

Our Point of View, June 30th 2005

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Statistics of leading stock markets

A) Year to date

		in US dollar	in local terms
Switzerland	SMI	- 3.05 %	+ 9.05 %
Germany	DAX Xetra	- 4.83 %	+ 7.08 %
France	CAC 40	- 2.45 %	+ 9.77 %
U.K.	FT-SE 100	+ 0.07 %	+ 5.74 %
Sweden	OMX	- 6.51 %	+ 9.52 %
Europe	STOXX 50	- 4.78 %	+ 7.14 %
USA	S&P 500	- 0.85 %	- 0.85 %
	Nasdaq	- 6.94 %	- 6.94 %
Japan	Nikkei	- 6.47 %	+ 0.22 %
Bloomberg-	Effas US\$ Bond Index (5-7 years maturity)	+ 2.25 %	+ 2.25 %

B) Over five years

		in US dollar	in local terms
Switzerland	SMI	+ 1.68%	- 20.01%
Germany	DAX Xetra	- 16.75%	- 33.93%
France	CAC 40	- 18.01%	- 34.94%
U.K.	FT-SE 100	- 3.23%	- 19.36%
Sweden	OMX	- 30.25%	- 38.08%
Europe	STOXX 50	- 22.56%	- 38.55%
USA	S&P 500	- 17.40%	- 17.40%
	Nasdaq	- 59.92%	- 59.92%
Japan	Nikkei	- 36.28%	- 33.87%
Bloomberg-	Effas US\$ Bond Index (5-7 years maturity)	+ 42.40%	+ 42.40%

EVERYTHING IS RELATIVE

The crucial impact of the Dollar's turnaround

The past six months produced reasonable returns for most non-US markets, but if we look at the returns in terms of U.S. Dollars, one wakes up with a rude shock. In Dollar terms each and every market suffered a setback and it is blatantly obvious that exchange rates have once again proven to be the joker of the year – as mentioned by us in our previous 'Point of View'. Consequently, the performance of the first half of 2005 must be primarily seen in light of the Dollar's turnaround. It was indeed very difficult to turn in a positive result for Dollar based accounts during the period under review, unless one held a considerable percentage of total assets in long term bonds, which turned in a truly magic performance during the second quarter. We think we are right in saying though that actively managed accounts throughout the world have missed out on this trend inasmuch as the risk-award factor of long term bonds has turned negative quite some time ago. Only pension funds and Central Banks are still engaged in long term bonds, i.e. holders who base their investment decisions on liability factors and strategic/political considerations respectively. Balanced global accounts of the sort we manage, have reduced the average duration of their fixed interest investments long ago and have thus not benefited from the unexpected strength of all bond markets.

Sickly yet sound

The US dollar is still the international benchmark currency

Our headline may sound like a contradiction in terms but it is an accurate reflection of the economic reality in the United States today. Although the country seems to be a constant butt of criticism – perhaps because of the unpopularity of the Bush Administration – there is no objective foundation for this. Even the smallest regional bank seems to know for certain that America is heading for a fall. And almost any bank manager will tell you that the twin deficits are a disaster in the making, Americans are living beyond their means and the budget deficit is untenable. If they had been in Buenos Aires or Bogotá, America's financial authorities would long since have had the IMF inspectors knocking at their door. But America is not just another country. Why not? Because the greenback is the world's unchallenged reserve currency. And that is not going to change.

