

## Ray of hope

Economic decline or recovery, deflation or inflation? These questions have put a spell on the investment community. News reports are contradictive and correspondingly investors are acting indecisively.

### Slowdown in economic decline

Unchanged, economic development continues to cause concern. Then at the end of June, the latest report by the World Bank revealed itself as a prompt damper on sentiment. According to the World Bank, global GDP will decline by 2.9% in the current year. For the Eurozone, a decline by 4.5% is predicted, significantly higher than the previous estimate (-2.7%). Whereas the USA will suffer a decline of 3% in its economic prowess, the Washington institution is predicting a drop of 6.8% for Japan.

The repercussions on the emerging economies of such a scenario would be dramatic. In 2007, this region of the world grew by 8.1%. In 2008, the figure was still 5.9% and according to the World Bank, this will be down to a meagre 1.2% in 2009. Stripped of China as well as India, who are accredited with a relatively solid positive development, the group of developing and emerging economies would retrench by 1.6%. As the World Bank warns, this would mean job losses for millions of people and a relapse into poverty.

The OECD's latest forecast is less gloomy. It expects less of a decline for developed nations than hitherto and marginal growth in 2010. With this, the Paris-based organisation delivered its first upward revision since mid 2007. The OECD estimates that economic performance amongst the 30 member states will decline by 4.1% overall in 2009 and will rise by 0.7% in 2010. Back in March, the organisation of the leading industrialised nations was expecting a decline of 4.3% and a recovery in the following year of a mere 0.1%. To the OECD, it appears to be a fait accompli that the recession in the USA will end during the second half of the year. Europe, on the other hand, is likely to take longer to get back on its feet. While a decline is expected in American GDP of 2.8% in 2009 and a rise of 0.9% in 2010, the organisation anticipates a decline in the Eurozone of 4.8% during 2009 and a break-even in the following year.

### Commodity prices as positive leading indicators

A number of individual factors allow the optimistic version to appear the more likely scenario. Commodity prices were recently once more displaying some strength. Most of all, the price of crude oil recovered significantly. The managers of the Guinness Global Energy Fund identify higher demand from China as the main reason. Daily demand from the Middle Kingdom is around 3.9 million barrels per day (one barrel =

159 litres) and as such, close to the record set in the winter of 2008. In addition, increased investor confidence in a global recovery is pushing prices up, however, related to this, a build-up of (speculative?) positions on the futures exchanges has also been observed. Other commodities have equally left their lows behind. The same applies to freight rates, as measured by the Baltic Dry Index.

The Eurozone's overall economic sentiment indicators for June reached a seven-month high. Furthermore, consumer, as well as industrial confidence, contributed to improving values for the third month in a row.

Average **growth- and inflation expectations** of economists surveyed by „The Economist“:

	Real GDP Growth		Inflation	
	<u>2009</u>	<u>2010</u>	<u>2009</u>	<u>2010</u>
Germany	-5.5%	0.5%	0.2%	0.8%
Euroland	-4.1%	0.5%	0.4%	1.0%
United Kingdom	-3.7%	0.6%	1.5%	1.7%
Japan	-6.7%	0.8%	-1.1%	-0.5%
Switzerland	-2.3%	0.3%	-0.5%	0.4%
USA	-2.8%	1.6%	-0.8%	1.2%

### Financial markets less febrile, but not yet fully recovered

Financial markets calmed down during the second quarter. Equity markets experienced impressive advances. In step with this, volatilities declined. In return, investors shed government bonds pushing yields up. Even last year's much maligned hedge-fund industry comes out as adaptable by surprising on occasion with innovation as well as positive returns.

It is doubtful whether investors have already shot their bolt in equity markets. Investors are still holding above average amounts on current accounts and in low-yielding money market funds, which one day may move back into equities.

A survey undertaken by Barclays Wealth Switzerland amongst globally 2100 wealthy private investors (investable assets from 0.5 to 30 million Pounds) between March and May this year illustrates this uncertainty. More than two thirds of the participants were of the opinion that in historical terms, there were extraordinary investment opportunities to be had. However, as uncertainty reigns as to the likelihood of another big storm striking, they are withholding action.

