

# Our Point of View, June 30<sup>th</sup> 2004

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**2004 Statistics of leading stock markets**(January 1<sup>st</sup> – June 29<sup>th</sup> 2004 in local terms)

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Switzerland	SMI	+	3.65 %
Germany	DAX Xetra	+	2.64 %
France	CAC 40	+	5.58 %
U.K.	FT-SE 100	+	0.79 %
Sweden	OMX	+	9.68 %
Europe	STOXX 50	+	2.46 %
USA	S&P 500	+	2.18 %
	Nasdaq	+	1.58 %
Japan	Nikkei	+	11.09 %
Bond World Index	(incl. interest)	-	1.83 %

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## CLASH OF CIVILIZATIONS

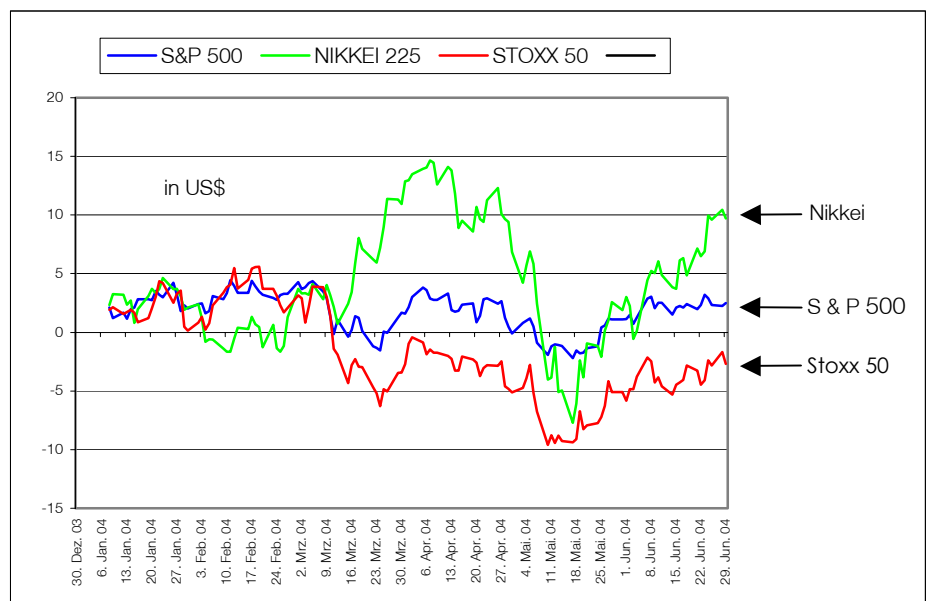
What really affects markets these days

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We hope you have read Samuel P. Huntington's book "The Clash of Civilizations". If not, you should visit your favorite bookstore today. It is just about mandatory to be aware of what this publication tells us in order to better understand current political turmoil and in fact the behavior of financial markets.

Up until March 11<sup>th</sup> financial markets acted in a conventional manner, i.e. fundamental and macroeconomic factors dominated market action and thus our investment performance figures came jogging along in a reasonably satisfactory way. Then, however, the world's attention was swiftly caught by the atrocious Madrid bombing event, ever increasing Iraqi resistance against U.S. forces and clear signals from Al Khaida that time is ripe for a major assault on Saudi Arabia's regime. These events,

coupled with record oil prices and a clear warning from Mr. Greenspan that U.S. interest rates had to be hiked in the not too distant future, was just too much of a culmination of bad news. Financial markets duly succumbed to a heavy bout of selling during the course of April and May. Gone were the nice gains secured previously and all major market indices fell swiftly to year “lows”.



This setback did not primarily occur on the back of economic factors, but mainly in consideration of terrorist threats and total uncertainty surrounding the political future of the Middle East. One does not like to admit that terrorism achieves its aim, but the fact of the matter is that uncertainty, widespread fear of being the next target and clear indications to the effect that America’s war against terrorism is far from being a success, prove that the clash of civilizations is far from being won by either side. “Terrorism” is a matter of definition anyway. What is the difference between a freedom fighter, a partisan and a terrorist? Tricky question... Fact is that the set-back recently witnessed was almost entirely due to developments surrounding the ongoing clash of

civilizations, rather than economic developments. This turns our business at times into a nightmare and it goes without saying that even the most diligent analysis is futile under such conditions. We obviously have to base our work on objective criteria rather than obscure assumptions, conspiracies or other subjective aspects.

