

Catharsis

Twelve months after the collapse of Lehman the world is in the process of stabilising. It did not go under but developed a dangerous list, at least temporarily. Fortunately, in the meantime, there are increasing signs that the severe recession is abating or even that the economy may be recovering albeit somewhat diffidently.

Financial markets have „celebrated” the stabilisation in the past month with an impressive rally. Today, the MSCI World Index is back to its level on the day prior to the Lehman debacle, and up about 26% since the end of 2008. All the major equity markets advanced during the third quarter and in some instances delivered undreamed of nine-month returns, as a plus of nearly 55% of the DJ STOXX Asia Pacific (ex Japan) since the beginning of the year underlines. Credit markets have equally calmed markedly.

Economic measures – to big to fail?

Apparently, the opening of the governmental monetary floodgates has helped. A commentator recently likened the government rescue packages to the Allies invasion of Normandy in 1944. Thanks to the vast resources committed, the burning question of the day was the same as it is now, not so much if the tide will turn for the better, rather when it will take place.

Indeed, the improvements this year have been surprisingly quick in coming. The question as to their sustainability and strength, however, remains unanswered. Important economic measures are currently coming to an end, such as subsidies for new car purchases in Germany, France and the USA. Already both German and American car dealers are lamenting disappointing September sales. The purchases brought forward are acting as a damper on current demand. Equally, the labour market is likely to continue to get worse before it starts to get better. With its link to consumption, this should slow the economy, particularly as further stimulus measures are likely to be few and far between in future.

The state coffers are in the meantime empty (well, they were actually already empty before the crisis) and now, more than ever, governments lack the resources to open the floodgates again. Even the sovereign ability to incur debt has its limits. In the EU, the Maastricht criteria for new borrowing have been stretched to the limit on more than one occasion.

Unshaken Credit Rating

According to the credit rating agency Moody's, there is no threat to the credit-worthiness of the major industrial countries, at least for the time being. The top score of “Aaa” remains in place for Germany, France, Spain, U.K. and USA and the outlook is stable. The U.K. came within a whisker of a downgrade but managed to remain in the top league. According to the “NZZ”¹, it looks like Ireland is the only major industrialised nation to date to have lost its top-notch credit rating due to the financial and economic crisis.

Yields on 10-year government bonds have increased in all countries, with the exception of Switzerland, during the course of the current year but are lower than three months ago.

	<u>Dec. 2008</u>	<u>Sept. 2009</u>
USA	2.1%	3.3%
Europe	2.9%	3.2%
Switzerland	2.1%	2.0%
United Kingdom	3.1%	3.6%
Japan	1.2%	1.3%

Economists raise forecasts slightly

The majority of analysts have revised their economic projections upwards. Compared to our last Investment Policy Report, expectations for the current year have only declined in respect of the U.K. This apart, improvements in 2009 as well as 2010 are expected for all other countries, according to a survey of economists by “The Economist” magazine.

Even though inflation is currently not a topic, inflation expectations for 2010 are currently a tick higher than in summer. The notable exception is Japan, where, measured by consumer prices, a deflationary trend remains stubbornly in place and from which the Land of the Rising Sun is not expected to break away even in 2010.

The IMF is also looking to the future less gloomily. According to the IMF, GDP is likely to shrink by 1.1% this year but will expand by a vigorous 3.1% in 2010. The interna-

¹ NZZ = Neue Zürcher Zeitung

tional monetary fund identifies China as the single most important growth driver with an expected economic expansion of 8.5% in 2009 and 9% in the following year.

