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KWR Advisor Economic Survey

Please take a moment to participate in the following KWR Advisor Economic Survey. **Last month's results are HERE.**

To register your views on the questions below, please click on the following link. This should take no more than about 5 minutes of your time. Results will be published in the next edition.

Click **THIS LINK** to answer the following questions:

1) Where do you see the Nikkei at year-end?

2) Where do you see the Dow Jones Industrial Average at year's end?

3) Do you believe Japan is in the midst of a sustainable economic recovery? (Please answer on a scale of 1-10, 1 indicating extreme doubt and 10 indicating no doubt)

4) Who will win the U.S. presidential election?

5) Do you see another downleg in the US stock market during the summer?

6) Do you believe the government that is scheduled to be installed in Iraq on June 30th will be judged to be a success in one years time? (Please answer on a scale of 1-10, 1 indicating major failure and 10 indicating major success)?

Click THIS LINK to see the answers from last month's survey:

The U.S. Stock Market – The Looming Uncertainty

By Scott B. MacDonald

NEW YORK (KWR) Markets hate uncertainty. Unfortunately that is the one thing that is in great abundance at the present time. Brutal and deadly attacks against foreign oil workers in Saudi Arabia, ongoing conflict in Iraq, China's threatening behavior vis-à-vis Taiwan, North Korea's nuclear threat, and angst over interest rates in the United States have opened a Pandora's box of investor anguish. Even the U.S. presidential election offers no comfort as opinion polls indicate a close contest. Yet there are other, more positive signals – strong corporate earnings, ratings upgrades, and robust economic growth over the last two quarters. Malls are reporting a lot of foot traffic as the intrepid consumer is still out buying goods from Wal-Mart. Consequently, the U.S. stock market resembles a rollercoaster as bulls and bears seek to push and pull investors along. Who is right? Are we heading into another bull market period or is there another lap in the multi-year bear market looming? We lean toward the later.

The bulls argue the U.S. economy has returned to a path of sustainable growth, which in turn will help rectify the fiscal deficit and current account imbalance. The worst is over as strong economic growth will translate into corporate America going out and hiring. At last, the lagging indicator of unemployment will fall – just in time for George W. Bush to win re-election. The war against international terrorism will continue, but is likely to be controllable. There is only a small likelihood that a major attack will occur in the mainland United States – the struggle against the Axis of Evil and its allies is to be found elsewhere.

While some of the above bull scenario is accurate (stronger and most likely sustainable growth as well as an improved corporate performance), some of it is overoptimistic. The bears do have some valid points. The U.S. economy is carrying too much debt. According to Standard & Poor' U.S. households continue to set new debt records, with total debt (as of April 2004) at 113% of after-tax income. The consumer at some point must step back and replenish savings as the housing market is going to cool and employment generation remains a gradual process. We have already seen some correction in the housing market as the most recent data showed an 11.8% decline in new home sales -- the largest drop in 10 years according to the U.S. Department of Commerce.

In addition, the fiscal deficit and current account imbalance are not going away anytime soon. The latter could be greatly complicated by the trade policies of both the Democrats and Republicans, as both appear equally keen to be seen as the greater protectionist. Consequently, we have moderately strong economic growth, but weak confidence; improving performance from the corporate sector, but a slow approach to hiring; and a nation dependent on foreign trade and capital flows, but lead by political parties preaching protectionism.

How does all of this play to the stock market? The short answer is not very well. It sets an uncertain path in the weeks ahead. June 30 looms as a potential swing date – the FOMC meets to decide on interest rates and the U.S.-led coalition is scheduled to hand over sovereignty to an Iraqi government. Both events are important. The market anticipates an increase in interest rates to begin a new cycle. The Fed has claimed it will begin with a measured approach. We believe it will increase rates by 25 bps in June, again in August (25 bps), and possibly once more before the year-end – if the economic data supports such an action. There is a deep concern that if the Fed moves too quickly as it did in 1994, it could slow growth. We do think the path to raising rates and containing inflation must be carefully balanced with the fragile condition of the consumer and the housing market. There is a possibility if growth is slowed too much, these two parts of the economy could plunge – and that would certainly send the market into a tailspin.

As for June 30 and Iraq, the Bush administration has invested a considerable amount of its political capital into knocking out Saddam Hussein and replacing his dictatorship with a democracy. The invasion of Iraq was also expected to provide the American-led world order with longer-term benefits. By holding Iraq, the Americans could bring Saudi Arabia, Iran and Syria under pressure to make changes in their countries – along the lines of western democracies, while also putting acute pressure on the state sponsors of anti-Israeli terrorist groups.

Instead, the Bush administration underestimated the Iraqi resistance of the former regime (and new Islamic Jihadists), has been embarrassed over the alleged justification for the war (weapons of mass destruction which have not been found), and is now seeking United Nations help in finding a way out of the Iraqi mess. June 30, if all proceeds well, will begin to take the monkey off the back of the Bush White House. If it is postponed or the new interim government is unable to restore order (which is a distinct possibility), the turnover could be problematic, adding to market uncertainty (not to mention pressure on international oil prices).

Post-June 30, markets will still have to confront uncertainty around the U.S. presidential elections, which we expect to be very close. We still regard the contest as Bush's to lose, considering that Senator Kerry has not made a sufficient distinction between himself and the President in the minds of many voters, the divided nature of the Democratic Party (between the liberal and moderate wings which is hurting his ability to make a clear-cut message), and the gradual improvement in the economy. The Green Party candidacy of Ralph Nader could also hurt Kerry in a close election, much as it did Al Gore in 2000.

Despite that, Kerry has a track record of being a strong campaign finisher – as witnessed during the primary season in his performance against Howard Dean -- and there remains a lot of things that can still go wrong for the Bush presidency in terms of the economy and geopolitically.

We are in a multi-year bear market, which commenced in 2000. Considering the relatively fragile nature of market confidence, we think there is a strong chance of another pronounced downward leg in the Dow before the end of the summer. It could be precipitated by another major terrorist attack in the United States, a string of bad economic data or a confluence of negative factors on June 30 (a botched handover in Iraq and a sharp hike in interest rates). It is going to be a long hot summer for the stock market and gold is probably going to look better as the months move along. We should add that although the short-term looks potentially rocky, we do not see the U.S. economy falling back into a recession and the stock market toward the end of the year could have some bounce as some of the current uncertainties diminish.

