

The emotional rollercoaster is draining on nerves and prices

The Greek drama, currency turbulences, as well as growth concerns, were the dominant themes of the second quarter 2011. In contrast, the immediate fear of inflation has faded into the background. At least in the US, interest rate hikes were once more postponed. While bond markets had a good run, the stock exchanges absorbed this cocktail in differing ways.

Multi-facetted economic picture

Increased growth expectations for Germany and Switzerland, lower ones for the USA and possibly a mild recession in Japan – this is how the economic expectations present themselves mid-year. While growth expectations for the developed industrial nations as a whole are not creating any waves, other countries are booming. For China, economists expect 9% growth this year and 8.7% next year. India and Indonesia are equally growing at a fast pace of 8 and 6% respectively. With Argentina, Brazil, Chile and Columbia, South America too is prominently represented in the field of the rapidly flourishing economies.

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

	Real GDP Growth		Inflation	
	<u>2011</u>	<u>2012</u>	<u>2011</u>	<u>2012</u>
Germany	3.2%	2.2%	2.4%	2.0%
Euroland	1.9%	1.7%	2.6%	2.0%
United Kingdom	1.6%	2.0%	4.0%	2.6%
Japan	-0.2%	2.6%	0.2%	0.4%
Switzerland	2.4%	2.1%	1.1%	1.5%
USA	2.6%	3.0%	2.8%	2.0%

Inflationary expectations have been revised upwards. It looks as though the current year in particular will experience a flare up, whereas the situation in 2012 is likely to ease. However, economists only expect critical tension in the U.K. during 2011.

The past quarter was balm to yield structures. Long-term rates in large industrialised nations have pointed south since April. Interest rate hikes are not in the foreground any more, at least not in the USA, where they are expected for 2012 at the earliest.

In Switzerland, where the economic engine is ticking over nicely, the National Bank's (SNB) hands are tied. As long as the European Central Bank (ECB) does not move, the normalisation of interest rates, here too, will have to wait unless the SNB intends to add fuel to a rising Franc.

China is grappling different problems. In the Middle Kingdom, inflation in May reached a three-year-high at 5.5% and is now on course to reach the 6% hurdle. Under certain circumstances this may motivate the Central Bank to hike interest rates for the fifth time since October 2010.

The global community cannot be indifferent to this. In China, signs of a gradual slow-down are already discernable, which would have repercussions on the global and, in particular, the developed economies. The latter are already struggling with the concerns in Europe (debt of peripheral countries, the need for bank write-offs), in the USA (high unemployment, weak housing market) and in Japan, which once again plays hard to get as a driving force.

Energy agency helps to lubricate

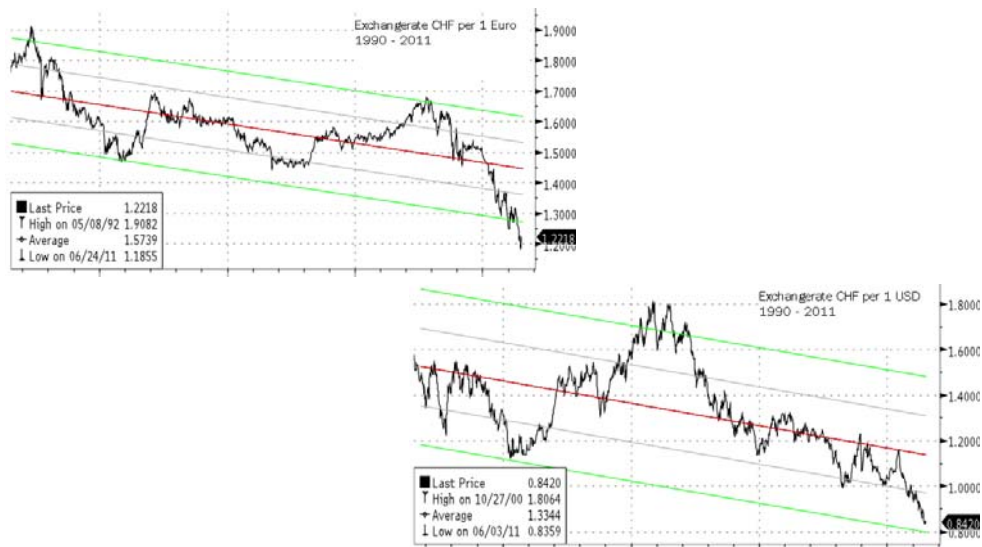
Nevertheless, the opening of the industrialised nations' strategic oil reserves by the International Energy Agency (IEA) comes as a surprise. Even though the two million barrels per day held out as a prospect for July only amount to less than 2.5% of daily consumption, this measure has caused some consternation. Even more so as it was announced in an environment of already declining prices and a deceleration in global economic activity.

