

## **Odey Asset Management**

### **ODEY EUROPEAN INC.**

There are some stories that are symptomatic of their age. “No Debt please we’re British” is the rag to riches tale of a windscreen salesman from Southport called Mr Meadows, his blushing bride Michelle and their little problem that just kept on getting bigger. Little did Mr Meadows know, when he took out a £5,750 home improvement loan in 1989 that this debt would have grown to £385,000 by 2004. Unable to service this debt and faced with financial ruin, he turned to the courts for salvation. It is a simple lesson in compound interest and in what can happen when consumer balance sheets are stretched too far. Luckily there is a happy ending to this tale. The local magistrate of Liverpool Crown Courts ruled that the 34% rate of interest was usurious and that the outstanding debt should be cancelled, concluding with unparalleled insight that part of the problem was “the long period without re-payments made.”

To our minds this is a cautionary tale which delineates many of the reasons for our bearish stance on markets. In the UK mortgage equity withdrawal has been the principal source of funding for the purchasing appetite of the individual (see above). This source of funding can only stretch so far. Payment by plastic tends to prove less than elastic when debt capacity reaches its ceiling. Yet it is this consumer spending impetus that has spurred topline growth in 2004. More importantly, this top line growth has been unaccompanied by wage inflation. In the UK, public sector wages have compounded at +6% pa over the last five years, whereas in the private sector wages have remained flat with increased borrowing taking up the earnings slack. Next year either wages must rise or sales must fall. Either way we believe in a profit recession in 2005 and it looks like the bond market is agreeing with us.

The twin engines of economic recovery: fiscal stimulants and re-financing have both broadly run their course. The market is right to be increasingly focused on the US Non-Farm Payroll numbers as wage and employment growth are all that can stave off a recessionary bite. On our numbers we are at the peak of the economic cycle and so we derive little enthusiasm for broader European indices albeit trading cheaply on 12x earnings. For the most part European profits have been insulated from the deflationary pressures of Asia. High shipping rates are protecting European cost bases from low import prices. This phenomenon will only last as long as shipping remains in short supply. Likewise the Eurotop’s exposure to the financial industry, where profits are peaking, is a cause for concern. Our friend Mr Meadows provides a timely reminder that loan recovery can prove problematic. It will be the asset price cycle and not the interest rate cycle which will come to dominate the fortunes of Europe’s banking sector as the underlying collateral gets marked down and classic credit cycle dynamics kick in. Under this scenario low interest rates become bad news for banks.

The third quarter proved remarkable for its seemingly contradictory outcomes. Who would have guessed that those unlikely bed fellows “bonds” and “oil futures” would both have their best performance in the same quarter? Or that cyclical stocks would rally to the tune of a flattening yield curve? To our mind however, this is symptomatic of the fact that the economy seems finely poised between a binary outcome. Either inflation or deflation. Whilst we would ascribe a higher probability to deflation and would agree with the bond market in this regard, it should be recognized that inflation better sings to the authorities’ hymn sheet. Inflation after all pacifies the pension crisis and cures, through natural attrition, personal debt. Certainly asset values suffer in real terms, but at least systematic risk can be avoided. Since 1974 house prices are up 25x whereas CPI is only up 9x; some mean reversion wouldn’t be amiss. It is for this reason that we remain bullish on both oil and China. Ironically, the interest rate necessary to temper the oil bull would uproot the financial sector. Likewise China will continue to benefit from an interest rate that is too low for its level of economic activity.

The portfolio is attempting to capture this inflation/deflation dichotomy through large weightings in special situations which, through their non-correlating characteristics, tend to provide insulation from deflationary headwinds. OPAP, the Greek lotto operator is a good example of this. Shareholders will continue to profit from the Aegean addiction for lucky lotto numbers as the Greek government attempts to lure the E5 bn of illegal gambling onshore. Another good example of non-correlating risk is the Swiss re-insurer Converium.

