

Blair and Sunwear in 2004

By Martin Denholm

Before I give you my top investment recommendation for 2004, as the Taipan Group's resident Brit I'd like to give you a brief rundown on what to expect from America's staunchest ally in 2004—both politically and economically.

Right off the bat, I think it's fair to say that 2004 promises to be another testing year for British Prime Minister Tony Blair.

Allow me to set the political scene...

After sweeping to power back in May 1997, Blair enjoyed an extended "honeymoon" period thanks to the collective sense of relief among Brits that the staid and desperately out-of-touch Conservative Party were finally removed from office.

Of course, Blair's Labour government inherited a number of problems and immediately set about fixing them as well as fulfilling key election pledges. But as Blair himself would probably admit, the process of reforming and improving Britain's crumbling infrastructure has taken much longer than originally forecast—and cost much more money than anticipated.

Despite this, the Labour Party enjoyed a landslide re-election victory in June 2001, thanks in large part to woeful opposition from a Conservative Party still reeling from its crushing election loss in 1997. Preferring to bicker and fight than to reorganize and unite, the Tories were light years away from offering themselves as a viable alternative to Blair, and suffered another demoralizing defeat.

And Blair benefited from presiding over the tail end of a significant period of economic health in the UK—health that is still very evident today.

Time to Perform

But having been granted a second term in office to push through his election pledges, Blair's favorite phrase that he "inherited all the problems from the ineffective Conservative government" is far less likely to be accepted by the British public. Public patience with Blair—and his popularity—is most definitely waning and the pressure is now on. Brits are patient, but not eternally so. They are now far less likely to be forgiving of inactivity, a lack of accomplishment, and mistakes.

However, like former president Bill Clinton, Blair is an incredibly accomplished public speaker. Regardless of what he is saying, he seems to convey integrity, determination and conviction. That quality has helped him enormously. Even when he's under the fiercest pressure (as so often in 2003), Blair always manages to buy himself some time with a spirited public appearance.

He's going to need more of the same in 2004 if he is to stave off a triple threat and keep the Labour Party in power.

One Year... Three Political Challenges

Brassed-Off Brits! Blair's Public Relations Struggle:

First, and arguably most important, the British public is growing increasingly dissatisfied with Blair and the Labour Party's overall performance. Much of the dissent arises out of what many perceive to be Britain's unadvisable involvement in the war in Iraq and too-cozy ties with George Bush.

According to a Guardian/ICM poll taken in November 2003, while 63% of Brits are favorable towards the US, compared with 15% who aren't, Blair's approval rating has plummeted to just 40%. In the eyes of many Brits, not only was the decision to go to war with Iraq ill-judged, siding with the US so strongly has heaped

pressure on the UK, putting it squarely in the firing line of would-be terrorists.

When Bush visited the UK in November, around 100,000 Brits took to the streets of central London to protest against the US president's policies and the war in Iraq. Undoubtedly, a good dollop of the angst was also reserved for Blair. But I wonder how many of the demonstrators knew that at that very moment, terrorists were busy bombing the UK Consulate and HSBC Bank headquarters in Istanbul, Turkey, killing (among others) the UK General-Consul Roger Short and injuring scores more? Demonstrating against Bush and Blair is easy, but what's their alternative?

Not So Conservative Now—Tories to Put up a Serious Fight at Last?

Second, Blair suddenly faces a more realistic threat from the Conservative Party. In November, the Conservatives cast a vote of no confidence in Iain Duncan-Smith and he was forced to resign as leader. But then something strange happened. Instead of a leadership scramble between several candidates that would have divided the party even further, all the frontrunners declined to put their names forward to lead the party.

They chose instead to throw their collective weight behind Michael Howard, who was the clear favorite to take over anyway. As UK Home Secretary when the Tories were in power and Shadow Chancellor until recently, Howard is a vastly experienced politician and loyal servant to the party. Having been installed as leader without a vote, he has the crucial mandate of a now seemingly united party from the very start. He will pose a considerable challenge to Blair in 2004. However, from his time in office under the old Conservative government he does still have scars that Blair will seek to exploit at every opportunity during their verbal jousts each Wednesday in the House of Commons. It promises to be an interesting contest! Of course it remains to be seen whether Howard can now pull his party together to form a viable alternative for government... and whether he can do so in a reasonable amount of time.

