

## Annual Report 2007

*'This brings on the bulls. They tend to have no macro view to speak of. They are a younger generation with little memory of even the dotcom crash and certainly none of the 1990 recession. They go with the flow, finding plausible explanations to validate each successive rise, without fearing a reckoning. Asia and the developing world are growing fast. Core Europe appears to be warming up. The US economy may slow a little, but it will benefit from the weaker dollar against Europe and will muddle along. Interest rates may vacillate a bit, but who cares. Inflation is not a threat and is really something only the old boys still wearing their ties in the office talk about. The paradox is that most of these young Turks read Business Studies and Economics. A paradox because never have so many economic models failed. The Balassa-Samuelson model had a 100% record in forecasting that developing economies running large and growing current account surpluses who did not allow their exchange rate to rise against their trading partners would suffer domestic inflation that would effectively do the work that the rise in the exchange rate would have done. 100% accurate up until last year; China has shown it to be 100% wrong. Equally painfully have disappeared the Kitchin cycle, the Kuznets cycle, the Juglar cycle as well as many others that I have forgotten the names of. The survivors don't look that healthy, and I reckon there are only another few quarters' life in the Harrod-Domar one sector growth model. The Philips curve, at best a fair-weather friend, deserted us again last year as the US pay data revision in August confounded reasonable expectations of a marked pick-up in wage claims with unemployment so low.'*

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There is an African saying that 'sometimes an old man lying on the ground can see further than a young man at the top of a tall tree.' I like the word 'sometimes'. However, last year the guys wearing the ties saw furthest. Indeed they were probably out done by the even older guys wearing the cravats. Unusually in my case, this was all achieved without breaking into a sweat. Markets which had seemed impossible to read for the previous two years because they did not listen to the past suddenly started to fall over as they encountered worries that they had not known existed. Who would have believed that a bear would have got into the inter-bank money market?

Of course in the language of the markets not much has yet been said. Emerging markets have continued on course for the moon; Developed world markets have crept along silently but not painfully. There are more red faces than red ink at present. However, the future is now rather more clearly in outline and with it comes the realisation that it is not going to be easy for the authorities to keep the show on the road. Five years of living off expanding balance sheets has not so much grown the world economy as bloated it. Expanding the waist line has turned out to be no solution to improving the metabolism.

The banking sector has been the unwitting author of the coming disaster. The story of Northern Rock is instructive. Here was a widely admired and highly successful financial institution, which failed but not because of the normal banking weaknesses of bad lending or misfeasance. Rather it had grown too fast

and too far from its foundations. It started almost 10 years ago with a fairly harmless habit of extending its growth a bit beyond its normal capacity through selling some mortgages and using the proceeds to lend again (securitisation). Encouraged by experience and applauded by observers, this top up activity gradually expanded until by 2007 it had become the core business. Northern Rock had ceased to be a conventional bank; it had become a debt originator and loans were growing at 40% pa. For some time the Bank of England had warned that it would not advance money against mortgage collateral and as gravity was switched back on it became clear that NR were just one part of a debt creation process, and could not survive without the continued connivance of their funding counterparts - the investment banks and their clients. Little by little they had lost control of their destiny and there was no way back.

Another example is Intermediate Capital Group, the established and respected mezzanine finance provider. In common with other private equity market participants it had dealt with the difficulty of negative carry on deals in recent years by accepting PIKs (Payments In Kind) instead of interest. During asset inflation the practice flourished, but now, as the tempo slows what started as money has turned out to be smarties. ICP announced a rescue rights issue today.

What were the authorities thinking when they revoked the Glass-Steigel Act which had carefully ensured the separation of investment banks from money centre banks? The nature of investment banks is to be transaction-orientated, focussing on the short term. The strength of general bankers is that they are relationship based and forced to think long term. Put the two together and the investment banker's quick buck approach starts to predominate, simply because that is where the profits are greatest and most immediate. Very quickly the game becomes how much can you package and how little can you can commit. SIV's spring instantly to mind. In the hang-over stakes, it is not yet mid morning. Surely we will see some re-enactment of this post 1929 legislation later this decade?

However, for my money this year is going to be dominated by rising WAGES. For the last twelve years the OECD has enjoyed an exceptionally benign inflation environment thanks largely to the influence of cheap labour in the developing world helping to cap wage pressures in the developed world. We are now experiencing exceptionally high cost of living increases thanks to commodity price increases and 20% + per annum wage growth in emerging markets; yet so far wages in the OECD countries have not started to move. It seems hopeful to believe that this will continue, even into a developed world downturn.

