debt burden that is setting the agenda for politicians, not the other way round.

Robert Brooke

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