What is worrying is that the United States spends about USD 600 billion more on imports than it earns from exports every year. That amounts to about USD 2.5 billion per working day. Evidently, the gap has to be plugged by encouraging foreigners to invest on the stock market and in private companies and making treasury bonds attractive to foreign central banks. This is where Beijing comes in. None of that is new. The only difference is that figures have increased steadily. US assets totalling USD 3,000 billion – about a quarter of the country's GDP – are now in the hands of non-Americans. Critics have been saying for

a long time that America is living beyond its means because it goes on consuming and does not save. There is no doubt that the savings mentality is an anathema to Americans. On average, people save only about half a percent of their income. The Swiss are a good deal better on that count: they save about 15 % of what they earn. However, we have American consumption to thank for the little economic growth we can muster on this side of the Atlantic. The figures speak for themselves: while the US economy is growing by 4 %, we Europeans cannot report growth of even half that level and the thrifty but critical Swiss do not manage to grow a quarter as fast as America. What use are all those savings if the country has no idea what to do with its money, venture capital is in short supply, the willingness to take business risks is even scarcer, and the politicians are constantly inventing new types of taxation? The problems are relative. While America may appear to be sick, it does better in relative terms because so many other countries spend their time talking about reforms but never actually get round to implementing them. As a result, the United States attracts about three-quarters of the world's savings, including substantial sums from the Chinese and Japanese treasuries, to name but the two most significant sources of capital inflows. However, they invest in the dollar zone for political and economic reasons, not because they obtain higher returns. Of course, Tokyo and Beijing could invest in euro zone bonds, but they are too illiquid for them to invest such enormous amounts. Besides, we feel that the euro is too weak and too unproven for central banks to use it for massive diversification of their portfolios. Effectively, the euro is still in the very early stages of its

development. In fact, it resembles a premature baby that is still in an incubator facing an uncertain future.

It is perhaps worth asking why the inflow of funds from foreign central banks into the dollar has not dried up despite the currency's apparent problems and why capital market rates have declined instead of rising. For the past eighteen months, the whole world (including us!) has been waiting for capital market rates to increase but they have not, because too much foreign capital is pouring into America.

There have been no end of warnings about the dollar: there are constant predictions that the property bubble is about to burst, interest rates will rise massively, consumer spending will plummet and the whole world will be plunged into a recession triggered by America. And yet, nothing of the sort has happened. The world watches enviously as the US reports unbelievably good growth rates. Despite all the criticism levelled at it, China has not turned its back on the USA and continues to invest heavily in US treasuries. As we predicted in previous publications, sometime China will allow the Yuan to appreciate and will then naturally sustain massive currency losses. All that seems to be included in its plans and the central bank will not have to justify its write-downs to anyone. That is good news: if countries with a net surplus were to listen to the cries of gloom and doom and no longer used their reserves to bolster the US deficits, US interest rates would skyrocket, the country would plunge into recession and automatically drag the global economy down with it. Although America seems to be so sick, it is still a source of hope for us that nothing will go seriously wrong. And yet, the joker is held

by China and Japan. The global financial system is vulnerable because economic well-being will be determined by exogenous factors in the next few years. Despite its much-criticised twin deficits, America is in a relatively comfortable position. For us Europeans, our dependence on the American economy puts a good deal at stake. Turning to our view on US investments, we are currently more upbeat about the prospects for the US dollar than the consensus. Everything is relative. Western Europe tends to be far too arrogant about its own potential. That applies above all to the euro, which we believe was stunted at birth. If we were to be banished to a desert island for ten years and faced the choice of placing our assets in either dollars or euros for that time, we would definitely opt for the currency that can boast that its position as the world's reserve currency has been proven over time: the US dollar.

The stealthy thief

Inflation is still alive and kicking!

Isn't it nice to know that inflation is now little more than an ancient relic: it is under 1 % in Switzerland, zero in Japan and only around 2 % in the likes of France and Germany. That, at any rate, is what the statistics used by our politicians say. However, the Germans have coined a new word for the euro – they call it the “Teuro”, derived from the word “teuer” meaning expensive. Indeed, if we look at the price of basic commodities, we are tempted to say that the (to quote the politicians) “ill-informed” man on the street may well be right. Price rises over the past couple of years seem to bear little relation to the official

statistics. No wonder the middle classes are feeling the pinch!

