BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com DECEMBER 29, 2003

An Interview With Hugh Hendry

From Bad to Awful

A U.K. hedge-fund chief sees two possible investing scenarios, and one's downright scary

By Vito J. Racanelli

AS YOU ENTER THE ODEY ASSET MANagement conference room in London, you'll see a large painting of a fog-enshrouded skiff that a lone figure is piloting toward a dull and faraway light. It goes a long way to explaining the firm's attitude toward investing. Hedge-fund manager Hugh Hendry happily concedes that he's an apostate from fundamentalism, uses technical analysis liberally, and hasn't met with a company management in "five years, thank God." The Scotsman with Glasgow working-class roots admits to having no friends beyond the Reuters mini-terminal he carries in his pocket. He eschews the focused-fund approach and what he calls Taliban-like fundamentalism in the market.

Instead, Hendry believes that asset allocation is crucial. Choosing among a wide variety of asset classes that he considers promising, he populates the fund with hundreds of small positions. "We're like a centipede. You can lose 30 legs and you can still march forward," he says. And march he has: This year, his Odey Eclectica hedge fund, which has amassed $100 million in assets since its founding in October 2002, was up 45% through November.

Right now, a generally bearish Hendry thinks profit expectations are much too low for mining stocks, gold and many basic-resources companies, and he likes the return from Japanese property stocks. And, he contends, the bullish prospects for technology and big pharmaceutical stocks are significantly overestimated.

How much of a bear is he? Well, in his more optimistic scenario, the Federal Reserve reflates the economy and stocks essentially go nowhere from now until 2020. In his Armageddon scenario, the S&P 500, now hovering near 1,100 could drop as much as 80% from its all-time high of 1527, putting it at 304. For more, read on.

Barron's: What's your current view of the global economic picture and financial markets?

Hendry: What's happening today happened 300 years ago in the French economy when John Law, another Scotsman, was allowed to launch the first government-sanctioned bank, which replaced coins with paper money. Commerce boomed. Politicians recognized this correlation between issuing more money and people liking you. They issued more and more money, but it was a false promise. Nothing intrinsically was being added to the economy except promises, which could never be redeemed. Selling by speculators caused the stock market to correct. The correction encouraged the authorities to print more funny money. Ultimately, the continued pumping of liquidity destroyed the economy, the stock market and France's currency.

More recently, the U.S. came off the gold standard in 1971 and the Dow Jones Industrial Average bottomed in 1974. Over the next 25 years, the Dow goes up 20-fold because every period of economic anxiety brought forward an orthodoxy of generous liquidity. Money has to go somewhere. It seeks to perpetuate itself by going into a rising asset class. This time, it is financial assets. Just like the Mississippi stock scheme in 1720 and the South Sea Bubble in London at the same time.

Today, liquidity is being pumped in by Greenspan, then?

Yes. The mechanism is the government-sponsored enterprise sector in America, the Fannie Maes and the Freddie Macs. The U.S. has nationalized the credit-creating process, previously the preserve of the banking sector. Freddie and Fannie can borrow money at almost the risk-free rate. At times of anxiety, they are profit-motivated to expand their balance sheets because government bond yields, the risk-free rate, fall during times of risk aversion. The spread widens between riskier assets like mortgage-backed securities, which Fannie and Freddie buy, and Treasury bonds. The combined balance sheet of Fannie and Freddie is $3 trillion, 30% of the U.S. economy. The annualized growth rate in September and October of their balance sheets was 50%. Now when people talk about M2 or the old monetarism, it hasn't kept pace with the disintermediation, which has gone on in the economy. It doesn't include agency paper. The money supply looks as if it's waning. It's not. There's enormous dollar creation. You can control the domestic price of money. Short-term interest rates have not gone up in America because of this economic Frankenstein. But you can't control the external price: The dollar is weakening versus everything, even versus the ruble.