Geopolitical Issues - Saudi Arabia Dominates

By Scott B. MacDonald and Robert Windorf

NEW YORK (KWR) Oil prices briefly peaked above $42 a barrel on Monday June 1, 2004. The primary driver of the price spike was a violent attack against foreign oil workers in Saudi Arabia over the preceding weekend. In response, OPEC members promptly vowed to increase oil production. Oil prices fell…for now. However, we now have in place the "al-Qaeda oil tax." Although more oil is to be pumped by OPEC, the threat of terrorist actions against the oil fields and foreign workers needed to work them, leave uncertainty of delivery, hence ongoing upward pressure on prices. We see oil prices at $35 on average for 2004 and $31 for 2005. [Prices are also likely to stay above $30 in 2005 due to the reluctance of the major international oil companies to commit additional capital to major new exploration efforts.]

Saudi Arabia is and will continue to be a critical battleground in the war on international terrorism. With its major Muslim holy places (Mecca and Medina) and the world's greatest oil reserves, Saudi Arabia is the ultimate prize for al-Qaeda. Should the House of Saud fall and be replaced by a new radical fundamentalist regime, the rest of the region will be at heightened risk. It is a historical fact that revolutionary regimes seek to export their revolution - we have seen this with the French, Haitian, Russian, Chinese, Cuban and Iranian revolutions in the past. A potential radical Islamic regime in Saudi Arabia would not be any different, especially considering that much of the current al-Qaeda leadership looks upon the world order as a clash of civilizations, which propels the needs for a large, centralized and militarily well-equipped Islamic state. Consequently, the recent round of attacks in Saudi Arabia should be seen in both the light of international oil politics, as well as the war on terrorism.

Over the weekend of May 29-30, a Saudi group affiliated with al-Qaeda claimed responsibility for the May 29 attacks in Khobar. The attack on foreign residences left 22 civilians dead, 19 of them foreigners (mainly Westerners and Indians). This was the fourth such incident involving suspected Islamist militants in the Kingdom during May. It followed the May 1 attack in Yanbu on an oil installation that left five oil workers dead, the May 20 clash between Saudi security forces and militants near Buraida (in which most of the militants escaped) and the May 22 shooting of a German expatriate in Riyadh. Despite Saudi assurances that al-Qaeda was no longer a force in the Kingdom, Khobar was followed by a new attack on U.S. military personnel on June 2, when gunmen opened fire on two vehicles leaving a military housing compound south of Riyadh. No one was killed.

Khobar is significant for four reasons. First, the attack was a skilled operation, reflecting well-disciplined training and considerable forethought. The attackers wore uniforms to disguise their approach, there was a specific choice of targets (Westerners and Indians), indicating an solid knowledge of the attack sites, and three of the attackers escaped. In addition, the attack was very similar to the earlier Yanbu attack: both assaults were against Western energy company employees, struck several target sites and attackers dragged the body of a victim behind an automobile. This was a calculated and brutal action meant to shock.

Secondly, the assault on the House of Saud has intensified as the terrorist action occurred on the oil rich eastern side of Saudi Arabia. This marks a distinct shift from most previous attacks, which took place along the west coast and in and around Riyadh. As one intelligence service report (Stratfor) notes: "The militants might be sending a message to Saudi authorities -- as well as to foreigners in the kingdom -- that no part of the country is safe from attack. This will add to concerns of foreign firms -- already looking to withdraw personnel and families from Saudi Arabia -- and further strain the already taxed Saudi security forces."
A third point about Khobar, according to Stratfor, is that the attackers went to considerable lengths to clarify they were not out to harm Muslims. In the November 2003 Riyadh apartment complex bombing 12 Arab nationals were among the 17 dead. This led to a public backlash against the attackers. Consequently, the attack was careful to make a difference between Muslims and non-Muslims. At Khobar, Muslims were free to leave; non-Muslims were executed.

The fourth point about Khobar attack is that al-Qaeda or an affiliated group claimed direct responsibility. The House of Saud has been fighting two other more Saudi groups, the Islamic Fighters of the Arabian Peninsula and the Brigades of the Two Holy Mosques. In this case, a message delivered on the jihadunspun.com Web site, the al-Quds Brigades of al-Qaeda in the Arabian Peninsula, claimed responsibility for the group, warning that further attacks were coming. This marked a shift in post-attack tactics by al-Qaeda, and could signal an even more aggressive plan of operations by the al-Qaeda-linked militants in Saudi Arabia. The attack on U.S. servicemen indicates that the fighting is not over.

In the aftermath of the Khobar attack, the Saudi government actively claimed that it had the situation under control and that all al-Qaeda cells in the country were now dismantled. Sadly, the autocratic (and often repressive) nature of the Saudi government, the painful lack of an official opposition, and a lack of transparency all have meant that any opposition groups to the House of Saud, moderate as well as radical, are underground. The country's high unemployment (over 12%), blatant corruption of the ruling family and its cronies, and dependence on foreigners in the economy all add to societal discontent that cannot be swept away by a few words.

This is not to argue that the House of Saud has done its people poorly. As Middle Eastern specialist Milton Viorst observed in 2001: "Whatever its flaws, Saudi Arabia has risen from the desert in a few generations to have prospering cities, efficient communications and transportation systems, state-of-the-art factories and seaports, well-run universities and hospitals." Despite the concentration of wealth at the top, there has been some spreading of wealth among society and the Saudis as a people are probably the best educated they have ever been. It should also be added that though there is a growing undercurrent of discontent, Saudi Arabia has never been a police state and throughout most of its modern history there has been a high degree of social order. However, that is beginning to change as more Saudis are aware of the inequalities in society and there is an increasing desire for greater accountability on the part of the government.

Along these lines, al-Qaeda and its affiliates have in Saudi Arabia transmitted a powerful message, combining the appeal of social justice with that of radical Islam. Malise Ruthven, author of Islam in the World (1984) provides an important historical context between early Islam and today's al-Qaeda which is worth noting: "The Prophet of Islam set his followers the impossible task of realizing the ideals of Islam in a violent and wicked world, using the available sources of political power…The utopian aspirations of primordial Islam, though never fully realized, never ceased to activate discontent and to provide the ideological fuel for generations of Muslim revolutionaries." Although written before the advent of al-Qaeda as a household name, Ruthven captures the issue in Saudi Arabia, the home of two of Islam's most revered holy places. For a number of Saudis, al-Qaeda's simplistic and religious message of purity is in stark contrast to the corrupt and repressive House of Saud.

