

**Euro Weekly**



**Europe**

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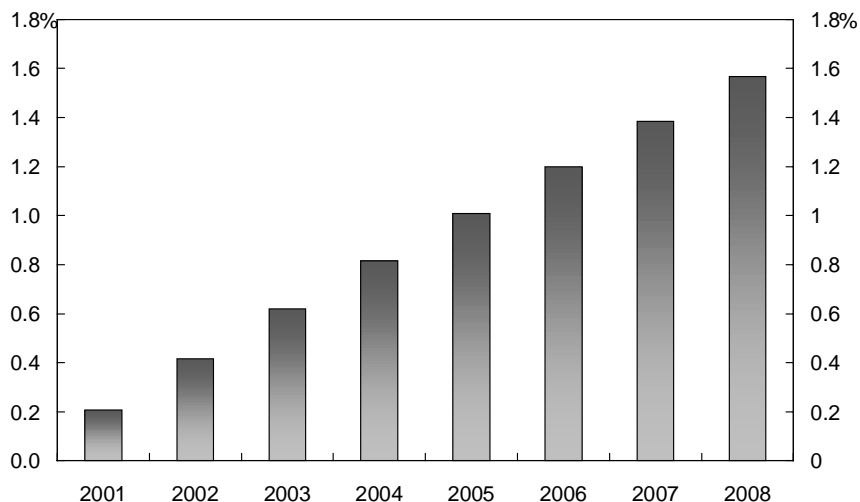
José Luis Alzola  
A. Steven Englander  
J. Paul Horne  
Jean François Mercier  
Stephan Monissen  
Carmen Nuzzo

Forecasts	3-month hence	12-month hence
\$/€	0.89	0.98
Repo	4.75	5.50
10-yr Bunds	5.35	5.40
£		
£/€	0.62	0.66
Base Rate	6.25	7.00
Spread vs Bunds	25bp	40bp
<b>Sweden</b>		
SKr/€	8.50	8.55
Call Money	4.00	4.75
Spread vs Bunds	10bp	25bp
<b>Switzerland</b>		
SFr/€	1.52	1.56
Call Money	3.50	4.00
Spread vs Bunds	-135bp	-135bp

**Defusing the Pension Bomb**

- **The German pension plan will probably generate modest extra inflows to equities and bonds.**
- **But inflows will not be big enough to materially alter the outlook for equity and bond markets. Even if takeup is high, annual inflows to the new pension funds are unlikely to significantly exceed 1% of GDP until the latter part of the decade.**
- **Nevertheless, the plans have a broader importance as another symbol of the move towards structural reform in the euro area, and might help trigger further shifts towards funded-pension systems across the euro area (see page 2, Stephan Monissen).**

**Figure 1. Germany — Maximum Pension Contributions (As a Percentage of GDP), 2001F-08F**



Sources: Bundesbank, Bundesministerium für Arbeit und Sozialordnung and Schroder Salomon Smith Barney calculations.

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## Euro Area: Implications of the German Pension Plans

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- **German pension plans are likely to trigger modest extra inflows into financial assets in the next few years.**
- **Although initially small, flows might pick up over time, if the German reforms are mirrored elsewhere...**
- **...but inflows into bonds are unlikely to be big enough to produce a U.S./U.K.-style scarcity premium.**

*The German pension reform will generate modest extra flows into financial assets, but the effect may grow over time.*

The German government's pension reform plans probably will lead to extra inflows into financial assets in coming years. The extra inflows will be modest in size initially, especially compared with the recent shift in euro-area mutual fund flows. Nevertheless, the plans also have a wider symbolism. They demonstrate the German government's willingness to follow up its tax reform with other measures aimed at rectifying structural weaknesses. And if the German plans prove popular, then this will raise the chance of similar moves in other euro-area countries that, over time, could lead to large extra flows into financial assets.

*Germany will keep a public pay-as-you-go system...*

The German reform will introduce a privately funded system partly to replace the existing state scheme, which will continue to operate on a pay-as-you-go basis. The level of state pensions gradually will fall from 70% of wages now, to 64% in 2030. This should limit the extent to which the aging population requires a rise in pension contributions, although contributions still will edge up from 19.3% of gross wages now to just below 20% in 2020 and just below 22% in 2030. These costs are split 50-50 between employer and employee.