The response to the crash since March

(over please)

DOW JONES PROOF

THE PUBLISHER'S SALE OF THIS REPRINT DOES NOT CONSTITUTE OR IMPLY ANY ENDORSEMENT OR SPONSORSHIP OF ANY PRODUCT, SERVICE, COMPANY OR ORGANIZATION.
Custom Reprints (609)520-4331 P.O. Box 300 Princeton, N.J. 08543-0300. DO NOT EDIT OR ALTER REPRINTS • REPRODUCTIONS NOT PERMITTED #30901
DOWJONES

2000 has been to create even more money. Just as it was 300 years ago. We've created a tidal wave of liquidity, with the Dow back at 10,000. But in doing so, strange things have happened. Gold has broken its 25-year downtrend and has now established an uptrend. The CRB index is at a nine-year high. Oil prices didn't come down after the Iraq war concluded. Strange things are going on in the world at large. But not strange to a citizen of Paris in 1720.

And this suggests?

The authorities have broken their trust with us. Middle-class society preserves its wealth in paper assets and the honesty of the paper asset is that the central banks will not dilute your financial assets by printing too much money. We're having to go to extreme measures to preserve our wealth by owning gold, a barbarous relic. Greenspan is the smartest guy on the planet, but you know what? Wise guys make mistakes. That's what LTCM [the Long Term Capital Management hedge fund] was all about. In 1998, the Fed made the same mistake it did in 1927, used an overseas agenda to determine its interest rates. The Asian economies are on their backs. Russia does the unthinkable and defaults. LTCM defaults. And Greenspan, acting like James Bond, saves the world by cutting interest rates when the U.S. economy is expanding at 7 1/2%. In doing so, he throws petrol on the flames. Nasdaq goes exponential. He unlocks a bubble in domestic stock markets and we've been paying for it ever since. He knows the consequences are a period of prolonged economic weakness and that terrifies him because he's got so much debt in the economy. Debt today is 360% of GDP. Not just in America but elsewhere. We're ill-prepared for a rise in savings. And so he's done everything to prevent a rise in savings.

If the Fed succeeds in re-inflation, then the good news is that the Dow is going to be at 10,500 . . . in 2020.

That's the good scenario?

The other scenario is that we can envisage a situation where it becomes possible that the tail can wag the dog. The stock market today is capitalized at 100% of GDP and debt is 360%. Here we are with the U.S. gross domestic product recently having shown 8.2% growth, a classic economic recovery. But history suggests that if growth continues, then 10-year bond yields will have to go to 6%-7%. But that debt level–i.e., mortgage refinance-based consumer spending–can't accommodate such high interest rates. That's why the Fed keeps saying that it will be putting the short rate up; it's desperate to control the long rate. This is a bear-market rally. They have never lasted more than 12 or 13 months in any asset class. This market bottomed on the ninth of October last year, so we're [generally] in that 12-month period. At this point, I feel very much like Jesus in the desert. I haven't eaten for 40 days, and I'm getting fed up with the juniper berries. The devil is saying to me: `Look what I've done to the Nasdaq. Up 80% or so. Russian equities were up 100% a few weeks ago. All of this, this could be yours if you would give up on your disciplines.' If it rolls over, if all the bears are converted back into bulls, concluding it's a natural cycle, then this market will test last year's lows. If those are breached, then I believe you could lose 80% of the value of the S&P and the Dow from their peaks.

You point out two scenarios. Which do you think is more likely?

Can I guess? I can't. What I can say is that gold seems to act well in both scenarios. People are speculating again this year in the equity market. They're buying things like Applied Materials. Why? Because from 1994 through 1999, the return from Applied Materials was 7,000%. Today, it is relevant to embrace the antithesis of the past. So I'm buying businesses that in the past 20 years have been so desperate, the view is they have no future.

That's a natural lead-in to some stock picks.

I'm buying stocks with inelastic supply curves. That means as a producer, you can't produce more of the product in the short term. If demand rises, the only way you can ration demand is by raising prices. I see monetary inflation and I'm betting this money will bid up prices in the wider economy. So it takes me into mining companies. We have Anglo American. It's raised diamond prices three times this year. It also has gold. And you see what's going on with gold. Others I own are Lonmin, BHP Billiton, Rio Tinto, Phelps Dodge and Xstrata. Yet put them all together and the market cap is less than Vodafone's. There is an enormous reluctance on the part of institutional investors to buy these stocks. They've looked at the past 20 years, and they say 'You know what? They stink.'

