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PART II

WHAT THE TEA LEAVES SEEM TO SAY ABOUT 2008:
THINGS COULD GET A LOT WORSE BEFORE THEY GET BETTER

Since the publication of this medium's report of January 9, 2008 (Please refer to **TARGET** Intelligence Report, Volume X, Number 6: **'*WHAT THE TEA LEAVES SEEM TO SAY ABOUT 2008*'**), things have gone, pretty much, as predicted with the exception that more and more banks are owning up to their past, massive miscalculations/faux pas with regard to the subprime, mortgage-industry crisis and the effects of the attendant, international credit crunch, that followed.

There is every reason to believe that the next 6 months will be just as difficult as the first 14 days of 2008, if not a great deal worse.

Here are some of **TARGET**'s reasons:

Earnings

Over the past few years, the key indices of Wall Street have been propped up by increased earnings from a number of the *'darlings'* of The New York Stock Exchange and The NASDAQ.

It is likely that there will be fewer positive results from these, and other, companies and it is almost a certainty, now, that many companies will report much-lower earnings, with quite a number of them, even producing losses.

Last Friday, Countrywide Financial Corporation, the largest mortgage company in the US, was taken over by Bank of America Corporation at the bargain-basement price of $US4 billion – satisfied by the issuance of Bank of America shares, not cash!

As **TARGET** () pointed out last Monday (please see **TARGET** Intelligence Report, Volume X, Number 9), in effect, the takeover of Countrywide Financial Corporation was at a 7.60-percent discount to the then market price of its shares.

Also, without question, this was a force majeure situation.

As one would have expected, the share price of Countrywide Financial Corporation fell by 18 percent on The New York Stock Exchange, last Friday, as a direct result of the takeover announcement.

Also, last Friday, American Express Company announced a profits warning: Its share price fell by about 10 percent on the back of that official announcement.

American Express Company said that it was suffering a growing number of credit-card defaults.

So, it is confirmed that American Express Company will be reporting lower earnings.

What is very telling about the announcement from American Express Company is that consumers in the US are suffering immense trouble in meeting their financial commitments, even to credit-card companies.

The strong global economies of the industrialised world, over the past few years, have managed to cloak a number of the underlying problems, inherent in the fabric of *'America Incorporated'*.

But that outer garment has been lifted of late and one can, now, see, clearly, the soiled linen, underneath the cloak.

A surprising number of the financial problems, plaguing the most-important economy of the world, are being made manifest, day after day.

As **TARGET** pointed out numerous times in 2006 and 2007, the rapidly depreciating prices of US homes had the potential of putting the skids under the US economy because:

a. Home-owners would have problems in meeting debt service, sooner or later, let alone being able to put money on the table in order to retire repayment of principals; and,

b. US mortgage companies would be left, holding onto the screaming baby in due course as defaults increased and home-owners walked away from their once-prized possessions.

Sadly, **TARGET**'s predictions were spot on.

With nothing – or little – to bolster share prices on the major equity markets of the US, it is a sure bet that prices will continue to fall in the shadow of lower corporate growth rates, followed, naturally, by reduced dividend payouts – if dividends are not deferred, that is.

Also, it is almost a given that international economic growth will slow, probably decelerating at a hitherto, unheard-of rapid rate.

Still, that which is not completely known is the financial pain that the international credit squeeze and the US subprime mortgage-industry crisis has caused to many companies, from Wall Street to the major financial capitals of Europe.

More shocks are expected: Only a ninny would think differently.

Toward the second half of 2008, things are likely to become clearer, but, at this juncture, it appears to be bad news for the US equity markets and this is quite likely to spill over onto European equity markets and, to some extent, affect the psychology of investors of Asian equity markets.

Energy Prices

The price of crude oil has been hovering at the $US100 mark for the past month.

It is unlikely to fall very much because the price of crude oil is denominated in US dollars so that, as the translation value of the US dollar vis-à-vis other *'hard'* currencies continues to fall, so the price of crude will continue to rise.

There still remains a great deal of pressure on the oil markets of the world from the industrialised countries of the world as well as the developing countries.

The People's Republic of China remains a very large purchaser of the black ooze, catching up the insatiable thirst of the US.

It will take a decade, at least, before the world finds a viable substitute for fossil fuels as the major energy source.