In our last report, we suggested that readers should keep a small sum invested in gold – to protect them against political uncertainties and, not least, inflation. For Swiss franc investors, this piece of advice has so far been rather like the story of Columbus' egg. The market evidently agrees with the politicians that inflation is not on the agenda at present.

During our extensive research we recently stumbled across a very interesting little book: the 1974 edition of the Polyglott guide to Germany. We were utterly amazed to read what prices would have been like if we had travelled to Germany thirty years ago. To give you some idea of how the local currency has become devalued over the years we would like to quote some examples of the prices we could have expected in Cologne (random choice) back then. We have converted them to euros using an exchange rate of 2:1.

In 1974 a 4-hour tour of the city cost the equivalent of EUR 4, while a room in a first-class hotel like the Excelsior cost EUR 17–40. According to the Polyglott guide, a meal cost between EUR 2.50 and a maximum of EUR 10. Those were the days! And we are not talking about prices way back in the dim and distant past! Today, the same city tour costs EUR 12, and the Excelsior hotel charges EUR 210-295 per night. That represents inflation of 300 %-800 % in 30 years. We trust you will excuse our laxity, but we have not taken the trouble to calculate the official German inflation rate for this period. However, it is certainly

nowhere near the level suggested by the increase in the prices of these services in Cologne. It is quite frightening to see how quickly a currency can lose value.

So what conclusion do we draw from this example? To our mind, it illustrates quite clearly that investors should not think and act on a short-term horizon. The present decade has not been a particularly happy one for equity investors and some people now seem to be considering investing their nest-egg in risk-free savings products despite the paltry interest rates. Avoid risk at all cost is their motto. And yet, if we consider how money loses value over time, that seems to be the best way of losing purchasing power as the sad example of Cologne prices shows. We need to take a disciplined, business-minded approach to investment, not just from time to time, but all the time. To counter the stealthy devaluation of our savings, we have to invest at least part of our capital (we believe that 50% is a reasonable and conservative benchmark) in a more business-minded manner, in other words in shares. Otherwise our nominal capital will continue to grow but its purchasing power will decline steadily. The official inflation figures are no more trustworthy than the politicians' electoral promises. Statistics can prove anything. The Americans take a far more honest approach to this game: they simply exclude food and energy costs from their inflation data. Elsewhere, the figures are simply manipulated.

From now on, just think of the Polyglott guide whenever you wonder why a one hundred euro note disappears so quickly. And be patient with your investments: in the long term they will offset the loss of purchasing power.

Back to the Seventies?

“Stagflation” has reared its ugly head again

During the 1970s we were confronted with the phenomenon of “stagflation”, in other words a combination of low growth, rising inflation, high energy prices and labour market problems. That was not a pleasant constellation and recent events have given rise to speculation that the spectre of stagflation may be re-emerging. There are, indeed, a number of factors that seem to point in this direction. Even the US authorities seem concerned about rising inflation and declining consumption. In fact, there are growing signs that global growth is stalling and consumer confidence is declining. At the same time, inflation is rising, especially in Britain and the United States. In Continental Europe, too, prices are moving closer to the two-percent ceiling set by the European Central Bank. Hence the talk about stagflation.

Nevertheless, there are no real parallels to the situation in the Seventies. In 1979 the US inflation rate was 7 % and growth was 1 %. Now, inflation is 2.5 % and growth is about half as high again. Although there are clear signs of economic stagnation in Europe, inflation is not comparable to the situation in the Seventies because of the general pressure on wages. In the United States, as in Europe, real interest rates are low, and it seems highly likely that Alan Greenspan will be keen to raise them again.