Yet, these stocks are already performing. The valuations don't look remarkably cheap, but the analysts are pricing expectations by the absolutely awful 20-year prior history.

There's a better chance of these stocks doubling than any other stocks doubling in the marketplace. I own a zinc mine in Ireland called Arcon International, a tiny company. Zinc is at a 70-year price low versus the real economy when you've got China growing and you've got every other metal higher. If we are wrong, Arcon is [already] priced as if it has no future. If we are right . . . . Arcon's on two times earnings. I'm going to make 10 times our money.

Does this implicitly suggest that you believe in the 20-20 reflation view more than the super-bear scenario?

Yes and no. The reinflation scenario is manna from heaven for these stocks. But in deflation, it is ultimately an ownership of these tangible, finite resources if we have the depressionary scenario. Commodities had a very good relative performance in the 1930s. But in a deflationary scenario, you are going to lose money in all equities. You would lose less quickly with some of these. That's where you really want to be in gold. Gold's got nothing to do with mining. Gold works both ways. If we have the deflation scenario, it will be hoarded, on monetary demand rather than on economic demand. Gold is simple. You just buy something big, say Newmont Mining. It looks like a technology company if you look at the valuations–six times revenue, which is very high. But it's predicated on the option valuation of its exposure to gold. Barrick Gold and Placer Dome are also picks. You buy Newmont at six times revenue because there is a possibility that gold may return to its previous high of $850 an ounce.

Is that what you think?

It's more than possible. It's broken its 25-year downtrend. Because they're not making any more gold. Whereas [Japan's central bankers] have made a $150 billion worth of yen this year. They've done the same in Hong Kong, and Fannie Mae and Freddie Mac are growing their balance sheets of $3 trillion at a 50% rate. That's why the euro could go to $1.80. The pound sterling could hit $2.20 in 18 months. In that world, gold takes care of itself.

So, the stocks could double?

Absolutely. A period which is very similar to today, where central banks of the world were intervening by creating money, was 1984 to 1987. The economy was rather moribund over that period and so

the liquidity went into the stock market and the Dow went from 1200 to 2800 before the October 1987 crash. Over that period, Newmont went from $13 to $80. Newmont again bottomed at $13 in 1997. We are at $48. And I can see it being back at $80. If gold breaks the uptrend, then I never want to see gold again. But I don't think it breaks this uptrend. It's trading above all of its moving averages.

I own Phelps Dodge, Freeport-McMoRan Copper & Gold, and Sumitomo Metal Mining. I also own GrafTech International, which makes carbon rods for steel-making. It's an oligopolic market. There's a European rival with a euro cost basis, and a Japanese consortium of three companies, with a yen cost basis. GrafTech has no price competition. As the dollar weakens, it can raise prices because no one will offset that from overseas. This is an intrinsically good business. It doesn't grow enormously quickly, but the growth is being fanned by China. And it's not terribly expensive: 1.5 times sales and 20% margins.

What about Japan?

Small-cap domestic Japan is like buying U.S. equities in 1976. An 8% dividend yield, a price-earnings ratio of 6, and you're going to make 20 times your money if you hold it for the next 20 years. Japan has had a bear market. Apathy abounds. Secondly, we have valuation. In February of this year, the Japanese market touched its 50-year moving average. For the Dow, that would be roughly equivalent to 2000.

We own Kanaden, an electronics-component manufacturer with 1.5% Ebit [earnings before interest and taxes] margins. Not a great figure. But here's a remarkable thing: Kanaden has a billion dollars in revenue and I can buy it for $30 million. You can't find companies trading on 3% of revenue. My bet is it won't even become a better business in the future, but that it will trade on 20% of revenue. The weakest business I can find in Europe trades on 20% of revenue. Kanaden has the misfortune of having endured a 12-year period of disinflation in its domestic economy.