*...and add privately funded pensions.*

Under the plans, individuals will be able to pay part of their income into a privately funded scheme (either a personal or a company scheme). These contributions will be capped at 0.5% of gross wages next year, rising to a maximum of 4% of gross wages in 2008. These contributions will be made out of pre-tax income, while there also will be modest subsidies for some groups, notably those on low incomes and parents. Upon retirement, the proceeds of the pension fund could be used to buy annuity-type products (fixed or variable). The draft does not address the tax treatment of returns within the pension funds, and it appears that current standard income tax rules will apply. In this case, investment in life insurance contracts will be tax-exempt and capital gains on equities will be tax-free after a one-year holding period.

**Figure 2. Germany — Possible Maximum Flows Into New Pension Plans (Euros in Billions), 1999-08F**

	Gross Wages		Pension Contributions	
		YoY		Share Of Wages
1999	€849.4bn			
2000F	876.0	3.1%		
2001F	906.6	3.5	€4.5bn	0.5%
2002F	938.4	3.5	9.4	1.0
2003F	971.2	3.5	14.6	1.5
2004F	1005.2	3.5	20.1	2.0
2005F	1040.4	3.5	26.0	2.5
2006F	1076.8	3.5	32.3	3.0
2007F	1114.5	3.5	39.0	3.5
2008F	1153.5	3.5	46.1	4.0

Note: The scenario assumes that gross wages rise 3½% each year and that allowances for pension contributions are fully used.

Sources: Bundesbank, Bundesministerium für Arbeit und Sozialordnung and Schroder Salom on Smith Barney calculations.

*Net inflows will trend higher over time.*

The new plans probably will prove popular, not least because of the tax incentive. The recent rise in mutual fund inflows in Germany suggests that people also are becoming more sensitive to the need for long-term savings. As a rough guide, total inflows to the new pension funds could rise from 4.5bn in 2001 to 20.1bn in 2004 (0.6% of GDP) and 46.1bn (1.8% of GDP) in 2008. This estimate assumes that contributions match the maximum of 0.5% of wages in 2001, rising to 4% in 2008, and that wages rise by 3.1% this year and 3½% per year thereafter. Initially, we assume that there is no offsetting impact on other savings. For this reason — and also because we assume that inflows immediately hit the permissible ceiling — these estimates have to be viewed as a maximum.

*Dutch pension fund inflows suggest flows into bonds will exceed flows into equities...*

As a rough guide to the possible effect on various asset classes, we assume that the new German pension schemes match the asset allocation used over the past decade in the Netherlands, which has a large funded private pension industry. Over 1990-98, Dutch insurance companies and pension funds allocated about 57% of their inflows into bonds, 33% into equities and 9% in other assets. In the United Kingdom, net inflows to bonds over the last 15 years also have been roughly twice the inflow to equities. If we use the Dutch parameters, then the net inflow to bonds via pension funds would be about 2.6bn next year, rising to about 26.4bn in 2008. Inflows to equities would be about 1.5bn next year, rising to 15.4bn in 2008. The rest might go into other assets, like real estate and short-term assets.

**Figure 3. Germany — Impact of the Pension Reform on Financial Market Flows (Euros in Billions), 2001F-08F**

	Pension Contributions	Asset Allocation based on Dutch Benchmark		
		Bonds	Equities	Others
2001F	€4.5bn	€2.6bn	€1.5bn	€0.4bn
2002F	9.4	5.4	3.1	0.9
2003F	14.6	8.3	4.9	1.4
2004F	20.1	11.5	6.7	1.9
2005F	26.0	14.9	8.7	2.4
2006F	32.3	18.5	10.8	3.0
2007F	39.0	22.3	13.0	3.6
2008F	46.1	26.4	15.4	4.3

Note: The scenario assumes that gross wages rise 3½% each year, allowances are fully used and that the asset allocation follows the pattern reported for The Netherlands (excluding private loans) over the 1990-98 period.

Sources: Bundesbank, Bundesministerium für Arbeit und Sozialordnung, De Nederlandsche Bank, OECD and Schroder Salomon Smith Barney calculations.