Change in **equity markets since the beginning of the year**

		<u>December 2008</u>	<u>June 2009</u>	<u>change<sup>1</sup></u>
Asia ex Japan	DJ STOXX A/P	268.1	337.0	25.7%
Germany	DAX	4'810.2	4'808.6	0.0%
Europe	DJ STOXX 600	198.4	205.8	3.8%
Japan	TOPIX	859.2	929.8	8.2%
Switzerland	SPI	4'567.6	4'662.6	2.1%
USA	S & P 500	903.3	919.3	1.8%
World	MSCI World Index	227.7	244.9	7.6%

The **equity funds employed by us** achieved the following returns year to date:<sup>2</sup>

Aberdeen Asia Pacific (USD)	33.0%
Performa Fund - Asian Equities (USD)	26.2%
Performa Fund - European Equities (EUR)	12.5%
SIM European Stock Portfolio (EUR)	26.7%
Neuberger Berman US Equity Value (USD)	6.9%
Performa Fund - US Equities (USD)	2.0%

**Other funds employed by us** developed equally pleasingly:

	<u>USD</u>	<u>EUR</u>	<u>CHF</u>
Thalmann & Verling			
Fund of Hedge Fund Global <sup>3</sup>	1.7%	1.5%	0.7%
Blue Bay High Yield Bond Fd.		25,3%	

Be gone with the state crutches!

At least the risk of a system collapse appears to have been averted. Ten banks in the USA received permission by the American Treasury to repay 68 billion dollars of state support. After only nine months, the rescue operation financed with tax money is ending for these institutions. Apart from JP Morgan Chase, Goldman Sachs and Morgan Stanley, the lights were set on green for U.S. Bancorp, BB&T, American Express, Capital One Financial, Bank of New York Mellon, State Street and Northern Trust.

Not everybody is happy about the prompt end to the rescue operation. It is obvious that early repayers hope for a bonus of confidence vis-à-vis the competition still limping on crutches and with it additional market share. On top of this, many observers are

criticising the top echelons' intention of ridding themselves of the government prescribed wage and dividend tutelage as soon as possible.

Lending continues to falter

Equally, a full functioning of the credit markets cannot be deduced from these early repayments. How else could one explain US banks in June 2009 holding 14% more bonds issued by state or parastatal debtors (e.g. Fannie Mae, Freddie Mac) than a year ago? At the same time, banks reported that there was a decline in demand for corporate lending.

In Europe too, banks are hesitant to lend or, alternatively, credit demand is low. The priority of financial institutions still appears to be securing their own liquidity. When the European Central Bank (ECB) offered unlimited liquidity for twelve months to commercial banks, a third of the 442 billion Euros allocated was immediately re-deposited with the ECB, according to the "Neue Zürcher Zeitung". The fact that banks appear to be willing to suffer a 75 basis points loss in interest through this rearrangement speaks volumes. This course of action was surely not in line with the intentions of the initiators of the economic stimulus package.

But is it really the banks' fault that they are offering too little lending? Or is it much rather the borrowers, corporate as well as private, not looking for funds for fear of further doldrums? Statistics from the United States show that during the last boom, for example, consumer indebtedness in relation to income overshot its long-term trend growth massively. The counter movement so far is only marginal. Saving is "en vogue" in the country of limitless consumption. The savings rate of American households recently climbed to 5.7%, the highest it has been since the mid-nineties. The consumers' deleveraging is likely to last for some time, which will have a negative impact on economic growth. If the consumer is not willing to spend, businesses have little reason to invest, no matter how cheap borrowing is. Or to put it differently: you can lead the horse to water, but you can't make it drink.

Lower risk premiums – higher long-term interest rates

On the interest rate front, a normalisation is evident by a further decline in risk premiums. In the US, as well as in Europe, the difference between the three-month inter-bank rate and three-month government securities declined to or below the levels of early 2008. Equally, spreads between ten-year BBB bonds (lowest "investment grade rank") and prime government bonds continued to decline.

<sup>1</sup> Development of index in local currency. Exceptions DJ STOXX Asia/Pacific ex Japan and World in USD.

<sup>2</sup> Performance in currency of fund.

<sup>3</sup> Performance since beginning of year until end of May 2009.

Since the beginning of the year **yields on ten year government bonds** increased throughout:

	<u>Dec. 2008</u>	<u>June 2009</u>
USA	2.1%	3.5%
Europe	2.9%	3.4%
Switzerland	2.1%	2.3%
United Kingdom	3.1%	3.7%
Japan	1.2%	1.4%

Changes in Asset Allocation

In its meetings, the investment committee decided upon the following changes in the asset allocation for medium-risk balanced portfolios not subject to client restrictions:

**Bonds:** The existing position in a high-yield-bond fund was increased. Conventional corporate bonds of prime quality (not to mention government bonds) are only offering low yields. On the other hand, we expect the yield differential vis-à-vis prime quality bonds to decline. As such, high-yield-bonds offer performance potential. As we anticipate a rekindling of inflation within two to three years, it seems appropriate to give high-yield-bonds preference over conventional bonds. We continue to hold fast to our previous structure with a maximum remaining term of five years. Overall the bond allocation remains steady but the weighting therein is slightly tilted in favour of the high-yield segment. The Blue Bay High Yield Bond Fund employed by us returned +21.5% during the quarter.

