

Odey Asset Management



ODEY EUROPEAN INC. BI-ANNUAL REPORT

Six months ago in the midst of strong market moves we hazarded that 2004 was likely to be much more problematic than investors were forecasting. We cited three areas of consensus – the plight of the dollar, the direction of stockmarkets and the strength of the world economy - and in each case felt that consensus would be confounded. It has been. However, whilst we were bullish of the oil price and indeed have been forecasting a \$50 per barrel price since 2002, even we failed to realise how quickly our dream would come true. For us the crucial uncertainty has come from the fillip to economic growth given by individuals in G7 countries spending ten percent of the gain made from the price rise in their house. All the tosh written about productivity gains last year was nothing more than wage earners choosing to borrow money and spend rather than asking for higher wages. A simple model of a company highlights this effect. Year 1 Sales 100, labour costs 88, profit margin 12. Year 2 Sales 106, labour costs 88, profit margin 18. If in this year wage claims rise by 5% but housing profits decline and are therefore not spent, Sales 105, labour costs 93, profit margin back to 12. That is precisely what I think is the likely outcome for next year. This was likely even before the oil price started to reflect the imbalances between demand and supply. The oil price rise is interesting because it is not altogether terrible for central bankers. A shock to the system which produced an oil price of \$90 per barrel would profoundly alter wage patterns. Central bankers, worried that debt is too great relative to incomes, must welcome anything that encourages incomes to rise relative to debt. Equally, and most importantly in view of the pressures arising from increasing globalisation, a rising oil price disadvantages emerging economies more because they are less efficient energy users.

Globalisation becomes less of a threat if this scenario pans out. So what are the chances

that we get a \$90 per barrel oil price and wage inflation? It is probably no more than a 35% chance but interestingly, of course, it is given no chance by the markets and therefore would produce great opportunities for the fund.

The main likelihood still remains that, when combined with the hike in interest rates and oil price rise that we have already seen, a government spending cycle which is poised to decline next year will produce, at the very least, a profits recession but as likely a decline in real GNP synonymous with a proper recession. Without a hike in both oil prices and wages, this fall in economic activity will re-establish the deflationary pressures that so frightened policy makers back in 2002. The major worry being that if this scenario starts to pan out there are no further cuts in interest rates possible. We have for years drawn attention to how central bankers have been willing to countenance asset bubbles to keep nominal GNP rising and we have warned of the dangers that can follow when such bubbles burst, but now, without an inflationary shock, economies should start to suffer from a deflationary embrace similar to that which hit Japan in 1995. Never have western banks been less prepared for what is about to hit them. Every borrower has been encouraged to borrow short term and expects to refinance within two years. The economic growth of the last few years has arisen from the fact that the borrower is only looking at what he has to pay in interest and has no intention of repaying the principal borrowed, but the lender still lives under the illusion that he has an asset equal to the principal amount lent. When banks are lending forever money on a collateralised basis, and individuals have given up term-structured borrowing, nobody thinks about redemption yields. That has created the property bubble and it will only be the reintroduction of a pay back period by lenders that will pop the bubble and drive asset prices ever lower. All that is in the

future. For now, the rise in interest rates in the UK appears to have halted the binge in mortgage lending. With 3 month libor rates back in line with base rates, the pressure is off for those banks who have been over-lending. It does mean that we will start to see a marked slow-down in consumer spending in this third quarter in the UK. Our recessionary scenario should start to play out.

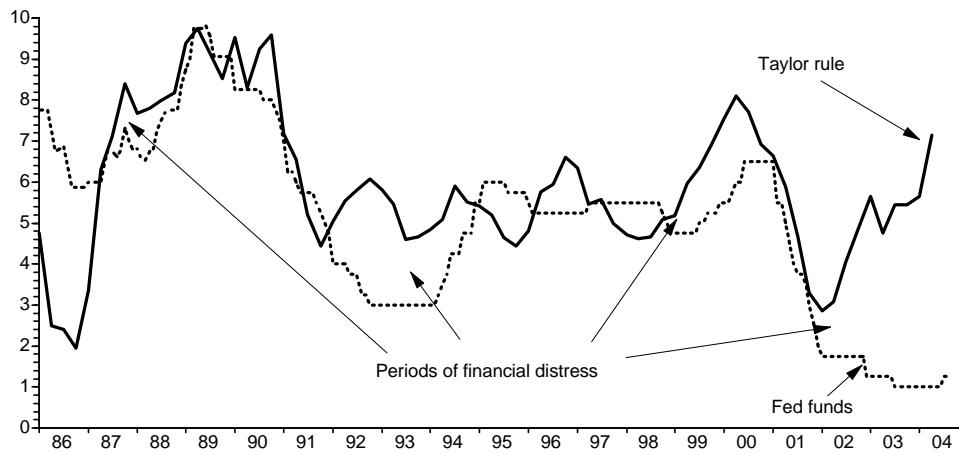
Have markets already discounted all this? They have all been quite weak since February, falling by some 8%, but there is little of this thinking around the market. On the whole the consensus remains convinced that economies are still on a recovery path and that the weakness that we have seen is a reaction to the higher oil price. As we showed earlier, profits growth was startling last year and only recently have there been signs in the traditional cyclical sectors – semiconductors, shipping, commodities – that the peak of the cycle might be past. This has meant that the fund has continued to be defensively positioned. Indeed throughout this year we have had a net short position, something we have never before contemplated for longer than a month.