Khobar is not an end of al-Qaeda in Saudi Arabia as stated by the Saudi government, but the beginning of a well-planned escalation of violence. Al-Qaeda is at war with the House of Saud and the West. It is now hitting the House of

Saud where it hurts the most - in its pocketbook. We expect that trend to continue.

Russia's Pipeline Game

By Sergei Blagov

MOSCOW (KWR) Russia has sent signals that it could clear the way for construction of private oil pipelines as a way to increase petroleum exports to the West. The move, if it takes place, would signal an end to the long battle between Russia's private oil companies and the state pipeline monopoly Transneft, opening the door to a $4.5 billion project for shipping oil to the United States and other Western markets.

Russia's oil pipeline monopoly OAO Transneft has been opposing the private project, which would build a line from western Siberia to the ice-free Arctic port Murmansk. Despite its distance, Murmansk is closer to the U.S. market than the Persian Gulf.

Russia's oil majors -- led by embattled YUKOS, including LUKoil, Tyumen Oil Company (TNK), and Sibneft -- have been lobbying in favor of a new U.S. export route through the Arctic port of Murmansk. The project, which is scheduled to start exporting in 2007, would pump up to 80 million tons of oil per year, or 1.6 million barrels per day.

By building private pipelines, Russian private companies aim to be free of direct Transneft control over export volumes and transit fees. For instance, Transneft has requested a tariff increase of 9 percent-11 percent in 2004. Transneft didn't increase the fees it charges oil companies in 2003 but it requires hikes this year to finance pipeline expansion and upgrades along existing routes.

Transneft, which now ships most of Russia's oil, boosted the capacity of an oil pipeline and a Baltic Sea oil port by two-thirds earlier last November month and expanded the link by another 40 percent in early 2004. The pipeline and the Primorsk port will be hauling 845,000 bpd by spring.

Transneft said it spent about $700 million to build the pipeline and the oil terminal at Primorsk, north of St. Petersburg, and plans to spend another $500 million on expansion.

In the meantime, government control over Russian oil pipelines has been cited as yet another hurdle hampering development of the country's oil market. Russia has 46,800 km of pipeline some of which is more than 30 years old. Some pipelines have been modernized, but modernization of the trunk pipeline network remains a priority. The existing pipeline network operates at 99 percent capacity, limiting Russian oil exports to 4 million bpd.

There are also important new pipeline projects such as the Yamal – Germany project, which will require the installation of 12,000 kilometers of large diameter pipeline; or the $5 billion North European Pipeline designed to deliver 30 billion cubic meters of gas to Germany, Holland and UK.

The government controlled monopolies that control Russian oil transport and the natural gas sector are stunting industrial growth and undermining the interests of the state and of oil corporations, Russian LUKoil's founder and chief Vagit Alekperov stated last year. "It is obvious today that state monopolism in any of its manifestations hinders the development of the Russian oil and gas sector," Alekperov said.

Russian companies "have all the necessary resources" to boost production to 10-11 million bpd by 2010, from 8 mm bpd at present, Alekperov claimed, adding that the only obstacle blocking this growth is the lack of space in the country's crowded pipelines. "Russia has an acute need for 2.6-3 million bpd of new pipeline and loading capacity," Alekperov said. But it was practically impossible to attract the $10 billion to $15 billion needed to finance such an expansion as long as the construction and operation of pipelines remained under the control of a state monopoly, he said. LUKoil's leader stopped short of naming either state-run pipeline monopoly Transneft, which controls Russia's oil pipeline network, or gas giant Gazprom, also controlled by the state.

The moves to expand capacity of the Russian oil pipeline system have been seen as an indication that Moscow will keep raising production and challenging the Organization for Petroleum Exporting Countries (OPEC), while pursuing policies aimed at the U.S. market. Russian companies are trying to capture a 10 percent share of the U.S. oil market, offering an alternative to OPEC. In 2003, Russian oil accounted for about 1 percent of U.S. imports.

Russia is sitting on the world's richest natural wealth, priding itself with an impressive ranking in the oil ratings. With the country's proven 12 billion metric tons of oil deposits, Russia is the world's second biggest oil producer, generating some 8 million barrels per day (bpd). It is also the world's biggest natural gas producer. Russia's natural gas output reached 580 billion cubic meters in 2002, while the country's reserves are some 47 trillion cubic meters.

Subsequently since 2000, Russian economic growth has been driven by the oil and gas sectors. Despite a history of resistance to foreign participation in the industry, Russian companies now increasingly appear to see partnerships with foreigners as an acceptable compromise between the perceived need to keep the industry in Russian hands and the need to attract foreign investments.

The Russian Ministry of Energy believes that foreign investment of up to $70 billion could be attracted into Russia's oil sector over the coming decade. Offshore the Russians are looking to develop oil and gas reserves in the Northern Seas (Barents, Kara, Pechora & Chukotka Seas), Sakhalin, the Black Sea and the Caspian Sea. Future onshore oil exploration work is focused on a number of sites in Western Siberia (Tyumen, the Yamal Peninsula, Khanti-Mansiisk, Tomsk, Omsk, Novosibirsk), European North (Arkhangelsk, Komi, Yamal Nenets and Timan Pechora) Volga-Urals (Udmurtiya, Orenburg) and Eastern Siberia.

Yet despite some domestic hurdles, Russia's rising oil output has confounded OPEC. But in spite of growing oversupply and a government promise to cut back, Russian producers are showing no signs of slowing down. In January 2002, the Russian government indicated it was considering a plan to create a strategic oil reserve, which could help to sop up the excess. But no more has been heard of the idea.

Russia has been keen to cooperate with OPEC as an "independent" oil producer, presumably so as to buoy oil prices in the near term. Riding on top of hydrocarbon exports, Russian government officials have depicted a rosy picture of the country's booming economy. President Putin has promised to double the country's GDP by 2010 and pledged that the average Russian will "be happy" also by 2010, although that magic date is well after the expiration of his maximum constitutional presidential term. However, there have been warnings that continued over-reliance on oil and gas may eventually push the nation into a vicious circle of debt crises and an increasing dependence on commodity prices, a pattern well known among developing nations.