The official line is that the intention was to compensate for the absence of Libyan oil, particularly so as the Organisation of Petrol Exporting Countries (OPEC) was recently unable to agree on an increase in production. The suspicion remains, however, that we are looking at a measure targeted to support the economy. Do the IEA augurs know something the rest of the world does not? If this is the case, opening up the taps is not a good sign. Or worse, have they been prompted by higher-ups because somewhere in the network a systematically-important player was under threat of going under? Either way, the announcement caught crude traders wrong-footed: Prices initially plunged but have now largely recovered from the upset.

The Franc has overshot itself

Exchange rates kept investors in suspense during the second quarter. Against an ever rising Swiss Franc, the US Dollar and Euro reached historical lows at times. A move

we view in the meantime as exaggerated. At the time of writing, both currencies trade around two standard deviations (lower green lines) below their 20-year median (red lines). Deviations of such magnitude have in the past always led to countermoves. This time too, we do not expect the slump in the Dollar and the European single currency to be a one-way street and expect the Franc to weaken against the Greenback and the Euro.



Change in **Equity Markets since beginning of the year:**

		Dec.2010	June 2011	Change ¹
Asia ex Japan	DJ STOXX A/P	491.3	497.3	1.2%
Germany	DAX	6'914.2	7'376.2	6.7%
Europe	DJ STOXX 600	275.8	272.9	-1.1%
Japan	TOPIX	898.8	849.2	-5.5%
Switzerland	SPI	5'790.6	5'684.5	-1.8%
USA	S & P 500	1'257.6	1'320.6	5.0%
World	MSCI World Index	330.6	341.8	3.4%

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

The **equity funds employed by us** achieved the following returns in the year²:

Aberdeen Asia Pacific (USD)	-0.8%
Invesco Asia Infrastructure (USD)	1.8%
Nomura ETF Topix (Yen)	-4.3%
Performa Asian Equities (USD)	-1.9%
Black Rock Swiss Small & Midcap Opp. (CHF)	-8.2%
Raiffeisen Futura Swiss Stocks (CHF)	-1.4%
CIIM European Stock Portfolio (EUR)	0.7%
Performa European Equities (EUR)	2.2%
Performa US Equities (USD)	3.8%
Perkins US Strategic Value (USD)	4.4%

Other funds employed by us developed as follows:

BlueBay High Yield Bond Fund (EUR)	3.9%
New Capital Wealthy Nations Bond Fund (EUR) ³	5.1%
New Capital Wealthy Nations Bond Fund (CHF)	4.4%
New Capital Wealthy Nations Bond Fund (USD)	5.2%

Commentary on Asset Allocation

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

Money Market: Liquidity has been slightly reduced to invest in floating rate bonds. By their nature, such securities are very close to money market instruments. Overall, this allocation is overweight vis-à-vis our internal benchmark.

Bonds: Corporate bonds had a pleasing quarter. Equally, the New Capital Wealthy Nations Bond Fund and the BlueBay High Yield Bond Fund were able to please. On the other hand, bonds of the problematic peripheral countries Portugal, Ireland, Italy, Greece – the PIGGs – went to the dogs again. By the way, PIGG's could find itself spelled with an additional capital S soon, which would stand for Spain. This could be the case if the Greek situation is not brought under sustained control. The problem –

² Performance in fund currency. Source: Bloomberg.

³ Performance in all currencies incl. re-invested dividends

and therefore the now demonstrated willingness to help – is not so much a problem of the Hellenic debt–Acropolis, but much rather the risk of contagion to other countries.

Since the beginning of the year, **yields on 10-year government bonds** have hardly changed:

	<u>Dec.2010</u>	<u>June 2011</u>
USA	3.3%	3.2%
Europe	3.0%	3.0%
Switzerland	1.7%	1.7%
United Kingdom	3.4%	3.4%
Japan	1.1%	1.1%

Even the currently AAA-rated USA is faced with massive mistrust. After Fitch, now the rating agency Standard & Poor's has also threatened to lower America's rating massively without further warning should Washington fail to service bonds due in early August on time. This could happen if Congress fails to agree on a new debt ceiling. In the eyes of the Chinese rating agency Dagong, the United States are already only rated A+ at the moment. Both China and Germany are rated AA+ in the Far East, with Switzerland awarded the top score of AAA.