**US Equities:** The US equity allocation has equally been increased. Apart from the attractive valuation of American companies, the expectation of the US being the first of the large industrialised nations to climb out of the trough was at the back of our minds. Depending upon the portfolio constellation, we either employed an Exchange Traded Fund (ETF) on the S&P-500-index or increased existing investment fund positions.

**Asian Equities:** Establishment of a position in Asian emerging countries. The relative to the western world better growth prospects in Asia, moderate valuations as well as encouraging technical signals from the exchanges, have led to this measure. The current recession may dent the developing prosperity in the Far East, however, overall, the underlying long-term uptrend remains intact. Even though the West is suffering from a GDP contraction in the current year, we should not forget that heavily-populated nations such as Indonesia, India and China are expected to display growth rates in the region of 4 to 7%.

As measured by twelve-month lagging **price/earnings ratios**<sup>4</sup>, equity markets became dearer in the year to date (red). Only Switzerland and the USA turned more attractive (green).

	<u>December 2008</u>	<u>June 2009</u>	<u>Change</u>
MSCI World Index	14.3	17.3	<b>+21.0%</b>
DAX Index/DE	10.4	26.7	<b>+156.7%</b>
DJ STOXX 600 Index/EU	19.7	24.4	<b>+23.9%</b>
S & P 500 Index/USA	14.9	14.5	<b>-2.7%</b>
SPI Index/CH	28.1	24.0	<b>-14.6%</b>
TOPIX Index/JPN	13.0	27.8 <sup>5</sup>	<b>+113.9%</b>

**Price / Book and Dividend Yield** of major equity markets

	<u>Price / Book</u>	<u>Div. Yield</u>
MSCI World Index	1.6	3.3%
DAX Index/DE	1.3	4.3%
DJ STOXX 600 Index/EU	1.4	4.4%
S & P 500 Index/USA	2.0	3.1%
SPI Index/CH	1.6	2.7%
TOPIX Index/JPN	1.2	2.1%

Outlook pale grey to tender green

In our economic scenario, the USA as well as the U.K. could emerge out of the recession during the second half of the year and enter into a slight growth phase. Continental Europe will lag behind and it will be 2010 before the Old World shows marginally improving figures.

Deflation is making the headlines these days. Overcapacity, as well as weak demand, is indeed exercising pressure on prices but in our view this phase will be relatively short-lived and the deflationary tendency is mild. Monetary floodgates are wide open globally. Together with the extensive regulatory and protectionist measures and escalating government indebtedness, we find it difficult to picture a sustainable rise in the value of paper money (read deflation). Regarding de- or inflation, the governments of this world are probably siding with the prominent investor André Kostolany, who coined the phase: "Inflation is similar to nicotine and alcohol: in small doses it does

<sup>4</sup> Source: Bloomberg

<sup>5</sup> As of 31.3.2009.

not hurt, additionally it raises the well-being.” Whether small doses are all we are going to get in future, is an entirely different matter.

In an inflationary scenario, real assets such as equities, real estate and commodities are better investments than monetary assets such as bonds and cash. Equities are not exactly bargains but are trading at attractive levels, particularly so relative to fixed income investments.

On a personal note: SIM Fund turns into CIIM Fund – new Chief Investment Officer

During the past quarter Stefan Riesen, hitherto our Chief Investment Officer, accomplished his long held dream of independence. In his newly-established company CIIM in Vaduz, he will in future devote himself entirely to the till now Salmann-owned equity fund, SIM European Stock Portfolio. Consequently, the SIM-Fund will from 1st July 2009 be renamed CIIM European Stock Portfolio. During the first half of 2009, it returned a pleasing performance of 26.7%, beating the reference index MSCI-Europe by a remarkable 20.2% points.

Where appropriate, we shall continue to employ the CIIM-Fund in client portfolios and will continue the excellent cooperation with Stefan Riesen. In-house, Teja von Holzschuher has taken over the function of the Chief Investment Officer. He has been a director of the Zurich branch since 2002 which he heads.

Summary of our current asset allocation:

Investment Category

Money Market	underweight
Bonds	overweight / short duration
Equities USA	underweight
Equities Europe	overweight
Equities Switzerland	neutral
Equities Japan	underweight
Equities Asia	overweight
Non traditional assets	underweight

*Alfred Ernst*

Vaduz/Zurich, 30 June 2009