High refining margins come to the rescue of India's refiners

By Kumar Amitav Chaliha

MUMBAI (KWR) Indian oil companies are posting strong growth in profits and healthy refining margins, despite apprehension about the increasing cost subsidizing petroleum product sales.

High refining margins have rescued state oil companies from incurring losses from domestic product sales because of a steep increase in global crude prices. The government has barred oil companies from increasing local product prices since January, even as crude prices rose by a third.

State oil companies are maximizing run rates to capitalize on high refining margins. One outcome of this is an increase in naphtha production and exports. India exported 42,000 barrels per day of naphtha in May, up 17 percent from April. Increased Indian exports are putting pressure on naphtha prices in Singapore, as most petrochemical plants in North Asia are closed for routine maintenance. According to traders in Singapore, excess cargoes from India are hurting the market because there is less demand now for naphtha. Mangalore Refineries, Kochi Refineries and Indian Oil Corporation (IOC) are exporting more naphtha by tender as industrial consumers in India switch to cheaper natural gas. Naphtha prices in India are around \$6-\$7 per million Btu, compared with around \$4.70/MMBtu for delivered natural gas.

State oil companies posted a 30 percent increase in refining margins and profit growth of 20 percent or more for the fiscal year to March 2004, compared with the previous year. Bharat Petroleum Corporation's net profit rose 36 percent, while refining margins rose to \$4.64 per barrel, up from \$3.71 the previous year. Net profits for Kochi Refineries and Chennai Petroleum — stand-alone refiners owned by Bharat and IOC, respectively — increased by 21 percent and 32 percent. Margins for all state refiners including IOC and Hindustan Petroleum averaged around \$4.50. Private sector player Reliance Industries posted gross refining margins of around \$6 and posted a 49 percent increase in profits before interest and taxes from its refining business, compared with the previous fiscal year. Senior Bharat officials admit that high refining margins have protected the company’s bottom line. Marketing margins for state oil companies have suffered because of the product price freeze.

Meanwhile, critics are accusing oil companies of manipulating pricing formulas and overcharging customers. Since the government deregulated the oil sector in 2002, state oil companies evolved a formula whereby refinery gate prices are set at import-parity levels. The import parity price is the sum of the actual product price, the cost of transport and customs duties, which for most products such as gas oil, gasoline and kerosene are 20 percent. The import tax for crude is 10 percent, however. Also oil companies earn a margin on transport charges, as they can pay lower fees for crude but charge higher transportation costs for products. Some say the refiners make an extra \$11 per ton through the “import parity” pricing formula. This cushion has again helped refiners absorb losses on domestic product sales in recent months.

India’s New Government Slows Privatization

By Kumar Amitav Chaliha

MUMBAI (KWR) India’s new Congress Party-led government says it is scrapping the country’s privatization ministry and plans to retain control of the country’s leading state-owned companies, including several large oil firms.

Announcing the government’s new economic policy program, Prime Minister Manmohan Singh said that the Ministry of Disinvestment, which handled state company sell-offs, was being abolished, with functions taken over by the finance ministry.

He added that the top nine state companies — including Indian Oil Corp. (IOC), Oil and Natural Gas Corp. (ONGC), Hindustan Petroleum and Bharat Petroleum — would remain in government hands. However, later comments suggested that the sale of minority stakes has not been ruled out.

The planned privatization of Hindustan and Bharat was blocked by legal challenges last year, but the former government proceeded with other sales of stakes in energy companies in March. These included the $2.3 billion sale of shares in upstream producer ONGC.The Congress-led alliance is relying on leftist allies to form a government. India’s largest communist party had described the disinvestment ministry as “unnecessary”
and said that it would oppose the sale of profit-making firms.

The common minimum program, the new government's roadmap to economic and social policies in the next five years, emphasizes a review of the reformist Electricity Act passed by the previous government and calls for delay in the restructuring of state electricity boards. It does, however, offers the private sector a role in power generation and distribution.

The ruling coalition also said that it plans to retain majority control of state-run banks, continue with food and fertilizer subsidies, and promote foreign investment to help create jobs.

The government has agreed to pursue reforms in a bid to place the economy on a 7%-8% growth rate, according to the common minimum program document. “Generally, profit-making companies will not be privatized,” the policy document said. Singh, however, said there was no bar on even profitable state firms selling minority stakes. “We have to distinguish between privatization and disinvestment,” he told reporters after the policy announcement.

Initial market concerns about the change of government have eased since it became clear that the new coalition, while slowing privatization, would adhere to economic reforms.

Are Value Stocks and Defensives the Only Place to Be?

By Darrel Whitten

TOKYO (KWR) Surveys indicate that global investors are becoming increasingly anxious about inflation, and what this means for interest rates and monetary policy. Monetary policy around the globe (beginning with the FED's policy) is seen as too sanguine on inflation, and investors fear that central bankers are falling behind the inflationary curve–implying that when central banks do move, they will have to tighten monetary policy more aggressively than if they had moved sooner. The fear is that there will be a repeat of 1994, when the FED raised rates in rapid succession and caused a correction in the stock market.

Consequently, these same global investors are becoming significantly more risk adverse, and are adopting more defensive portfolio allocations. The majority of these investors apparently remain overweight Japan, although this weighting may also be at risk if risk aversion progresses further.

The US "rate hike syndrome" has already caused the US NASDAQ to drop below its 200-day moving average, indicating that the current correction will be more prolonged. While watching the NASDAQ, some Japanese investors pay more attention to the Philadelphia SOX semiconductor index in terms of its influence on the Japanese market. At this juncture, the Philly SOX is in even worse shape than the NASDAQ. So much, in fact, it has recently rallied from an oversold position.

Japanese semi majors such as Advantest and Tokyo Electron have generally not participated in all but the early stages of the 60% rally seen in the Japanese market, and moreover have ignored their return to profitability. Tokyo Electron, Japan's largest semiconductor and liquid crystal display making equipment firm, booked an Y8.30 billion group net profit for FY2003 to March, 2004, reversing its year-earlier loss of Y41.55 billion. Brisk sales of chip-making tools to Japanese and other Asian semiconductor and display manufacturers lifted its group sales to Y529.65 billion, up 15% from Y460.58 billion a year earlier.