As before, we continue to view corporate bonds as the better investment proposal. Added to that are the "wealthy nations", i.e. countries that are net creditors to the world. The outlook for all others remains cloudy. How the mountains of debt, still spiralling in spite of the danger signals, will ever be reduced remains unclear.

Swiss Equities: Wherever direct engagements are possible, our Swiss Stock Portfolio (SSP) has recently been employed. It consists of 20 equally-weighted Swiss equities selected by value criteria. Wherever such an engagement is not possible, this asset class is covered by the Raiffeisen Futura Swiss Stocks Fund. Added to that is a position in small- to midcap companies, for which we employ the Black Rock Swiss Opportunities Fund. It has to be said, however, that both direct investments as well as funds suffered from the listlessness of the Swiss Exchange during the second quarter and lost ground, whereby equities in small- and midcap companies suffered more than blue chips. Overall, the strategic weight of Swiss equities in a Swiss Franc-referenced portfolio is about 26%.

European Equities: Within the new orientation towards a „home bias“, the European equity content evolved differently depending upon the reference currency. In a Swiss Franc-referenced portfolio, its share declined. Unchanged, European equities continue to display an attractive valuation. Our European Stock Portfolio (ESP), which has gained + 2.52% this year, compares favourably to its benchmark with a minus of more than 1%. Since 1992, the ESP has on average produced an annual positive return of 9.68%, compared with +5.52% for the reference index.

US Equities: The US exchanges are well positioned in the race this year. Unfortunately, the Dollar's weakness ate into the returns for investors in this part of the world.

Asian Equities: The positioning in Asian equities remained unchanged during the past quarter. In comparison with the strategic target, we continue to maintain an overweight position in the portfolios.

Non-traditional Investments: We currently have no engagements here.

Summary of our current **asset allocation** ⁴:

Investment Category	
Money Market	overweight
Bonds	underweight/short duration
Equities Switzerland	neutral
Equities Europe	neutral
Equities USA	neutral
Equities Asia	overweight
Equities Japan	neutral
Non-traditional assets	no position

⁴ For a Swiss Franc referenced Portfolio.

Measured on the **price/earnings ratio**⁵ using the last 12 months earnings, all equity markets, with the exception of the Japanese and Swiss, have become more attractive (green) since the beginning of the year:

	<u>Dec. 2010</u>	<u>June 2011</u>	<u>Change</u>
MSCI World Index	15.6	14.2	-9%
DAX Index/DE	14.4	12.2	-15%
DJ STOXX 600 Index/EU	15.3	13.0	-15%
S & P 500 Index/USA	15.8	15.0	-5%
SPI Index/CH	14.9	15.4	+3%
TOPIX Index/JPN	16.3	16.8	+3%

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

	<u>Price / Book</u>	<u>Div. Yield</u>
MSCI World Index	1.8	2.5%
DAX Index/DE	1.5	3.3%
DJ STOXX 600 Index/EU	1.6	3.4%
S & P 500 Index/USA	2.2	1.9%
SPI Index/CH	1.9	2.2%
TOPIX Index/JPN	1.0	2.1%

And finally this

„Inflation? What inflation?“, is the question which poses itself when looking at the calculation of the commonly-applied consumer price indices. According to established interpretations, these indices measure a more or less representative consumer basket. The question is just this, who exactly should this selection be representative of? Doubts are justified for example in the USA and other countries, where attention is focused on the core-rate (excluding food and energy prices). This inflation is of primary interest for people who neither eat nor drive a car. This – at least in the first point – is likely to be an extremely tiny minority. And yes, there are inflation observations targeted at other „marginal groups“. In these cases, inflation appears in part to be downright galloping. Two (subjectively picked) examples: The markets for art as

well as luxury residential properties. Taking a look at the art market reports, the striking difference between the estimate and the price actually realised at auction stands out – not seldom it is double or more. Furthermore, the great success of the Art 42 Basle exhibition is of note and not just due to its record attendance of more than 65'000 visitors. According to observers and traders cited in the media, volumes as well as prices have returned to 2008 levels. Luxury homes in inner London have equally reached or exceeded pre-crisis levels. As reported by the “Neue Zürcher Zeitung”, an index calculated by estate agents Knight Frank is now 2% above its March 2008 peak. During the past 12 months, prices have increased in excess of 8%. No signs of a crisis to be seen far and wide. Inflation on the other hand, yes.

With our best wishes for pleasant and restful summer days, we thank you for the trust placed in us.

Alfred Ernst
Vaduz/Zurich, 30th June 2011

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⁵ Source: Bloomberg