Party Politics Burned Blair in 2003... More of the Same in 2004?

Third, and as if all that weren't enough, Blair faces increasing criticism from within his own party. Former cabinet ministers Robin Cook (Foreign Secretary) and Clare Short (International Trade & Development) quit in 2003 over the government's position on Iraq, and Blair came under stinging criticism for his handling of the issue. And, of course, while ridding Iraq and the world of Saddam Hussein was obviously a positive outcome, the public reason for going to war—that Saddam posed a real and imminent danger with his elusive "weapons of mass destruction"—still hasn't been proven.

Although no longer a constant issue for the media and public, and despite Britain suffering relatively few casualties, the damage has already been done (hence Blair's 40% approval rating).

Students and Politicians Unite!

As 2003 comes to an end, the next storm clouds are already gathering over Blair in response to his latest controversial domestic proposal—university tuition fees.

Back when I was at college, my tuition was free. It's true. I didn't pay a penny in tuition fees—I just had to support myself. Fee payment came from the government and taxpayers. I was lucky and very grateful for that. But I was also one of the last students to be granted such a luxury. Shortly after I graduated, with academic institutions facing an increasingly tough time paying the bills, the government introduced a law requiring university students to pay £1,000 in tuition fees per academic year.

Naturally, hard-up students protested the move, but to no avail. To tell you the truth, I wouldn't have minded paying... as long as the price of a good education was worth my hard-earned cash. And UK statistics show that those with a college education usually end up with better-paying jobs than those who don't have a degree.

Now, however, both students and political parties are angry over Blair's latest plan to raise tuition fees even further. A vote on the issue was scheduled for December, but it had to be postponed until the end of January in the face of imminent defeat and the fact that 149 of Blair's own Labour Party members signed a bill opposing

the plan. The fear is that under the proposal, individual universities will be allowed to charge students up to a maximum of £3,000 per year in fees. Students would repay the fees once they graduate and are earning at least £15,000 a year—although an amendment to the plan may raise that threshold to £20,000.

A recent Guardian/ICM poll suggests that 60% of voters disapprove of Blair's plan. But history has shown the PM to be a very gutsy politician. He is refusing to back down on the issue, arguing that it's essential for the long-term financial health of universities. It will be the first real test of Blair's authority in 2004... and should his proposal fail to pass the House of Commons, it would be disastrous for him. It would also leave colleges with an estimated £8 billion revenue hole to fill.

Blair Forced Resign in January?

But that's a pure policy decision. There's another issue that could prove to be fatal to Blair in the New Year—he's admitted as much himself. An issue that has faded from the limelight in recent weeks, but still remains critical... and could rock Blair's world.

I'm talking about the results of the official enquiry into the suicide death of weapons expert Dr David Kelly in July 2003. In January, Lord Hutton will deliver his verdict on the circumstances surrounding Kelly's death. If you remember, Kelly became embroiled in a bitter public row between Blair's government and the BBC over allegations that the government had "sexed up" the dossiers of information on Iraq's weapons of mass destruction. When it came out that Kelly was the source casting doubt on the government's position, he took his own life.

If the evidence shows that Blair knowingly overstated the case with Iraq, he's already admitted he would be forced to resign.

The Heir to Blair

The rumors surrounding Blair's apparently edgy relationship with his chancellor, Gordon Brown, also continue to swirl, but who really knows what goes on behind closed doors at 10 Downing Street? It's true the two men have disagreed on some major policy issues, but isn't that natural in any democratic government? The real trouble arises when issues cannot be resolved: disagreements become bitterer and spill into the hands of the media for rigorous public scrutiny. My feeling is that the Blair-Brown relationship is pretty strong (or, to quote Blair, it will "endure"), and rumors that it is testy and fragile are simply media hype.