The company's group operating profit for the year rose to Y22.28 billion, up from Y1.12 billion a year earlier. In addition, for the January-March quarter, TEL's orders outstanding nearly Y262.3 billion, up about 90% from Y138.3 billion for the three months to March 2003. Orders in its electronic components unit also rose 29% on year to Y8.7 billion during the quarter. Chip-making equipment sales were particularly strong in Japan, Europe and Taiwan, and combined semiconductor-making equipment sales in the three regions stood at 65% of the firm's group sales. Conversely, full-year chip-making equipment sales in the U.S., which accounts for 12% of total group sales, fell by 32% to Y50.6 billion. Moreover, for the current year to March 2005, the company is forecasting its group net profit to surge more than six times to Y52.0 billion, on sales of Y630.0 billion, up 18.9% YoY. According to Tokyo Electron, appetite for capital investment among global semiconductor makers is recovering rapidly and it expects more demand for its products this fiscal year.

This notwithstanding, Tokyo Electron's stock has been falling since September of last year. It appears that analysts and investors generally expect a peaking-out of the upward phase of this silicon cycle in 2005. US market researcher VLSI predicts that Q2 2004 revenues will in fact decline for tool vendors following the end of the Japanese fiscal year and buying cycle. If not, the semi equipment industry is in danger of repeating the boom/bust cycle of 2000, achieving two years' worth of growth in one, VLSI warns – a scenario its analysts have been worried about for the past several months. The favorable April B:B ratio followed seven consecutive months of B:B ratios above parity. Meanwhile fab capacity utilization rates were down from March's level of 88.5 percent to 87 percent. Indeed, some semiconductor analysts are warning of a peak in the silicon cycle as early as next month (June).

But PC demand, historically a major driver for semiconductor demand, is in the midst of a major replacement cycle. According to Gartner, nearly 100 million PCs are likely to be replaced this year, with 120 million being swapped out in 2005. The volume of replacements in the next two years will surpass the number of units replaced in the run-up to Y2K in 1998 and 1999, Gartner said. In 2004, replacement units will drive global shipments to 186.4 million - an increase of 13.6 per cent over 2003.

Partially reflecting this, worldwide semiconductor equipment revenues grew 24 percent to $11.9 billion in Q1, following sequential increases of 16 percent in Q3 of 2003 and 14 percent in Q4, according to VLSI Research. Indeed, if replacement demand for PCs is as large as Gartner foresees, this demand will come on top of already diversifying demand for semiconductors from mobile phones, digital consumer electronics, and flat panel displays–and it will diffuse through the semiconductor industry, helping to support what the bears insist is the beginnings of the bust portion of the silicon cycle.

In Japan Late-Cycle, Domestic and Defensive Sectors Have Been Leading

Reflecting increasing risk aversion by investors, late-cycle, defensive sectors have so far led 2004's performance, despite strong upward estimate revisions in profits and evidence that the economy is in the early stages of recovery and therefore is surprising on the upside, both in the US and Japan.

Indeed, that is the hidden message behind the recent hard line stance the auditors and the FSA (Financial Services Agency) have taken regarding UFJ Holdings and the pressure they are now under to clean up their loan books–i.e., what the FSA is saying to the banks is "reduce your non-performing loans to levels required by 2005, and de-link your balance sheets from the stock market so that Japanese interest rates can normalize". On the other hand, the BOJ is not about to back off of ZIRP prematurely, which means that when they do, they will be fully confident that Japan's economy and financial sector can handle it.

Yet the consensus of the major domestic think tanks for Japan's GDP growth in 2004 is 3.2%, with 1.6% growth foreseen in 2005. Behind such estimates is the assumption that Japan's business cycle will be peaking over the next six months. But if Japan's global competitiveness is indeed recovering, what happens with earnings and the impact this will have on stock prices is many times more powerful than the short-term psychological impact of an eventual abandonment of Japan's zero-interest rate policy, or ZIRP.

Moreover, if investors are really worried about inflation and rising interest rates, growth stocks at some point deserve another look Historically, growth stocks outperform value stocks as interest rates rise - as they are now. That could happen again in this cycle, particularly as Japan's economy enters a secular recovery that would overlay a peaking of the current business cycle.

THE POWER OF PURSE STRINGS: Asian consumers' central role in the region's growth

By Jonathan Hopfner

BANGKOK (KWR) Of all the economic dilemmas facing Asian governments few now seem as pressing as how to persuade reluctant consumers to open up their pocketbooks. While officials in the past tended to direct most of their energies toward cultivating new export markets, luring foreign investors to local bourses, or building up foreign exchange reserves, an increasing number are realizing just how significant a contribution domestic spending can make to overall expansion – a realization that, in some cases, may have come too late.

In no two countries is this lesson being more starkly illustrated than South Korea and Thailand – consumers in the former still struggling under a mountain of debt and consumers in the latter just beginning to tighten their purse strings after a borrowing and buying spree fueled by a few heady years of stellar growth. How these scenarios play out in both countries is likely to have just as much impact on their respective economies as external factors such as oil prices and the performance of major export markets such as China and the United States. A flurry of policy initiatives in both nations demonstrate the increasing emphasis their governments place on nurturing domestic spending, but questions remain as to whether the desired outcomes will be achieved.

In South Korea, the situation seems to be one of worrying imbalance. Perhaps weary of the austerity brought on by the 1997 Asian financial crisis and the International Monetary Fund bailout that followed, South Koreans responded to historically low interest rates and credit-card giveaways by racking up an record $13 billion in debt by the end of 2003. The same year, nearly 4 million of the country's 48 million people were three or more months behind on debt payments. Credit card companies were soon forced to engage in massive write-offs of defaulted debt, leading, in the most highly publicized case, to the near collapse of LG Card Company, rescued only this January after its creditors agreed on a 5 trillion won ($4.2 billion) bailout package.

The results of the consumer credit bubble have been, at least in terms of domestic spending, extremely troublesome. According to the Bank of Korea, the economy grew by just over 3 percent last year, but exports were responsible for 98.2 percent of this growth and domestic consumption a mere 1.8 percent, compared to 42.7 percent and 57.3 percent, respectively, in 2002.