Performance has been disappointing and only now is the fund's return starting to be positive. The ten percent rally in stockmarkets late in March and into early April resulted in a five percent fall in the fund. Since then the accent has been again on making money but at the same time being very careful not to lose any. Markets have been very unvolatile even though individual shares have been. This has presented difficulties because of how we protect our risks. This year has favoured those who have been stock pickers where the diversification of their portfolio is allowed naturally to reduce their risk. They suffer when the markets become more volatile. In the meantime our research capability has grown immensely and that is now allowing me to put on larger positions, knowing exactly why we have a different view and feeling that it is being re-examined as often as is necessary. Before, given how much was going on, it was difficult to have the ideal size of position for the fund. Watch this space.

We touched on the subject of volatility but it has been remarkable how little bothered the markets have been in the face of a deteriorating situation in the Gulf, weak economic numbers and signs of bubbles in the housing market that may need to be burst with higher interest rates etc. Nick Carn has written about how de-sensitised individuals have become, how the endless disasters and crises inevitably lead individuals to expect yet another shock to appear tomorrow and that maybe it is time for the markets to get bored and boring. He has a point, and it certainly appears to be the situation now, but the way that the stockmarket in the USA only picked up the economic recovery a year after it began, means that to me stockmarkets have become more hooked on credit than profits, a fact only strengthened by how much of quoted companies' profits come from banking, insurance and capital markets. If they have become blind then where do you and I go to see the future? In this regard the current vectoring of the Gadarene swine into hedge funds, says more about what they don't like than what they are buying. The peace movements of the early 1930's told only of the fear of war.

For me the outcome of the current times seems impossible to predict. Moreover, that outcome will make for radically different methods of wealth preservation. What is certain is that, even after five years in which European stockmarkets have gone nowhere, the downside still seems to dominate the horizon. As Peter Hargreaves of Hargreaves Lansdown wrote, the unwillingness of central bankers to allow recessions is starting to look dangerous, because not only has it encouraged the wrong kind of risk taking but also complacency amongst the ignorant. **(See chart, courtesy of James Montier, DKW.)**

We have long gone on about too much sunshine creating a desert and an example of this ennui amongst consumers is how car sales slumped in the USA in June even though concessions had been markedly stepped up in May. Nobody has successfully forecast the level of credit in the economy that causes it to nose-dive, but we are all aware that there are more raffle tickets than prizes hanging around now and that living



An example of Greenspan's asymmetrical Monetary Policy. Interest rates which should be at 7% and currently at 1.5%.

off the windfall profits on one's house had all the solidity of going to sea in cardboard boat. What is worrying is that even as credit has expanded, trust has contracted. The laws of property have been weakened over several years but the boom in assets has hidden the fact. A downturn in assets which started to cause distress amongst the electorate could easily be ameliorated by changes in the law of contract. In the UK the latest insolvency law appears to allow those with debts of under £15,000 to walk away from them, ensuring that banks will have to write off all those student loans they have been making. In Spain it appears that any bank with a shareholding in a client will see its loan subordinated to the level of equity. All seems to be done with barely a squeak of opposition, but where the creditor cannot gain access to the underlying asset in the event of the debtor's default, the shareholder should not expect a dividend on his investment. L'occhio del padrone ingrandisce la vendemmia.

share price falls. **BSkyB** at £4.50 puts that company on a cashflow multiple of under ten times historic numbers and ensures that no future growth in viewers is now being discounted. Provided that James Murdoch does nothing demographics alone will oblige. Equally, **Converium** in Switzerland, after falling by 80% in price after revealing the reinsurance losses suffered in 1999/2000 thanks to the chicanery on Wall Street, means that shareholders stand to make a 30% return on their invested capital over the next few years. To the extent that it is becoming a stock-picker's market I feel confident we can make money, but the unwillingness of the Fed to run anything other than asymmetric monetary policies means that one eye has to be constantly on the look-out for the disaster that will inevitably follow at some stage. At that moment the difference between being roughly right and absolutely wrong will matter.

Crispin Odey, August 2004

Having written all of this there are opportunities starting to arise out of recent