But, while not actively lobbying for the job himself, it's abundantly clear that Gordon Brown is the heir apparent to Blair's throne and is simply biding his time until the PM's term is up (or he runs out of favor with party and people). Brown has an uncanny knack for crunching the numbers and has done an excellent job of steering the UK economy safely through some very choppy economic waters.

On Target in 2003... Better to Come in 2004

In mid December, Brown announced that the British economy is on target to meet his growth forecast this year... and is set for yet stronger growth in the next few months. The world's fourth-largest economy will grow 2.1% in 2003—the low end of the 2% to 2.5% forecast he made in April. He predicts growth in 2004 and 2005 to roll in between 3% and 3.5%. That would be well above the levels forecast for both the Eurozone and Japan.

Unfortunately, the government is also racking up a pretty big budget deficit, which is putting the strain on revenues. Brown may have been spot-on with his growth forecast, but his £27 billion deficit estimate for fiscal 2003 (April 2003-April 2004) was way off the mark. The deficit is now projected to be £37 billion, thanks to war costs, increased defense spending and a sluggish global economy earlier this year.

Messrs. Blair and Brown were hoping they wouldn't have to raise taxes before the next election in 2006. But new taxes look increasingly likely if Blair wants to deliver on his election pledge to spend £100 billion

upgrading Britain's infrastructure.

Brown has defended his borrowing spree, saying the current economic growth rate supports it and the extra investment is needed in order to get improved returns. He has also said he would have no qualms about breaching the EU Stability Pact rules if the UK enters the Eurozone and adopted the euro currency.

The UK economy has recorded growth in every quarter since the Labour Party assumed power in 1997 and Brown took on the job of chancellor. That's pretty impressive, considering the global downturn and economic malaise afflicting Britain's Eurozone neighbors.

Brown deserves his shot at the top job, and there's a good chance 2004 will be the year the "Brown for PM" chorus starts to swell.

Pumping up the Base in 2004

The US Federal Reserve may not have started to raise interest rates just yet, but in Britain the trend got underway in November with the Bank of England's decision to raise the base rate by 0.25% to 3.75%.

The bank's first move to tighten monetary policy came in response to brisk consumer borrowing, worrying levels of debt, and the rampant housing market. Consider these sobering statistics...

- The Bank of England says average household debt is £7,000 (US\$12,225)... with a third of UK households having no savings to fall back on.
- The average individual is £3,500 in debt.
- 12% of Brits owe £2,000 or more; 6% owe £10,000 or more.
- A survey by the CPP Group found that one in four Brits are concerned about debt and their ability to repay it.

And from the housing market...

- In 2002, UK house prices grew at the fastest rate since 1989. Prices are currently rising at a 14% annual rate.
- House prices rose 12% in the 12 months to October 2003.
- The average price of a home is £139,400—four times more than the average annual salary.
- Mortgage lender HBOS says house prices in northern England have risen by 60% over the last two years.

According to the Bank of England, the mortgage lending growth rate in October 2003 was 15% - the highest monthly amount since 1993.

Watch for the BoE to raise rates again in February. The upward move is likely to be another 0.25%, putting the base rate at 4% as the bank tries to stem the tide. I wouldn't be surprised to see interest rates back at 5% by the end of 2004.

OK... that's a taste of what to expect from the UK in 2004. But you'll want a way to make some money this year, too. So allow me to oblige by jetting back across the Atlantic to give you my top stock pick for 2004...

Add Some West Coast Offense to Your Portfolio

It's time to grab your boogie board and go surfing with what I think will be one of the top performing companies of 2004. A rapidly growing company that is steadily gobbling up the market shares of many of its bigger, more established rivals. And believe me, although you might not have heard of it before, this company is one of the hottest things in the west!

Based in Anaheim, California, Pacific Sunwear of **California Inc (PSUN:NASDAQ)** has its finger firmly on the pulse of all the latest trendy youth fashions. It specializes in two main product lines: casual sports apparel—beachwear and surfwear, snowboarding clothing and “grunge” skateboard gear—and the immensely popular “hip-hop” style of clothing.