*...although the new funds in practice may show a greater preference for equities than past experience suggests.*

In practice, the new pension funds probably will be more biased to equities than the Dutch and U.K. funds. The schemes initially will not need to pay out for a long time, and hence could opt for the higher long-term return of equities over the reduced volatility of bonds. Moreover, the superior recent performance from equities is tempting more investors into equities. For example, the bulk of retail inflows to mutual funds in Germany has gone into equity funds rather than bond funds recently. But these figures are intended as rough guides.

*The new pension scheme partly will displace other forms of saving.*

In addition, OECD estimates suggest that 50% of private pension contributions simply displace other forms of private savings (eg mutual funds, bank deposits, direct holdings of bonds and equities).<sup>1</sup> Allowing for this, the total net flow of extra money into bonds and equities would be less than in the table above.

<sup>1</sup> See OECD, *Aging Working Papers 1.1*: "The Macroeconomics of Aging, Pensions and Savings: A Survey".

*Flows into bonds may be tilted slightly towards the long end.*

Because of the long-term nature of these funds, they may have a slight tendency to overweight the long end of the yield curve within their bond holdings. However, as the draft plans stand, the only restriction on the funds' investments decision appears to be that they have to guarantee the nominal amount invested. This would actually be a sizeable constraint, but would not require the funds to match assets and liabilities in a rigorous way.

*The new pension funds are unlikely to generate an Anglo-Saxon-style scarcity premium.*

It is unlikely that the new pension schemes by themselves will lead to the kind of significant scarcity premium on long bonds seen in the United States and the United Kingdom. The inflow to pension funds will not be huge early on (in the above scenario, perhaps 14.9bn in 2005 and 26.4bn in 2008), and could be outweighed easily by other factors such as mutual fund flows. For example, in the 12 months ended June, there was a net outflow of 96bn by retail investors from bond-oriented mutual funds in the four main euro-area countries (Germany, France, Italy and Spain). By contrast, in the 12 months ended June 1999 they had a net inflow of 72bn. For this year, we expect net issuance of euro-area government bonds of about 142bn (with gross issuance of 439bn less redemptions of 297bn). Allowing for other issuance (by the private sector and foreign issuers), total net issuance of euro-currency long-term bonds is running at about 500bn per year.<sup>2</sup> Net government issuance is likely to fall over time, but private issuance is rising.

*Equities also will enjoy inflows; and pension providers will gain directly.*

Equities also will gain somewhat from the extra inflows but, again, the impact initially will be modest compared with other flows. In Germany, retail investors put 22bn into equity mutual funds in the first half of this year alone, and across Germany, France, Italy and Spain net inflows to equity mutual funds totaled 77bn in the same period. The main gainers might be institutional fund managers, who also will receive extra fees for managing the new pension funds.

*The pension plans will lead only to a minor loss in tax revenues.*

These plans will have little effect on the medium-term German fiscal position. The cut in future pension payments will be offset by the cap on future pension contributions. Thus, the only impact on the fiscal position will come from the tax relief on contributions. Government estimates suggest that the cost of tax relief might rise from about 0.3bn next year to about 9bn in 2008, once the full 4% contribution is reached (see Figure 4). Even in 2008, however, the cost would be only about 0.3% of GDP, which is small compared with potential effects from economic trends.

**Figure 4. Germany — Budget Implication of the Tax Incentives (Euros in Billions), 2001F–08F**

2001F	2002F	2003F	2004F	2005F	2006F	2007F	2008F
€-0.3bn	€-1.3bn	€-2.5bn	€-3.7bn	€-5.1bn	€-6.2bn	€-7.7bn	€-9.0bn

Note: The table shows the impact on the general budget of the tax incentives for private pensions.

Sources: Bundesministerium für Arbeit und Sozialordnung and Schroder Salomon Smith Barney calculations.

*Parliamentary approval is likely.*

The government needs agreement with the opposition for parliamentary approval. Talks will start soon, but opposition comments suggest that approval is likely. Over time, another issue — the tax treatment of capital gains and income within the pension funds — might be addressed, and it is possible that over time a more favorable tax treatment for these funds might be introduced.

<sup>2</sup> Source: *ECB Bulletin*, table 3.5. Net issues of longterm bonds totalled 492bn in the 12 months ended June 2000.