There is an old adage amongst fund managers to “beware the bearded CEO.” Certainly investors in Converium would have done well to heed this warning. The CEO of Converium, Dirk Lohmann, sports a beard. There have been several profit warnings under his stewardship as well as a rights issue and a halving of the equity value. Converium, you will recall, is the re-insurance arm of Zurich Financial services, spun out a few year’s ago to great applause. Growth opportunities were being pursued in the US and especially in the highly lucrative “D&O” insurance practice. Insurance is a game all about loading the dice of risk and, in a post Spitzer world, it became clear that Converium had made a mistake with its maths. That is the history of the company and of the share price. However there is nothing like three profit warnings to trim back consensus profit expectations and the CEO’s beard. In his newly tonsured form, Dirk is repentant. The truth is Dirk became CEO after the US acquisitions and had not yet had time to apply his cost cutting pencil to this hospital pass. Today, however, the share trades at 60% of book value for an insurance business whose European operations are still very robust. Indeed, even if the US was to be shut down tomorrow or “run-off” to use insurance vernacular, shareholders could still look to make a 50% return. This provides compelling risk reward asymmetry.

Opportunistic positions have been taken in sectors where the risk of inflation has been mispriced such as in some of Europe’s battered chemical stocks where early signs of pricing power are bucking the deflationary trend. Names include Solvay and DSM. Moreover we remain bullish on oil and oil stocks. Our preferences have migrated from

the more speculative end of the curve, these names have had their fun, towards the oil majors. We believe that we are in T. Boone Pickens territory.

T.Boone Pickens was the now legendary oil baron, who as CEO of Mesa Petroleum burnt \$300m in failed exploration projects. In an inspired move of double or quits he spotted a market inefficiency and bet the ranch, in his case literally. Gulf Oil (now Chevron), one of the Seven Sisters, was trading with an implied valuation for its oil reserves well below the actual oil price. Having blown his fortune trying to discover oil, Pickens reasoned he could make a fortune buying someone else's and so he launched a bid for Gulf Oil, sparking a takeover frenzy and multiplying the value of his original stake.

Forward to today and T.Boone Pickens would no doubt be up to the same tricks. The ten year oil future trades at \$38, yet the implied oil price in the cashflow valuations of European majors is \$22. In theory an arbitrageur could bid for Total, short the 10 year oil future and make \$16 a barrel for free. In practice this simply highlights that by using the 10 year oil future price, even the sleepy behemoth Royal Dutch has 90% upside and the Norwegians – Statoil and Norsk Hydro – could more than double. T.Boone is turning in his grave.

The same is true of the fertilizer market. Profits have been strong through this year on the back of high ammonia prices, which take their nod from Henry Hub. Yet the stockmarket values at little the chance of this pricing strength surviving the winter and more importantly the crop cycle. Conventional wisdom suggests that less cash for his crop will mean that the farmer spends less on his fertilizer. This is to misunderstand the productivity gain of fertilizer on yield, which is fourfold. The farmer cannot afford NOT to buy. Further, low wheat inventory levels in a record harvest year point to ripe returns for farmers through to 2006. Yet fertilizer stocks such as Norwegian Yara trade on a mere 6x earnings. Much like the oil shares above, Yara's valuation prices in no perpetuity to its current arable returns. In sowing our investment oats Yara stands out as a stock for all seasons. We are buyers.

Just to recap. We expect the outcomes for next year to be:

- A 60% likelihood that wages fail to keep up with the crimping to standards of living resultant from the rise in interest rates and general price rises this year, so much so that 2005 is a recessionary year.
- A 30% chance that we witness wage increases which both compensate for this year's cut in real wages, but introduce broader inflation into 05 statistics.
- A 10% chance that the oil price returns to \$25 per barrel and we forget the pain that 2004 has inflicted on the G7 consumer

Interestingly, whilst the bond market is happy aggregating the first and third percentages to endorse its view that rates will fall next year, the Stockmarket is relying on the 10% chance as happening, to justify current valuations. Our own portfolios have already

adjusted to take into account the 30% outcome. In this regard buying into those industries that are establishing pricing power – electricity, fertilizers, tyre companies, miners – makes us optimistic at least as to our out-performance of the markets.

*Crispin Odey*  
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