In the meantime, higher energy prices spell the increased threat of inflation.

Last Thursday, the **E**uropean **C**entral **B**ank (ECB) and The Bank of England determined to keep their key interest rates unchanged at 4 percent and 5.50 percent, respectively.

The ECB stated that it was concerned about inflation in the European Union and would be watching the situation, carefully.

TARGET's translation of the above: Interest rates are set to rise in Europe and the United Kingdom in order to contain inflation.

The resultant effect of higher interest rates in Europe and the United Kingdom must be a brake on corporate earnings as the year progresses.

Internationally, there is the potential problem of Iran and its continued harassment of US warships in the Strait of Hormuz.

It is confirmed that there have been 3 such incidents in the past 30 days.

About 40 percent of the world's oil shipments pass through this narrow Strait so that Iran has the power – and the seeming intent – to continue to play the role of the unsolicited, voluntary international watchdog of the vessels, passing through this waterway.

Some years back, **TARGET** made mention of the Strait of Hormuz, stating that, should the US apply too much pressure on Iran, this Muslim country could apply the thumb-screws on the US by shutting down shipments of crude oil to the Western World via this stretch of water.

Sadly, too, this prediction appears to be coming true.

As US President George W. Bush said, recently, Iran is the chief sponsor in the world of terrorism.

He urged the leaders of the Arab world to negotiate with the Government of President Mahmoud Ahmadinejad in order to stop this country's practice because the alternative was almost unmentionable: Another war.

There is little love lost between Iran and the Western World, but for the US and its allies, to wage war against this fundamentalistic Muslim country would be a disaster for all.

Even without a shooting war between Iran and the West, however, just the threat of another global struggle, even a limited one, could well send the price of crude oil higher than $US120 per barrel without too much effort.

Such a situation would have a deleterious effect on the West: Inflation would rise; corporate earnings would fall; and, the probability of a deeper recession in the US would, undoubtedly, follow.

What About Asia

This medium has been bullish about Asia for some years.

The single exception to **TARGET**'s view of Asia has been the economy of Japan due to its heavy reliance on exports to the US.

Japan, to its credit, has been continuing to diversify its markets and has placed a great deal of emphasis on being a partner with the People's Republic of China.

It has had a great deal of success in this regard.

But still the second-largest economy of the world is facing a rough passage in 2008.

The People's Republic of China, on the other hand, has, by accident and design, caused there to have been created an ever-stronger middle class in spite of there being a wide gap between the very rich and the very poor of the country.

The economy of the People's Republic of China continues to forge ahead at historic, high-growth levels and there is every prospect of this situation continuing for the next 5 years, at least.

For the Hongkong Special Administrative Region of the People's Republic of China and the Macau Special

Administrative Region of the People's Republic of China, it is almost a guarantee that the motherland's economic strength will continue to lead to a spillover effect on its 2 Special Administrative Regions in the south of the country.

Low interest rates in the Hongkong Special Administrative Region have led to a surge in property prices.

Property prices are linked, directly, to interest rates.

On January 30, 2008, the US Federal Reserve Board is expected to cut interest rates in the US, very aggressively.

The Chairman of The Fed, Dr Ben S. Bernanke, said as much, last Thursday.

He said, inter alia:

> *'In light of recent changes in the outlook for and the risks to* (US economic) *growth, additional policy easing may be necessary … We* (The Fed) *stand ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks …'.*

As US banks cut their interest rates, banks in the Hongkong Special Administrative Region will follow suit, no doubt.

It will mean another boost for the economy of these 416 square miles.

Property prices will continue to rise and, if, as **TARGET** maintains, the value of bricks and mortar is the backbone of an economy, then, this economy stands in good stead to become stronger … as the US economy continues to decline.

Lower interest rates in the Hongkong Special Administrative Region will fuel higher profits for a number of publicly listed companies, no doubt, but for exporters, reliant sales to the West, especially the US, there could be problems on the horizon.

One has to be especially careful in selecting in which company to invest.

This August will see the People's Republic of China host the Olympic Games in Beijing.

There will be a number of companies, publicly listed on The Stock Exchange of Hongkong Ltd, that will benefit from these Games.

In conclusion, **TARGET** reiterates: Stick with Asia.

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