Not sure what I’m talking about? Well, take a look at what kids are wearing these days, or flip on one of those youth-oriented shows on television to see what I mean. Such style is a huge part of music, TV and movies nowadays—and the fervent desire for it is helping drive sales at PacSun.

PacSun operates three divisions—the main PacSun brand, PacSun Outlet, and its five-year-old d.e.m.o. stores.

While PacSun stores focus on casual apparel, featuring brand names like Quiksilver and Vans, its younger offspring—d.e.m.o.—specializes in the burgeoning hip-hop clothing style.

By covering these trends in different stores (but under one company umbrella), PacSun manages to pull in young people from across the board in a way many of its rivals haven’t managed to match. This means the company is in a better position to protect itself from market shocks (you know how quickly teens can turn fickle over their fashions!).

Making its parent company proud: d.e.m.o.

And it’s the youngest chain, d.e.m.o., that is generating a huge chunk of the growth, in tandem with the incredible popularity of stars like Eminem, 50 Cent and Jay-Z. It already carries hugely popular hip-hop products like Phat Farm, Ecko, J-Lo, and Eminem’s “Shady Ltd” clothing range.

Check out PacSun and d.e.m.o.’s recent outstanding sales figures...

In September 2003, PacSun recorded sales of US\$82 million—29% higher than in September 2002. While PacSun store sales increased 18%, d.e.m.o. sales swelled by 24.2%.

In the difficult month of October, the company did US\$62.6 million in sales—an impressive 14.7% increase over October 2002. Again, d.e.m.o. sales beat its creator with a 14% spike.

For its third quarter overall (August-October), PacSun enjoyed 23% sales growth (\$281 million) over the same period in 2002, with d.e.m.o. notching up a 20% gain. In the first nine months of 2003, the company racked up US\$714 million in sales—beating 2002 figures by 23%, thanks to strong d.e.m.o. growth of 25.5%.

PacSun turns a triple play: Income... to earnings... to margins

Such stellar sales growth produces equally strong financials. Third-quarter net income raced to US\$24.5 million—a 54% gain on Q3 2002. Net income from January to September totaled US\$46 million (59 cents per share)—a 73% increase over the same period in 2002.

Third-quarter earnings per share jumped by 48% to 31 cents. That means EPS growth in 2003 has soared by a remarkable 73% versus the industry average of 26%. And if you think that’s good, the company expects earnings growth in fiscal 2004 to be 20% higher. For the investor, that means an 18% rise in EPS from this year’s 94 cents to US\$1.11 next year.

Because of such results, PacSun boasts a net profit margin of 7.1% (up 1.2%) and an operating margin of 11.3% (up 3.3%).

Surf’s up on the Pacific

Return on equity is a very healthy 21%. And fourth-quarter earnings are projected to roll in at US\$306.1 million—a further 9% gain.

PacSun currently operates 863 stores in all 50 states—664 under the PacSun label, 78 PacSun Outlet stores

and 121 d.e.m.o. stores. Thanks to rapid growth, new stores are popping up all the time. And the company has plenty of cash to expand further. For example, d.e.m.o. has stores in just 20 states, giving it lots more growth potential. The overall aim is to have 1,400 PacSun, PacSun Outlet and d.e.m.o. stores by 2007.

When I saw that PacSun stock has produced a 132% return since 2000, I feared it had topped out. But with its diverse brands and mass appeal to the fashion-hungry teen market, the company has become one of the most popular destinations for fashion-hungry teens. I believe its shares still have plenty more room to run.

PacSun should do well this holiday season. And with its trendy beach and surf-oriented clothing, next summer bodes well too (from mid April to early September 2003, the stock rocketed 73%). So consider this a long-term play. Look for another successful year in 2004.

Buy Pacific Sunwear under US\$21. ■

Company / Symbol	Dividend as of 10/31/03
Altria Group (MO:NYSE)	5.85%
AT&T (T:NYSE)	5.11%
General Motors (GM)	4.71%
DuPont (DD:NYSE)	3.47%
Merck (MRK:NYSE)	3.34%