Startling figures, to be sure, but some point out there are indications that things are about to get better – healthy exports in the first quarter of this year pushed gross domestic product (GDP) growth up to 5.3 percent, which appears to have given lackluster consumer confidence figures a superficial boost. The National Statistics Office reported that consumer confidence rose to a 19-month high of 99.9 percent in April – anything below 100 indicating the pessimists outnumber the optimists.

Unfortunately, it appears that while they're increasingly hopeful, Koreans aren't ready for any buying binges just yet. Private consumption is still falling – by 0.3 percent in the first quarter. The Ministry of Commerce also noted this month that combined sales at retail department stores dropped by 1.7 percent in April, and are likely to plunge even further over the next month or two.

The government's response to the situation has been concerted – interest rates have been kept at historic lows for nearly a year, taxes on high-end goods such as cars and golf clubs were cut in March, and in May a program was launched to help restore the bad credit of over 3 million individual loan defaulters.

Whether such moves will simply encourage Koreans to borrow more money and launch the credit-bubble cycle all over again is open for debate, but what does seem clear is that the initiatives will do little to shield consumers from shocks that are looking increasingly probable. As the world's fourth-largest oil importer, oil price rises are particularly damaging for Korea, and a US interest rate hike, coupled with China's efforts to put the brakes on its breakneck economic growth, would spell trouble for the Korean exporters that are apparently single-handedly propelling the country's growth. A month or two of lackluster figures would wipe out much of the hesitant optimism that just now appears to be taking root among Korean consumers. Therefore, over the short-term, the Korean economy appears to be standing on very shaky legs.

Thai officials, by all accounts well aware of Korea's recent problems, at least have the benefit of a form of hindsight to work with. The economy, registering growth of over 6 percent, was one of the best performing in Asia last year, and the stock market doubled in value. This prosperity was no doubt based partially on a relatively weak baht, China's appetite for Thai exports, and foreign investor interest, but was also thanks to a consumer base encouraged by low interest rates and government-initiated social spending programs.

The Bank of Thailand, however, is concerned that consumers have been encouraged a bit too much for its liking. Mortgage loans soared nearly 15 percent last year, and independent agencies like the Thailand Development Research Institute have estimated that average household debt has reached over 6 times monthly income, double what it was a decade ago. The response has been swifter and certainly harsher than that seen in Korea; in January the central bank released a master plan for the financial sector that will force many small-scale consumer credit firms to merge with larger – and more heavily supervised – banks or become extinct, and in March slapped new restrictions on credit card issuers, including rules on when and how they're permitted to market their products to potential customers.

Such restrictions may not completely eliminate the risk of a Korea-style debt bubble, but they do demonstrate a willingness on the government's part to take pre-emptive action – and a good thing, too, since last year, according to the University of the Thai Chamber of Commerce (UTCC), consumer spending accounted for nearly half of the country's impressive GDP growth.

Thailand also faces many of Korea's problems, of course – it too imports oil, and depends heavily on the US and Chinese markets – as well of a few of its own, like the unrest in the Muslim-dominated south. The stock market has taken a beating so far this year, and the UTCC's most recent survey shows consumer confidence dropped in April to 101.6, a six-month low. But the same survey also shows consumer spending continues to rise.

This relatively positive picture may be in part to the government's sunny rhetoric. Thai Prime Minister Thaksin Shinawatra has been careful to point out that the government will continue to subsidize oil prices and monitor the prices of basic commodities such as rice to ensure they don't rise excessively, and continues to insist growth will this year reach 7 percent. For now, at least, the general public appears prepared to believe him.

Whether they address it with policies or pronouncements, the cases of Thailand and Korea indicate governments across Asia would do best adopt a two-track approach towards economic growth, monitoring domestic spending and consumer confidence with the same diligence they've applied to foreign exchange and encouraging exports, particularly given the affluence of the region's swelling middle class. External crises can arise and pass with astonishing rapidity, but convincing consumers that it's once again safe for them to part with their hard-earned – or borrowed – cash seems a longer, and infinitely more delicate, task.

Chinese IPOs – The Glow Is Gone – For Now

By Scott B. MacDonald

NEW YORK (KWR) Throughout the late 1990s and first few years of this century, China was hot. Everyone wanted to find a way to play China. After all, Asia's largest economy was showing dynamic economic growth, political stability (including a peaceful transfer of leadership), and a growing middle class. The new China, fully part of the global economy, needed (and still does) vast inputs of oil, natural gas, coal, copper, nickel, and alumina for industrial production and a better national infrastructure. The expanding middle class was hungry for foreign consumer goods. The world rushed to meet these demands. China also was willing to allow its vast numbers of companies to seek foreign financing.

One aspect of this was the boom in Chinese equity Initial Public Offerings (IPOs) over the last couple of years. The NYSE has a total of 16 Chinese companies and there is a sizeable number of OTC (Over The Counter) ADRs for Chinese companies. According to The Asset, Chinese corporates raised an estimated $6 billion through overseas IPOs in 2003.

It was expected that Chinese companies would raise $7 billion in overseas markets via IPOs in 2004. That number now looks unrealistically high for three reasons. First, the Chinese government is seeking to slow the pace of growth (9.4% in Q1 2004). Inflation is an increasing worry. The big question is can Beijing manage a soft landing in the economy (we think yes) or does China have a hard landing ahead (many people are worried about this)?

Second, many investors are finally waking up and discovering that Chinese companies have a poor track record with transparency and disclosure. Considering that global investors have been burned by Enron, WorldCom, Nortel and Parmalat, Chinese companies do not look as attractive as the did when the economic boom looked set to continue forever. Investors are now asking questions and many Chinese CEOs do not want to answer, hence the decline in new IPOs.

The last factor is that many of the Chinese companies that have issued IPOs already have not been stellar performers. A number of investors complain that performance has not met expectations and management doesn't care.

Chinese IPOs are no longer on the menu – at least for now. They will be back. However, in the interim, the Chinese government has considerable work ahead in terms of cleaning up its banks (filled with bad loans), managing a slower pace of economic growth, and dealing with the enormous challenge of meeting the rising expectations of the population. For many investors the China glow is gone. They have moved on to other places to invest. But we expect that once the soft landing is managed, those IPOs will be back. We hope everyone has learned something from this last round of China mania – transparency and disclosure do matter.