*Over time, the plans may prompt more generous pension reforms or reforms in other areas...*

Even though the flows into the new funds probably initially will be modest — compared with overall flows in financial markets — the plans have important long-term implications. First, if these plans prove successful, the government over time might raise the amount individuals can put into these pension schemes, hence generating larger flows. Second, with tax reform and pension reform, the German government now has introduced two significant structural changes. This might raise hopes that Germany's biggest structural problem — the labor market — might be addressed. However, such reforms will not be easy. Labor market reform currently is not on the political agenda and the government may want to avoid potentially painful changes as the 2002 general election approaches.

*...and may encourage other euro-area countries to expand or adopt private pension schemes.*

The inflow to financial assets also would be amplified if other euro-area countries follow a similar path. Evidence at present is mixed. In Spain, long-standing tax incentives for privately funded schemes finally are triggering a significant rise in inflows to pension funds. In Italy, policy gridlock and fiscal constraints so far have limited efforts to encourage shifts of funds into private pension funds. However, some progress could materialize next year, as the pension reform of the public system of 1995 and the subsequent amendments of 1998 are due for review. The Belgian government also is considering introducing elements of a funded system. By contrast, a shift towards a privately funded system is unlikely in France in the nearterm. The French government instead is trying to build a buffer for the unfunded public system by putting windfall profits (eg part of the UMTS proceeds) into a reserve fund on a discretionary basis. At least initially, this fund is likely to invest in fixed-income products.

### Key International Economic Indicators

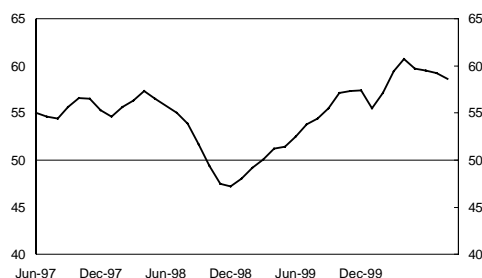
#### Euro Area

Oct 2  
09:00  
London Time

#### Purchasing Managers' Index — PMI (Sep)

**Forecast: 59.0**

**Previous: 58.6**



The euro-area Purchasing Managers' Index (PMI) probably edged up slightly to 59.0 in September after 58.6 in August. Thus, we expect a slight rebound after four consecutive drops. Most likely, 2Q00 activity was the cyclical peak. Nevertheless, the projected figure still would be very high, pointing to a continuing rapid expansion in manufacturing activity. This sector particularly gains from the export-led expansion, reflecting the soft euro. Going forward, the PMI is likely to hover around current levels, which would be in line with our view of an extended expansion.

Oct 5  
11:00  
London Time

#### Industrial Confidence (Sep)

**Forecast: +5**

**Previous (Jul): +7**

#### Consumer Confidence (Sep)

**Forecast: -1**

**Previous (Jul): 0**

Lower confidence in the manufacturing sector in both Germany and Italy over the summer, together with a probable deterioration in sentiment in France, suggests that the euro-area index of manufacturing confidence fell by about 2 points in September. Higher oil prices probably were influential in dampening profit expectations, despite the weaker euro and general prospects of tax cuts across the euro area. With respect to household confidence, we expect that it edged down in September, probably undermined by inflation fears, as data from Italy and the Netherlands would suggest.

France  
Sep 29

#### Producer Prices (Aug)

**Forecast: 0.1% Mo.-Mo.; 5.7% Yr.-Yr.**

**Previous (Jun): 0.5% Mo.-Mo.; 6.1% Yr.-Yr.**

Producer price data for July and August, which will be released simultaneously on Friday, should show a moderate deceleration in the year-on-year rate of PPI inflation, as the late August/early September price surge will not have been reflected yet in the statistics. If anything, the mid-July decline in oil prices should have kept the August index little changed from the July level. Excluding oil, however, the rate of PPI inflation should have crept up over the summer as earlier energy price increases boosted input costs.