The past six months therefore need to be assessed in the light of recent (and still ongoing) political imponderables. It is indeed worrying to realize that the investment world will in all probability go on being deeply influenced and affected by the ongoing clash of civilizations. It is difficult enough to make timely calls on equity markets, interest rates, currencies on fundamental merits, but it is outright impossible to foresee investment developments when unpredictable clash-events of the sort constantly witnessed rule the world. As investment managers we have to accept and live with this volatility and as a client you may need to be somewhat lenient and mindful of the fact that unquantifiable factors currently outweigh hard analytical work and long term experience. Giving thus undue weight to short term performance figures can be totally misleading. We all have to accept that we shall be living with continued market volatility. What goes up today on the back of fundamental merits may well collapse tomorrow for subjective reasons. Such an environment requires conviction, courage and possibly a bit of fatalism. Above all, the current environment requires a close client/manager relationship. It also requires your endorsement and trust that an investment manager is truly helpless against the kind of imponderables currently triggered by the ongoing clash of civilizations.

## COMPLACENT AND BLIND

Switzerland is not what it used to be. Nor is Germany.

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We apologize that we gradually establish ourselves as Europe bashers. We have written unkind words about the state of affairs in this continent and its new currency on a variety of occasions, but are compelled to keep on raising red flags. Other than in the U.K. where Mrs. Thatcher's legacy keeps on shining (... but poor Maggie was too clever to be loved) there is hardly any country on the continent of Europe that offers much to write home about. Switzerland included. The writer of these comments is annoyed to no end that the Swiss are champions at pointing their fingers at other nations whenever an opportunity arises even though they have every reason to look at their own affairs and to worry about a decade of economic stagnation. In this country one finds all sorts of reasons to be critical of America. Excessive spending, budget deficit, inadequate private saving and whatever. It will all end in tears, many Swiss say, but they forget America's innovative power, its rigorously competitive system, its deregulated economy, its productivity growth and whatever more. Or take recent developments in China (on which we shall elaborate later in this report). Following Peking's recent interventions, meant to cool down an overheating economy, the local press (and others, we admit) were quickly talking about an impending 'crash', the bursting of a bubble and other apocalyptic forecasts. Instead of lamenting about that country's growth rate falling from 9 % to 7 %, Switzerland and its neighbor Germany should rather worry about their own sleeping car. And that is a rather benevolent description of the state of affairs. If Europe's sclerosis of dishing out ever more social benefits, of cultivating abuse of democratic laws, of introducing ever more disincentive to create employment (witness Germany's new "employment tax") and whatever more, the old continent will soon wake up with a rude shock and the cockiness of leaders (do they deserve this attribute?) such as President Chirac or Chancellor Schröder

will result in no more than a shrug. Why is nobody questioning the fact that nations such as China or India are not permanent members of the UN Security Council nor invited to (pretty useless) G8 meetings?

We are, of course, just as concerned about the outlook for Switzerland. You can't say that all is well with a country whose citizens are asked in a referendum whether they would like to be subjected to a variety of tax cuts and out of pure envy that some well to do compatriots may get a tax relief, the majority votes 'No' (witness our recent elections of May 16<sup>th</sup> 2004). The Swiss still believe that they are part of the world's elite. No more. Amongst the top 60 nations, our country has the following, sadly looking rankings:

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Growth:	57 <sup>th</sup> place
Cost of living:	56 <sup>th</sup> place
Labor cost:	56 <sup>th</sup> place
Telecom investments	55 <sup>th</sup> place
Open mind to new ideas	55 <sup>th</sup> place
Subsidies considered detrimental to efficiency	52 <sup>nd</sup> place
Management Salaries	52 <sup>nd</sup> place

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Switzerland has some top rankings too. For instance relating to Nobel Price Winners per capita (although recent years were a bit lean). Or health cost per citizen, although we doubt whether this is good news. We are, however, undisputed champions and No. 1 in one respect: collection and recycling of waste paper and glass. Whether this "gold medal" produces much employment is another question.