Average **growth and inflationary forecasts** from „The Economist“'s September poll of economists:

	Real GDP Growth		Inflation	
	2009	2010	2009	2010
Germany	-5.0%	1.6%	0.2%	0.7%
Euroland	-3.9%	1.2%	0.4%	1.2%
United Kingdom	-4.3%	1.1%	1.7%	1.9%
Japan	-5.5%	1.4%	-1.1%	-0.6%
Switzerland	-2.1%	0.7%	-0.5%	0.4%
USA	-2.6%	2.5%	-0.4%	1.5%

China flexes its muscles

The world is recovering and Asia is becoming increasingly important. Thereby, China is not only hitting the headlines with its pompous 60th birthday celebrations, in the prestigious car market, the comrades in the Far East are ahead by a bonnet length. Sales increases of between 25 to 30% are expected there for the current calendar year, which are figures likely to bring tears to the eyes of car dealers in the industrialised nations. In the current twelve-month period, China has overtaken the United States of America as the world's largest market for new passenger cars. Should the bold growth forecasts materialise – and at the moment it looks very much like they will do just that – this year 7.3 million new cars will leave China's showrooms.

Similarly, the emphasis is on China with regards to IPOs. For example, in September Metallurgical Corp. of China placed 18% of its shares on the exchanges of Hong Kong and Shanghai. This resulted in the company coffers being filled with the equivalent of 5.3 billion Swiss Francs. In July, China State Construction Engineering Group raised 7.5 billion Swiss Francs. In the list of Going Publics for 2009, the two Chinese state entities are ranked in the top two places. To date this year, Chinese companies have raised 22 billion Swiss Francs overall, compared to just 5.6 billion raised by European and US American companies together. Even although the the government remains the majority shareholder, Asian cuisine seems to go down well with local investors. After all the estimated P/E ratios of their respective A-shares amount to a considerable 28 times (State Construction) and 23 times (Metallurgical) respectively. For the

Hong Kong traded H-shares, which are accessible to international investors, the valuations are slightly lower.

Financial Markets in very good spirits

During the third quarter, the financial markets presented themselves in good spirits in almost all sectors. Equities, commodities and corporate bonds trended upwards in rare unity. As the interest rate differential between good and less good creditors equally continued to decline, the recovery of bonds in the lower quality spectrum was particularly boisterous. Only the government bonds' sector, which we have been avoiding wherever possible for some time now, lapsed into lethargy. In predominantly quiet trading, small profits were possible even in this category.

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

		Dec. 2008	Sept. 2009	Change ²
Asia ex Japan	DJ STOXX A/P	268.1	414.9	54.8%
Germany	DAX	4'810.2	5'675.2	18.0%
Europe	DJ STOXX 600	198.4	242.5	22.2%
Japan	TOPIX	859.2	909.8	5.9%
Switzerland	SPI	4'567.6	5'461.3	19.6%
USA	S & P 500	903.3	1'057.1	17.0%
World	MSCI World Index	227.7	287.2	26.2%

The **equity funds employed by us** achieved the following returns year to date:³

Aberdeen Asia Pacific (USD)	59.2%
CIIM European Stock Portfolio (EUR)	53.3%
Performa Fund - Asian Equities (USD)	45.6%
Performa Fund - European Equities (EUR)	31.2%
Neuberger Berman US Equity Value (USD)	25.3%
Performa Fund - US Equities (USD)	20.3%

² Development of index in local currency. Exceptions DJ STOXX Asia/Pacific ex Japan and World in USD.

³ Performance in currency of fund. Source: Bloomberg.

Other funds employed by us developed equally well:

	<u>USD</u>	<u>EUR</u>	<u>CHF</u>
Thalmann & Verling			
Fund of Hedge Fund Global ⁴	3.3%	3.5%	2.1%
BlueBay High Yield Bond Fd.		43.8%	

Changes in Asset Allocation

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

Bonds: Conventional corporate bonds of top quality (not to mention government bonds) only offer low yields. The allocation to the high-yield bond sector has already been increased during the past quarter. As maturing conventional bonds are currently not re-invested until a certain liquidity reserve has been reached, the overall bond allocation is declining marginally. The target allocation is now around 37%. The principle remains unchanged that the maximum term of the bonds in the portfolios should not exceed five years. The BlueBay High-Yield Bond Fund employed by us continued to rise during the third quarter by about 14.8%.

Liquidity: As a result of the above-mentioned slight reduction in the bond allocation, the money market share has increased. The target allocation is currently 10% but is of rather more of a tactical than strategic nature.