Venezuela – Total Recall?

By Scott B. MacDonald

NEW YORK (KWR) Look for political uncertainty and turmoil in Venezuela in the short-term. After months of speculation and legal wrangling, Venezuelan President Hugo Chavez said June 3 that he is prepared for a referendum on his term of office. Shortly after electoral officials said that Chavez's opponents had collected more than the 2.44 million votes required to prompt a recall vote, Chavez stated in a nationally televised speech, "I accept it. I hope that some people realize -- if they are still confused -- that Hugo Chavez is not the tyrant some say he is." The referendum is likely to be scheduled for August 8.

The public response to the announcement that the referendum was likely to go through was mixed. Pro-Chavez supporters set fire to cargo trucks, severely beat up an opposition lawmaker outside Congress and fired on the offices of Caracas' mayor, a prominent anti-Chavez figure. Supporters of the referendum drive set off fireworks and honked horns. Venezuela remains a highly polarized society.

Chavez is calculating that the opposition will not be able to maintain any degree of unity and if the referendum goes against him, setting in motion a new election for the presidency, he should be able to win with 35% of the vote, which is what his political support has been throughout the last couple of years. With an opposition likely to produce multiple candidates, his chances of winning are good. Even with the referendum Chavez remains in relatively good shape. His current approval rating is now at 42%, while the burden will be on the opposition to make certain that enough voters get to the polls. No doubt, the authorities will seek to dissuade voters from turning out at the polls. It has already been reported that any government workers signing the opposition petition for a referendum have been fired (or are at least being threatened). In a country with high unemployment and a growing state sector, the possible loss of a job is significant.

One other factor to consider is the role of the country's military. Although Chavez moved since the failed 2002 coup to purge elements opposed to him within the ranks, there remain a core of "institutionalists" who favor a non-political, constitutional role. They favor upholding the referendum process. In contrast, there are the new commanders who were put in place by the President, who clearly identify their fortunes with Chavez. Annual promotions take place in July and it is likely Chavez could use this to further his control over the armed forces.

The Venezuelan economy is not likely to offer Chavez any help. Although real GDP growth is expected to grow by 6% in 2004, on the back of high oil prices, this comes after an 8.9% decline in 2002 and another decline of 9.2% in 2003 reflecting the damaging impact of the strike at PDVSA, the state-owned oil company. In addition, the private sector, one of the major sources of anti-Chavez opposition, has been decimated by high inflation (up to 27.1% at year-end 2003), political instability, government controls over foreign exchange and the lack of growth. Indeed, much of the upper and middle class that has had the option to leave the country has done so. Considering the deterioration in the economy and polarization of its political life, foreign investment has not poured into the country, though some credit has to be given to the government for making all of its external debt payments.

Venezuela faces a summer of uncertainty. Will the referendum go ahead? Will the military intervene to stop it? Will Chavez seek to bloc the referendum through the courts? What happens if the President fails to win a majority in August? Can the opposition pull together and provide a more unified front, including enough support for a single candidate to run against Chavez if they win the August referendum? All of these questions are going to percolate through Venezuela in the months ahead, leaving considerable uncertainty. All the same, there remains a strong possibility that Chavez may allow the referendum to proceed with the view that he can win it, hence putting to rest any constitutionalist threat to his rule for several years. However, if opinion polls begin to go against him and the opposition appears to be better organized than in the past, we would not rule out Chavez seeking new means to bloc the referendum.

Japan Briefs

By Scott B. MacDonald

Japanese Banks – And Now Comes the Hard Part: The most recent earnings season for Japanese banks was the best in years. Helped by an economic rebound, a higher Nikkei, and sustained pressure by the government to clean up bad loans, the major banks (with the notable exception of UFJ) posted solid earnings. Now comes the hard part. As the banks look into the current fiscal year that ends March 31, 2005, they have to find ways to make money. That is going to be a challenge. Lending alone will not provide a platform for the generation of strong profits. While loans to small and medium-sized companies and individuals through credit cards are rising, total lending fell each month since the Bank of Japan began tracking the figures in January 2001.

There are three reasons for the decline in bank lending and the ongoing difficult nature of the market. First, auto, electronics and other manufacturing companies are cutting their borrowings as they move production to China to reduce costs.

Second, utilities are slashing expenditures on new units to prepare for greater competition in the domestic energy markets. Third, most of Japan's top corporations, with investment grade ratings, are seeking fewer loans. Instead many of these companies are tapping stock and bond markets in Japan. They are also willing to tap foreign bond markets for cheaper funds. The impact of all three trends is to reduce loan demand and credit spreads, while loan margins are shrinking due to competition.

What is the solution for Japanese banks? The answer is a greater movement into investment banking and other fee-advisory services. The banks can also charge the borrowers more, though may only accelerate the shift into non-bank finance venues. U.S. banks have long made the shift to offering non-lending fee income driven business. Almost 32% of Citigroup's record $5.27 billion net income for Q1 2004 came from its global investment banking business, while half of the profit came from its global consumer finance unit, including credit card operations. In contrast, two-thirds of Mizuho's year-end 2004 gross profit was generated from its lending business, while non-bank fee income was only 13%. The weakness in the fee income side of the business is evident by the following: Mizuho ranks 8th in equities underwriting, 10th in local mergers & acquisitions advising and 3rd in bonds underwriting.

March 31, 2005 is still far in the distance. Most major Japanese banks are still enjoying the success of last year. However, the path forward is going to be very challenging. Japanese banks have considerable work ahead of them. Although non-performing loans have fallen, they remain an issue. In addition, the pace of economic growth could slow, making the business environment more difficult. Consequently, we think that Japanese banks are making a lot of progress, but making good profits in the year ahead is going to be even more challenging.