Now let us look at champion Germany, the aging economic locomotive. Well, Germany is in deep trouble. The Financial Times gave recently a

clear message. The headline said: 'Germany on course for insolvency'. The budget deficit grows like cancer, debt grows quicker than in Brazil (stability pact Auf Wiedersehen), unemployment languishes above 10%, consumption is weak (Germans' buying power suffered gravely following the introduction of the Euro), social wage cost are at absurd levels and the country's Government is busy creating ever new disincentives for employers. The most recent absurdity is the "Arbeitsplatz-Steuer" – an employment tax. The current economic situation is in fact a mirror image of many citizen's emotional state. The average German is disillusioned and disenchanting. There is something seriously wrong with a system when being (or playing) sick is materially more advantageous than reporting to work. We recently learned through a newspaper report that doctors' visits declined by 10 % (19 % in the case of specialty doctors) following the introduction of a cost contribution of 10 Euro per consultation. That's how fast people get well if you ask them to contribute a trifle to social benefits.

We do not wish to engage into a macroeconomic and political analysis of Europe, although we could easily list a few hair-raising examples for France, as another example of a European Nation where disincentives to create employment abound. None of our friends in France even consider hiring new staff. They rather forego new business opportunities. Even Nestlé considers a bailout. Nestlé threatens to sell Perrier unless the water company finds a way to increase productivity. No wonder. San Pellegrino produces three times as much sparkling water as Perrier's employees. Strange indeed.

And what message are we trying to bring across to you? Well, if one is subjected to a daily flow of factual economic news surrounding Europe's political and macroeconomic environment, one's common sense gives a clear message: Europe's climate for free enterprise and employment has reached a dangerous if not alarming state. There are, of course, exceptions to the rule (especially for certain niche players). We conclude,

however, that Europe should probably no longer be as prominently represented in our investment portfolios as in the past. Anglo Saxon investors feel at this time that European shares are rather attractively valued. That may be true in purely historic terms. But history may have changed and Europe is no longer what it used to be. The past is often a misleading advisor in our business. We have tended to reduce our exposure to European equity. Reduced in favor of Japan.

## GOOD VALUE INDEED

The reawakening of Japan's stock market

To our mind Japan's 'lost decade' is definitely a thing of the past. The same applies to the country's deflationary phase, which killed off consumption for years. Tokyo's real estate prices have gone on declining until very recently, but now there are first signs of a revival, whereas the private, countrywide housing sector has turned up for the first time in a very long time. Finally, personal consumption has picked up markedly and it is clear that Mr. & Mrs. Watanabe have rediscovered the shopping malls. The most recent economic statistics have produced an annualized growth figure of 6 %, which is reassuring. Many foreign analysts (probably those who are still uninvested in Japanese shares) are lamenting that Japan's apparent turnaround is merely based on export growth and the 'China factor'. This is outright wrong. The domestic economy has been the major factor contributing to recent growth as illustrated by the following table:

	Total	Consumption	Non-Res. Investment	Net Exports	Inventory private sector
4 <sup>th</sup> quarter 03	1.8 %	0.6 %	1.1 %	0.4 %	- 0.2 %
1 <sup>st</sup> quarter 04	1.5 %	0.5 %	0.3 %	0.2 %	0.5 %

Note: not all statistical items are listed

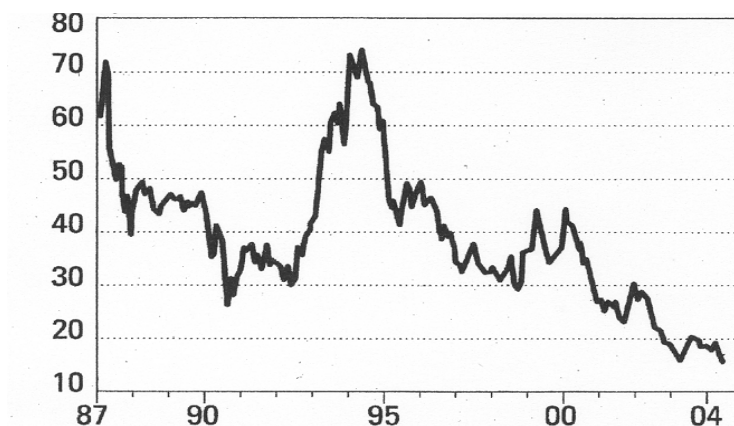
As you can easily see, plenty of apparent experts just don't do their homework. It is blatantly obvious that Japan's recovery is *not* mainly export-induced and contributes only in a limited way to growth. Germany, for instance, is much more dependent on exports than Japan.