Asian Equities: To give justice to the ever-increasing significance of Asia in a global context, the investment committee has increased the equity allocation in the Asian emerging economies segment by 2%. Infrastructure is at the forefront of our thinking and will be effectuated by the purchase of the Invesco Asia Infrastructure fund. Overall the target size for Asian Equities is now about 11.5%.

Non-Traditional Investments: Non-traditional investments have not done brilliantly in the current year. It is obvious that many managers are doing their utmost to avoid further negative performance figures. Additionally, they continue to suffer from the pressure to adapt in this industrial sector. The target allocation for this asset class has been reduced to 0% for the moment.

Summary of our current asset allocation:

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

Measured on the **price/earnings ratio**⁵ using the latest twelve-month profit figures, all equity markets have become dearer (red):

	<u>Dec. 2008</u>	<u>Sept 2009</u>	<u>Change</u>
MSCI World Index	14.3	26.5	+85%
DAX Index/DE	10.4	45.7	+341%
DJ STOXX 600 Index/EU	19.7	47.3	+138%
S & P 500 Index/USA	14.9	19.9	+34%
SPI Index/CH	28.1	42.9	+46%
TOPIX Index/JPN	13.0	n.a.	n.a.

Price / Book and Dividend Yield of major equity markets

	<u>Price / Book</u>	<u>Div. Yield</u>
MSCI World Index	1.7	2.7%
DAX Index/DE	1.5	3.7%
DJ STOXX 600 Index/EU	1.7	3.4%
S & P 500 Index/USA	2.2	2.4%
SPI Index/CH	2.1	2.2%
TOPIX Index/JPN	1.1	1.7%

⁴ Performance since beginning of the year until end of August 2009.

⁵ Source: Bloomberg

Outlook positive for real assets

In summary, we remain committed to our generally positive view of the economy and equity markets. There are still many uncertainties which here and there may lead to disappointment in the current climate of perhaps overly-optimistic expectations. Corrections or consolidation phases on the exchanges have to be anticipated at any time. These will, however, present buying opportunities.

Overcapacity, a moderate economic recovery and the low interest rate policy of many central banks argue for a continued phase of low inflation and low borrowing costs for the time being. We see this as a transitory phenomenon, however. The independent research institute "The Bank Credit Analyst" considers one of the most important insights of the crisis to be the realisation that the US Fed did not pay enough attention to the monetary figures during the Greenspan years. This already sends out a warning signal that the world must be wary of overextended periods of cheap money. We are convinced that a time in which real assets (e.g. equities) are distinctly superior to financial assets (such as bonds) will be with us again in the not too distant future.

US inheritance tax new for Europeans in Europe?

Is it possible that America wants to scare off its foreign investors? Looking at the balance of payments, one would expect that the unslaked thirst for capital on the other side of the Atlantic would indicate as careful a handling of investors as possible.

However, the changes to US inheritance tax targeted by the Obama government appear to be headed in the opposite direction. The line of attack at the moment is not only to include US citizens or foreigners living in the US, but to cover every natural person owning American securities worldwide. As a consequence, if a few IBM shares are coincidentally included in the estate which Mrs. A. from Zurich leaves her children in Switzerland, it may in future be subject to American inheritance tax.

Anybody believing the IRS (Internal Revenue Service) would and could not know about this inheritance is wrong. For years now, banks wanting to do business in the USA have been required to sign a so-called QI (Qualified Intermediary) agreement, which is a contract setting out which duties banks are subject to where American interests are involved. Should the House of Representatives approve the changes this autumn, the existing QI agreements are likely to be terminated immediately by the US government and new agreements with the corresponding amendments presented to the local banks for signature. These will most likely include a passage wherein es-

tates containing US securities have to be either disclosed or subjected to tax at source. This could be implemented as early as in 2010.

Nothing has been decided yet and many questions remain unanswered. A close eye has to be kept on this issue. US securities held by foreign investment funds (such as the US equity funds employed by us) are unlikely to be affected by this latest development.

Alfred Ernst

Vaduz/Zurich, 30 September 2009