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**Key International Economic Indicators**


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**France (Cont'd)**

Sep 29	<b>Unemployment (Aug)</b>	<b>Forecast: -25,000 Mo.-Mo.; 9.6% of Workforce</b> <b>Previous: +8,500 Mo.-Mo.; 9.7% of Workforce</b>
	Following a surprise rise of 8,500 in July (the first rise in 11 months), we expect that the long declining trend in the French jobless total will have resumed in August, reflecting still-strong job creation not only in the services but also the industrial sectors. It appears that the July rise was more the result of a statistical quirk — with the job market improving, more school-leavers start looking for jobs early in the summer, a trend not yet reflected in seasonal adjustments — than a change in trend. Still, upcoming unemployment declines should be smaller than earlier this year, when job creation was temporarily influenced by the shift to the 35-hour workweek in medium to large companies.	
Sep 29	<b>Manufacturing Confidence (Sep)</b>	<b>Forecast: +35</b> <b>Previous (Jul): +40</b>
	The general confidence indicator for manufacturing probably declined in September after a surprise jump to +40 in July (no survey was carried out in August). The July increase had appeared inconsistent with other reports of softer production prospects or lesser optimism on order books. This month, the confidence report should give further evidence that the peak in growth has been reached, but that the outlook remains encouraging by historical standards.	
Oct 4	<b>Consumer Confidence (Sep)</b>	<b>Forecast: +3</b> <b>Previous (Jul): +1</b>
	After reaching in July a new record since the monthly survey started in 1987, consumer confidence probably edged down 2 points in September, mirroring moves seen in other EU countries such as Italy or the Netherlands. The major reason for (relatively) poorer sentiment would have been the impact of higher oil prices on purchasing power expectations, which probably was not offset by the confirmation of household income tax cuts in the 2001 budget.	
<b>Germany</b>		
Oct 5 08:55 London Time	<b>Unemployment (Sep)</b>	<b>Forecast: -15,000 Mo.-Mo.; 9.4% of Total Workforce</b> <b>Previous: -18,000 Mo.-Mo.; 9.5% of Total Workforce</b>
	Seasonally adjusted unemployment probably fell 15,000 month on month in September, following an 18,000 drop in August. Thus, we expect unemployment to continue its downtrend. Forward-looking indicators point to a continuing improvement in the labor market. The unemployment rate probably edged down by one tick to 9.4% in September, expressed as a percentage of the total labor force. Since April 2000, the unemployment rate is based on the updated employment figures; thus the figure is not comparable with past data. Our forecast for the seasonally adjusted number implies that unadjusted unemployment fell by 87,000 to 3.694 million.	
Oct 6 Around 10:30 London Time	<b>Manufacturing Orders (Aug)</b>	<b>Forecast: 0.6% Mo.-Mo.; 6.7% Yr.-Yr.</b> <b>Previous: 0.2% Mo.-Mo.; 12.0% Yr.-Yr.</b>
	Manufacturing orders probably rose 0.6% month on month and rose 6.7% year on year in August, after July's 0.2% month on month and 12.0% year on year. The significant drop in the year-on-year figure is due to a base effect, as orders jumped 5.6% month on month in August last year. The year-on-year figure is likely to return to double-digit levels in September. Going forward, the recently approved tax reform is likely to lead to a temporary surge in capital goods orders, as companies lock in the old — more generous — depreciation rules.	
<b>Italy</b>		
Oct 2 08:00 London Time	<b>Producer Price Index (Aug)</b>	<b>Forecast: 6.6% Yr.-Yr.</b> <b>Previous: 6.6% Yr.-Yr.</b>
	The August drop in oil prices probably helped to cap the rise in intermediate goods prices, compared with the sizable gains of May-July. The passthrough of previous input price increases into consumer and investment goods probably continued in August. However, reflecting favorable base-year effects, consumer goods inflation probably slowed for the second month in a row, from a peak of 2.1% in June.	
<b>Spain</b>		
Oct 6	<b>Industrial Production, Cal. Adjusted (Jul)</b>	<b>Forecast: 8.0% Yr.-Yr.</b> <b>Previous: 4.3% Yr.-Yr.</b>
	Production expectations are consistent with a rebound of manufacturing activity in July, after a temporary blip in June. Strong demand for investment and intermediate goods products should continue to lead the expansion of manufacturing activity.	
<b>United Kingdom</b>		
Oct 2 09:30 London Time	<b>MO (Sep)</b>	<b>Forecast: 0.9% Mo.-Mo.; 7.6% Yr.-Yr.</b> <b>Previous: 0.6% Mo.-Mo.; 7.0% Yr.-Yr.</b>
	Partial data suggest that narrow money picked up again in September with, we estimate, the largest monthly gain since January. The link between narrow money and retail sales is not very close but, at the margin, the pick-up in narrow money suggests that retail sales probably remained quite strong in September.	
Oct 2 09:30 London Time	<b>Purchasing Managers' Index (Sep)</b>	<b>Forecast: 52.5</b> <b>Previous: 51.7</b>
	The August data showed a marked rebound in orders for manufacturing industry, and we expect this to be reflected in a further gain in the overall index in September. The August reading was similar to the average reading since the PMI series began in 1992, and over that period manufacturing output has risen by an average of just above 1% year on year (similar to its recent pace). So the recent readings suggest that manufacturing output will continue to expand modestly, neither accelerating nor slowing markedly. The prices series in August was a bit below the five-year high of 64.2 seen in April, but the September figure may well rise close to the April level because of the cost pressures from the recent rise in oil prices plus the drop in sterling against the US dollar.	
Oct 4 11:00 London Time	<b>CBI Retail Survey — Balance Reporting Sales Up Yr. on Yr. (Sep)</b>	<b>Forecast: 25%</b> <b>Previous: 18%</b>
	We expect a modest bounce in the reading for the growth of sales from a year ago, in line with the strong sales reported by retailer John Lewis for the first two weeks of the month and the strong gain in narrow money. The fuel famine probably will distort things a bit, adding to fuel sales while hitting sales of other items, but it is not clear whether the overall effect will be to boost sales or hurt them.	