It is also interesting to note that Government spending has recently had just about no impact on Japan's economy – contrary to all previous recovery phases. It is most encouraging to witness that private consumption – presumed dead forever – has come back to life and that is a most encouraging sign.

The outlook for the Japanese market continues to be good. The only aspect that may be cause for a bit of scepticism is the fact that optimism surrounding investments in Nippon is riding a bit too high although the vicious market correction in April/May has washed out a lot of hedge fund speculation. It is clear though that many fundamental investment criteria (such as price to book value) are currently more attractive in Japan than elsewhere. Price/Earnings ratios (PE) are at a long term 'low' and we feel that it is appropriate at this time to overweight Japanese stocks.

#### Long-term comparison

Average P/E for next 12 month period



Source: Lehmann Brothers

## HYSTERIA IS A BAD ADVISOR

We hold on to our investments in China

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One year ago we issued a circular in connection with our 'China Strategy Certificate' and made clear that an investment in China was not suitable for faint-hearted players and that such commitments are meant to be for the long pull. We also mentioned clearly that investors had to live with high market volatility.

Earlier this year it became obvious that China was about to run into an overheated economy and the Government realized that it was time to cool things down. Authorities stepped into action and simply stopped credit expansion for a number of red-hot sectors such as steel plants, building etc. Furthermore, interest rates were selectively raised. You may remember that we previously held the view that time is not ripe in China for a totally free market economy and that a very gradual phase-out of the country's rigid plan economy was in the interest of the country's future.

Well, as soon as it became evident that a cool-down phase had been initiated, we witnessed a flood of "we knew it all before" type press reports. Another end was nigh, the China bubble would explode, and it would all end in tears. Of course it is no fun to see one's stocks lose some 20% within a matter of days. It requires conviction and discipline just to watch and stay put under such circumstances. To advise one's readers – or worse, one's clients - to sell out immediately, merely because China's growth was thought to drop from 9 % to 7 % is pretty absurd, if not outright silly. And such clever advice originates out of countries such as Switzerland, where growth has been nonexistent for well over a decade. We have no idea whether China's ongoing interventions to cool down its economy will result in growth of nine, seven or five percent. That is not terribly relevant. The importance is to see the *trend*. And the trend is up.

For years to come. To wet one's pants though simply on account of a correction phase is absurd. It is especially ignorant and grotesque to claim that Chinese stocks have bubble valuations. The fact of the matter is that H-shares (which we primarily hold) have a current price/earnings ratio of around 10 (!) following the recent market correction. We are very pleased that many hedge funds and short-term operators have been washed out of the market. The downturn of April/May produced a buying opportunity for investors in the proper sense of the word, who share our view that this market is unsuitable for the faint-hearted, but rather suited for investors with a vision that a new economic giant is in the making. Rome was not built in one day. Nor is China's free market economy. If the middle kingdom were our only sorrow, we would have no sleepless nights. There is some other sore spot on the world map that worries us a lot more:

## SAUDI ARABIA

Next Middle East chapter?

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We do not like one bit what we see in Saudi Arabia. We are surprised how complacent the world is in light of this country's most obvious decay. The end is indeed near for the House of Saud. It is not surprising either that Al Khaida is now concentrating on its very home base. After all 17 of the 20 individuals who brought about September 11<sup>th</sup> were Saudis. Not Iraqis... We fear that we shall soon be witnessing a gruelling act of terror in this country, shaking the power base of the kingdom further. It certainly appears as if many of this country's numerous princes are just as worried as we are. We know from reliable sources that many of these royalties are busy scouting for palace-like dwellings in London and Paris. Whether these are merely meant to be investments leaves room for debate...