Pension Reform Ruckus: In early June, opposition lawmakers attempted to pull a ruling Liberal Democratic party (LDP) legislator from a podium in the Diet to prevent him from announcing the passage of a bill seeking to reform Japan's troubled pension system. Despite the effort on the part of the opposition members of the Diet, committee head Masayuki Kunii managed to announce the bill had been approved by a majority in the upper house committee. Pension reform has been a heated issue in Japan as the government is proposing to cut benefits and raise premiums. Adding tension to the issue, a number of Japanese politicians confessed to missing pension premium payments, including Prime Minister Koizumi and one-third of his Cabinet. In addition, two top politicians stepped down from their posts after it was revealed they had also skipped pension payments in the past. Katsuya Okada, head of Japan's largest opposition Democratic Party, pledged to try to block the legislation at all costs. Committee approval clears the way for the bill to be enacted into law by the full chamber, where Koizumi's LDP and coalition partner New Komeito, enjoy a majority.

The Diet has been debating how to save the pension system from insolvency, which is set to become a major election issue in the July contest for the upper house of the Diet. Japan's society is rapidly aging and many are apprehensive the smaller work force of the future will not generate a high enough level of premium payments to supply pensions to the growing ranks of retired people.

North Korea – New Talks Scheduled: A new round of six-nation talks seeking to end North Korea's nuclear weapons programs will commence in Beijing on June 23. The third round of six-nation talks will be preceded by two days of preliminary negotiations involving lower-level officials. Two previous rounds of high-level talks ended without any breakthroughs in settling the standoff, which flared in October 2002 when the United States said North Korea admitted operating a secret nuclear program in violation of a 1994 agreement. Washington and its allies have been attempting to arrange a new round of six-nation talks also involving the two Koreas, host China, Japan and Russia by July, which was agreed on by the nations when they last met in Beijing in February. After the second round in February, the six nations held their first lower-level meeting last month. The so called "working group" discussions are envisioned as trying to smooth the way and create an agenda for a third round of high-level negotiations.

AsiaLinks

Emerging Market Briefs

By Scott B. MacDonald

Chile – Inflation Up: Chile's central bank in early June announced that its inflation rate forecast for 2004 is rising, largely due to higher-than-expected oil prices. The old inflation forecast for the year was 2%, It has been raised to 2.1%. Chile imports 90% of its oil needs.

China – Fitch Calls for More Slowing Measures: On May 17, 2004 rating agency Fitch stated that China needs to do more to rein in its breakneck economic growth but a drastic slowdown is unlikely. According to Brian Coulton, head of Asia Sovereign Ratings at Fitch: "Our base case is not for a hard landing in China. Growth isn't going to come crashing down to a halt." Fitch expects China's economic growth to slow in the second half, with 2004's growth rate averaging around 8.5 percent and slowing to around seven percent in 2005. Coulton added: "Our view is the authorities in China have caught this boom early enough, meaning a hard landing is not inevitable. It doesn't mean they've done enough...we do want to see further measures and in our view they do need to bring interest rates up," China has not raised interest rates for nine years but media reports have said that a rate hike is imminent. China is struggling to slow its economy, which grew 9.8 percent between the first quarters of 2003 and 2004. Financial markets are worried that authorities may be moving too late to control growth and that boom will turn to bust. Alternatively, the measures to restrain the economy could themselves push it into a severe slowdown.

Indonesia – Presidential Elections: Campaigning began June 1 in Indonesia's presidential race, scheduled for July 5. Five candidates are contesting the elections, which will mark the first time Indonesians will directly elect the country's president. According to the most recent opinion polls, incumbent President Megawati Sukarnoputri (with 11% of potential votes) trails former Security Minister Susilo Bambang Yudhoyono (with 41% of potential votes). Megawati has been in office for 2 and half years, following the resignation of President Wahid. Although she has restored some degree of political calm to the country, many Indonesians believe her time in office has been marked by indecisiveness and she has sadly demonstrated a lack of initiative and new ideas. In comparison, Yudhoyono comes across as a more disciplined political leader, capable of providing stability as well as new ideas. The candidate in third place in the polls is former general Wiranto, who was one of the top military people under President Suharto's regime and is tainted by human rights abuses in East Timor. He polls at 10 and has the support of Golkar, which has a national organization and financing. Rounding out the field are Amien Rais (4.4%) and Hamzah Haz (3%).

In other Indonesia news, the consumer price index rose at a faster-then-expected 6.5% in May compared to a year earlier, the most in seven months. It is felt that faster inflation could force the central bank to raise interest rates, which are close to six-year lows. Inflation could average as much as 7% in 2004, higher than the government forecast of 6%. There is also concern that higher rates could break the pace of economic growth – not a good thing in a country where people have been struggling on the economic front since the debacle in 1997-98.

Mexico – The Political Pot Stirs: In early June, Mexico's political situation suddenly became a little more interesting with the resignation of Energy Minister Felipe Calderon. Clearly, his unexpected departure sent tremors throughout the Mexican political establishment. Though the presidential elections are two years away, Calderon's resignation was an indication that the country's political parties are preparing for battle. As one long-time Latin American observer, Walter Molano, noted: "Although we were never optimistic that the Fox Administration would pass any of the structural changes, Calderon's resignation formally killed energy reform. Fernando Elizondo Barragan, the new Energy Minister, said that he would launch "Plan B," but he failed to provide any details. Mexico is one of the two darlings in the emerging markets, but it is also marching towards a new sexenio crisis. It is too bad nobody really cares.".

Malaysia – The March 29th Elections: On March 29th, Malaysia voters went to the polls to elect a new government. As was the case over the last several decades, the ruling multi-ethnic coalition, the Barison Nasional or BN, won handily, reasserting the dominant role of the United Malays National Organization (UMNO) within the majority Malay community. The BN captured 198 of the 210 (90%) seats in the federal parliament or 64.4% of all votes cast (up from 56.6% in 1999 and just below the 65% it scored in 1995). This was decidedly good news for the standing Prime Minister Abdullah Badawi, who had earlier assumed the leadership role from longstanding Prime Minister Mohammad Mahathir. Despite considerable speculation as the strength of the Islamic issue in swaying voters to opt to non-BN parties, Badawi marked his first outing as national leader with a sweeping victory, which should provide him the opportunity to further put his own personal stamp on the direction of the country.

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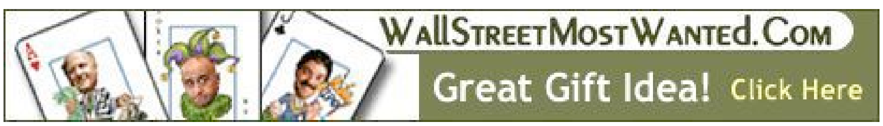

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