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**Key International Economic Indicators**


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**United Kingdom (Cont'd)**

Oct 4 09:30	<b>Services PMI (Sep)</b>	<b>Forecast: 58.5</b> <b>Previous: 58.4</b>
London Time	The services PMI has stayed around 57-60 in recent months and probably will remain around that range in coming months. The growth of new orders remains quite strong, although some of the forward-looking series (such as confidence) may weaken in response to fears that the recent rise in oil prices will raise costs and hurt profits going forward.	
Oct 5 09:30	<b>Private Housing Starts (Aug)</b>	<b>Forecast: 14,000 Mo.-Mo.; 7.7% Yr.-Yr.</b> <b>Previous: 13,400 Mo.-Mo.; 4.7% Yr.-Yr.</b>
London Time	Private housing starts have crept higher in recent months, and probably will continue to make modest progress in coming months. So far this year, starts have averaged 13,500 per month, compared with 12,900 in 1999. Starts are quite interest-sensitive, and their recent gentle rise fits in with other evidence suggesting that interest rates are not yet high enough to slow growth back to trend on a sustained basis.	
Oct 5 09:30	<b>New Construction Orders (Aug)</b>	
London Time	Construction orders have risen quite sharply in recent months, with orders in the past six months up 5% year on year. The gains include sizeable gains in public sector work, which probably reflect the rise in public spending announced by the Chancellor. Data are volatile from month to month, but we suspect that construction orders will remain firm in coming months as the fiscal boost continues to come through.	
Oct 6 09:30	<b>Industrial Production (Aug)</b>	<b>Forecast: 0.0% Mo.-Mo.; 1.2% Latest Three Months Yr.-Yr.</b> <b>Previous: -0.1% Mo.-Mo.; 1.8% Latest Three Months Yr.-Yr.</b>
London Time	<b>Manufacturing Output (Aug)</b>	<b>Forecast: 0.3% Mo.-Mo.; 1.1% Latest Three Months Yr.-Yr.</b> <b>Previous: -0.3% Mo.-Mo.; 1.5% Latest Three Months Yr.-Yr.</b>
	Manufacturing output fell back in July but, with surveys indicating that output continues to rise steadily, we suspect that output will rebound again in August. Industrial production has risen ahead of manufacturing in recent months because of strong gains in output of oil and gas, plus the utilities sector. Output of oil and gas is likely to remain buoyant given the rise in oil prices, which has boosted the profitability of the oil and gas sectors. But output of the utilities sectors may slip back after previous — perhaps erratically strong — gains. Such a reading would leave the average level of industrial production in July and August little changed from the 2Q level, which would pose a downside risk to our forecast of a fairly strong gain in 3Q GDP.	

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