We fear that the House of Saud is not just in danger, but actually on the way out and that the world's oil supply is anything but assured. Saudi

Arabia's oil supply is crucial and a production stop would inevitably drive the oil price above \$ 40 per barrel. Saudi Oil flows through thousands of kilometres of pipeline before it is pumped on to tankers. It is difficult enough to make Riyadh residences secure, but protecting the infrastructure of the oil industry is an outright impossibility. We hope that our fears are unwarranted although it looks as if Al Khaida has now indeed shifted its main attention to the destabilisation of Saudi Arabia's regime. We feel that a major assault on the country's stability would result in a call for help from abroad. America is Saudi Arabia's closest ally and coincidentally has in excess of a hundred thousand pretty well equipped troops next door in Iraq. America just said that the occupation ends on June 30<sup>th</sup>. That would suit the timetable.

All these theories are abstract. Whether they are merely a theory of conspiracy is another story. The facts are clear though: Saudi Arabia is destabilized, yet America's close ally and the world's largest oil producer. When you consider though how catastrophically wrong the Iraq assessment was and when you consider further that the same handful of people now assess things in Riyadh, it is not terribly far fetched to come to the conclusion that the Saudi crisis is just as badly handled as "Iraq's, world threat" and their deadly (phantom) weapons of mass destruction. Maybe Washington is a bit too sure of itself and thinks that what cannot be, shall not be. We have little faith in America's Middle East policy. Only Mr. Powell's input makes sense. And that is ignored.

Let us hope that the House of Saud is stronger than it appears. If not, we would all be confronted with a 'joker' that could double-cross even the best of investment policies. If our fear scenario were to come true, we would surely witness very negative market action. Gold might be a safe heaven. For this reason we have recently arranged for a capital protected Gold based Note through which the investor participates with 81 % in the appreciation of the Gold price. The downside risk of the Note (life of 12 months) is only 5 % and it is backed by a Triple A guarantor – the State

Bank of the Canton of Zurich, being one of the very few banks left with a AAA rating. This Gold note can readily be traded and as investor you can increase your stake daily – or inversely sell at any time. For you as a client of our firm it is in any case recommendable to discuss this investment – which is effectively an insurance policy on developments in the Middle East – with your advisor. One thing is clear, however. Should the U.S. intervene in Saudi Arabia following disruption of oil supply, the investment in this Gold Note will prove to be too small. Should all be well though, this insurance type commitment will have proven to be unnecessary. We would think that we should know more within the forthcoming twelve month, being the reason for the Note's limited life of one year only.

## WHAT ALL THIS MEANS FOR YOU

Conclusions for investment management

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The conclusion of all this may mean the following:

Bonds (with maturity in excess of two or three years are out for the time being. For clients other than our staunch long term fixed interest investors, we hold few straight bond holdings maturing beyond 2007/2008 although the Dollar segment may now well have discounted quite a bit of Mr. Greenspan's forthcoming medicine. You may recall that in earlier comments of ours we mentioned that it is merely for election reasons that the Federal Reserve Board has so far shunned away from interest rate hikes, which is of course wrong, but then most measures engineered by politicians are just that. Thus U.S. interest rates will be rising later than they should. Financial markets are clever institutions and have already priced in a rise of roughly 2 %, i.e. a doubling of the Fed Rate. U.S. equities are not particularly cheap at this time, but until we have seen three subsequent Fed Rate hikes, investors are probably alright. We do not expect Wall Street to turn south in the foreseeable future, but it becomes more and more difficult to spot undervalued shares.

We have elaborated on Europe earlier in these comments – on top of previously issued (critical) words on the old world. As far as the European equity component is concerned, it is even more crucial than in America to zero in on special situations or niche players. To allocate simply a certain percentage of a portfolio to Europe and investing such an amount in an index of leading shares is the wrong approach. As you no doubt noted from our earlier comments, we give America and Asia preference over Europe. Not for reasons of valuation, but for strategic reasons based on macro political considerations. An incentive killing environment that is hollowed out by ever more socialistic tendencies – as prevailing in Europe – just isn't fertile grounds for investors. This is to our mind the very reason as to why European equities appear to be cheap.

For the immediate future we have more faith in Asia, particularly in Japan. We think that amongst the major world equity markets, Tokyo will be the best performer for the whole of 2004.

Our next report will be written around Christmas. Let us hope that we then have reason to be in a festive mood.

MAB