In Japan, I like property shares, too. Property has fallen 80%, from peak to trough. There are about four or five Japanese real-estate trusts. We own them all. Their property portfolios yield 8%. Long-term government bonds yield 1.5%. Having fallen 80%, the expectation is that in 20 years time, the value of Japanese property will be zero. Well, I disagree. Just as it was absurd when the Japanese emperor's garden had the same value as California, it is absurd in the present day. So we hold Japan Real Estate Investment Trust and Nippon Building Fund.

How about some companies that you think will go down?

The remarkable thing, in my hedge fund, there's not many people more bearish than I am, and I have no shorts. Which fills me with some discomfort.

How can a bear have no shorts?

I've got put options predominantly on the S&P going out to June next year. As I said, it's a bear-market rally. My pan is the stock market. We've pretty much completed the process, the conversion process of bears into bulls. The greatest fear I have is that if I don't have shorts, you better bet no one else really has many shorts out there. Lowry Research calibrates turning points in the stock market by fleshing out the raw emotion of the marketplace. They express a panic date when 90% of the volume traded that day was associated with stocks that declined on the day. And typically, at turning points near the 1962, 1974 and 1982 bottoms, you had 16 to 17 of such panic days. The really odd thing was that, while we had the 50% drawdown in the equity market from March 2000 to earlier this year, we had one panic day.

Why? We have a mature hedge fund community that is profit-incentivized to buy equities when the market is down 3%-4%, which you didn't have in previous times. Because of that, we still haven't seen the true bottom. This time around if markets slide, there's no constituency ready to buy stocks to cover shorts because hedge funds don't really have shorts now. That concerns me. That opens up the prospect of a more immediate decline in valuations. This market has not been subject to intense selling pressure. If it were to be, I fear you might get a crash-like consequence. That's why I have puts on the S&P 500. I'm long the U.S. Treasury market and long index-linked U.S. bonds. Given that everyone has been converted from bulls into bears in the bond market, you've taken a lot of risk out of it.

Because everyone thinks interest rates inevitably are going to go up next year?

Yes. One eventuality may be that the currency market precipitates a crisis. Currencies have a tendency to overshoot and quickly. The currency market says, 'Let's take it to $1.25 or $1.30 . . . then let's go to the level where if the U.S. is concerned, it will start raising short-term rates.' At that point, you expose the Fed because the Fed will not raise rates. The Fed has taken a bull market in equities and put it into the housing market. The Fed can't raise rates. They have to say, 'You know what, 90% of our population don't have passports, but they have houses. Let the dollar go. You know what? We'll survive.'

The Fed needs to get the 10-year bond yield [now around 4.2%] back to 3% to keep refinancing moving. [Otherwise,] you might have to retrench your consumer spending−73% of the economy. Savings will rise, you become more deflationary in your outlook. Bonds work in that environment. The Fed probably can't succeed in getting yields back down to 3%, which is probably why I'm bearish.

You mentioned big pharmaceutical stocks before. Why don't you like them?

Big pharmaceuticals have been horrible. That will continue. I invest in the generic drug makers. The stock market sees a bright future for cheap drugs. It sees a lousy future for expensive drugs.

So you own some generic drugs?

Yes, Ranbaxy Laboratories. Stada in Germany. Teva Pharmaceutical likewise. In Hong Kong, we have China Pharmaceutical. These are all generics and they are all trading at all-time highs at a time when you see the travails of American big pharma. Investors have looked at big pharma, and said `For the last 20 years, they've been great companies and, on that basis, they look incredibly cheap.' You know what? Maybe the last 20 years are not the most relevant benchmark and maybe the next 20 years are going to be rather unpleasant. They're all in downtrends. This is still very, very early for them. They are massive companies in the indexes and everyone owns them.

Sum up your views for me.

I feel hungry. I want to go out and have a steak. I want to go out and buy Nasdaq stocks. I want to believe in the future. But I don't. The thing that concerns me is that we're just a few percentage points higher today on the Dow than we were on the 17th of June, which coincided with the bond market peaking, and we've had such a torrent of good bullish news. There's something wrong. It's not just me.

Thanks. ■