Thanks to the banking crisis, interest rates may fall in the short term, but inflationary expectations are rising and if I am right then the rise in wages this

year will surprise everybody in much the same way as the insidious inter bank bear. It will be compounded in some countries by their falling currencies..

In the U.K. for example my expectation is that sterling will fall some twenty percent against the euro and nearly that against the dollar. Simple maths suggests that the consequent import price rises alone should add some 7% to inflation, which is already running at close to 4.5%. Today's union pay demands of 7% may still be behind the curve!

At this point, I really cannot see how the Chancellor of the Exchequer or the Governor of the Bank of England can act to improve things from here. By April the effect of the credit crunch will no longer be confined to liquidity concerns; loan defaults and credit losses will be coming through too. House prices will be falling fast, and volumes will evaporate, whilst banks will be widening net interest margins to protect themselves and in the process driving ever higher the cost of borrowing. The Bank of England will be under enormous pressure to cut rates even though inflation will be rising and then we have a currency crisis like the one that Dennis Healey faced in 1976. So much for the monetary outlook. On the fiscal side, the UK Government's finances are so cyclically geared and their spending so out of control that by the end of this year, with a deteriorating economy, they will have to be talking about the most unpalatable taxes being raised. Possibly that may be the first time to start investing again.

Dominated by Germany and to a lesser extent France, Europe may be reasonably happy to have a strong Euro for its anti-inflationary powers. However, the PIGS, as they are known, will not be enjoying the ride. Portugal, Ireland, Greece and Spain will feel the pain and by the autumn will be envious that the UK, whilst it will have had the worst of this year, will be better set up to weather 2009.

The USA will suffer from many of the same problems as the UK -. they may easily be already in recession. They certainly have the same credit cycle problems. Wages should also start to misbehave. Furthermore they will have to contemplate a democratic victory in the autumn. Wall Street is fast becoming very unpopular auguring rising taxes for the rich. In this era of big government, which started in the USA with Bush jr as far back as 1998 and is ubiquitously entrenched elsewhere, the private sector must expect to be harried and taxed even as it finds itself coping with costs increasingly passing outside of their control. For the world the fact that the USA will be entering a collectivist era will weaken the spirit of free enterprise everywhere. I hope that you have thought about this because it will dominate how your wealth fares over the next few years.

We have already seen a little of this new world last month, when the state of Alaska decided to take another \$1.6 billion off the oil industry a year in taxes,

whilst at the same time revoking licences legally granted in the 70's which they felt were not being properly exploited. This action drives down the P/E for the oil companies and drives up the price of oil. There will be much worse to come because at present there is nobody to challenge the concept of big government.

So it is no surprise to find that the portfolio on the long side is defensively positioned. In the main it has not changed much. I remain overweight the property casualty insurers for their cashflow characteristics. Sadly one of my larger holdings, Kiln, in the UK, has been bid for by Tokyo Fire and Marine. I remain big in the agricultural sector, where prices from here should reflect wage rises in the West. Although the major part of the price rise in real terms is over, there is still nowhere else quite so good from where to watch the inflation story unfold. My biggest buying in the last quarter was of the food producers. They had a torrid time last year as rising input prices were difficult to pass on, so they announced profit warnings and their share prices duly fell. They still tell a story of woe, but it is difficult, given their minimal profit margins, for them not to pass on price increases. They sell at less than the replacement cost and they produce the staples which are supposed to be price inelastic. We shall see.

It is easier to see what to short. After such a long period of low interest rates, investors do not readily differentiate between a company enterprise value made up of 80% debt and 20% equity and one the other way round; with rising interest rates the difference will be plain. Small and mid cap shares had a harder year in 2007 but they still have further to fall in 2008. Likewise the banks have fallen by 30% over the last twelve months but they still trade close to 2 times book value whilst on the horizon rights issues loom. Too early to be a buyer. Stock exchanges defied gravity last year as investors still saw growth going out into the future, but in a world in which wages dominate, shares and share trading wilts. This year will be hard on these shares. Property will continue to do badly and so will the property retailers - the pubs and Big Yellow Group. After a halcyon period clothes retailers in the UK will suffer weak demand and rising input costs. Be especially worried if they are operationally geared like Next.

Currencies will be crucial, inflation is back and that means the carry trades will disappear. Some time this year even Japan will get inflation. Bonds have lived a charmed life but may be that is about to change. All in all then 2008 promises to be a roller coaster. However lying on the ground is not lying on the beach for this old man.

**Crispin Odey**  
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