Wages and productivity are another difference to the Seventies. Back then, productivity gains were unexpectedly

high and aggressive action by the trade unions led to stiff pay rises at precisely the wrong moment. These days, globalisation makes that totally impossible and calls for higher pay are doomed to almost certain failure. Consequently, we do not believe wages and productivity are another difference to the Seventies. Back then, productivity gains were unexpectedly high and aggressive action by the trade unions led to stiff pay rises at precisely the wrong moment. These days, globalisation makes that totally impossible and calls for higher pay are doomed to almost certain failure. Consequently, we do not believe that stagflation is back on the horizon. Nevertheless, slower growth and higher inflation make it very difficult for central banks to take astute action. A good deal depends on the consumer-spending boom in America. If this phenomenon should come to an end, Washington would have to take a closer look at the prospect of stagnation. We can only hope that Europe's fight against inflation does not deteriorate into shadowboxing and that it takes decisive counteraction by reducing interest rates.

Germany

Europe's driving force could be regaining its strength

All too often, it is the exception that proves the rule: having been castigated for years for its position at the bottom of the European growth league, we believe that Germany may well prove to be a more attractive investment prospects in the next few years. Now that

Gerhard Schröder has pulled the emergency brake, bringing new elections in the autumn, we feel that a cyclical turnaround could be on the cards. Of course, history does not always repeat itself, but if we look at the background to previous rebounds it seems plausible to bet on the revival of Europe's former driving force. Following the political shift from left to right in the Seventies, the FAZ index rose 80 % in four years. The next shift led to a very long period of right-wing government – from 1982 to 1998. During this time, share prices rose by almost 800 %. By contrast, periods of socialist government have always been detrimental for the German stock market. During Schröder's long period in office, the FAZ index has slipped 6 %, earning Germany a reputation as the worst-performing stock market.

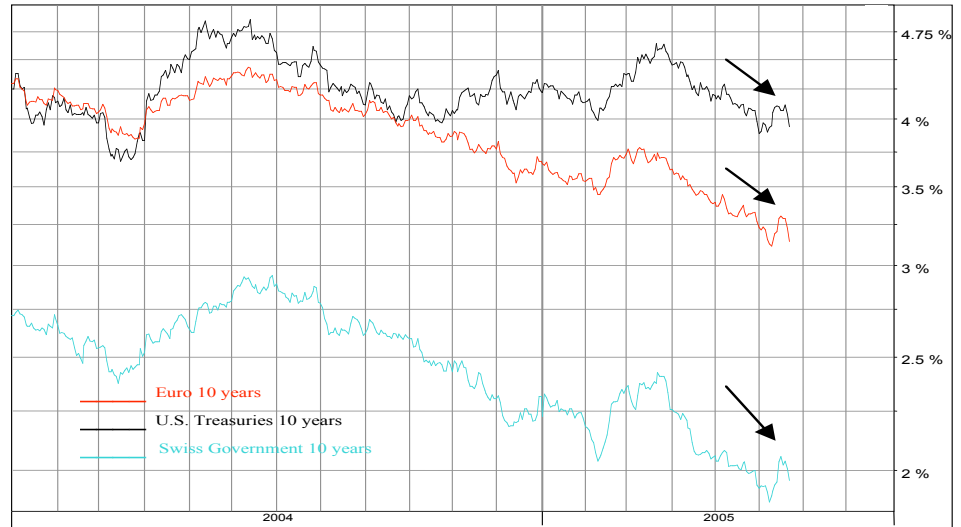
Assuming that the ruling SPD party suffers a clear defeat in the autumn, we believe that the FAZ index should have clear upside potential. Pre-election speculation about a German rally has not yet started. In typical Teutonic fashion, the immediate reaction is to wait and see. The disappointments of recent years are deep-seated and so far the best policy in periods of uncertainty has been to err on the side of caution. Despite this, we believe that it is currently advisable to analyse the risk-reward ratio of the German marketworth taking a risk now and raising exposure to German shares on a two-year view. We are currently analysing the stocks but expect to have made the first investments by the time you read this article.

Pitfalls ahead?

The Investment environment

The first six months of this year were a real roller-coaster ride on the markets, with clear uptrends in some months succeeded by rapid downtrends. The biggest surprise was the unbelievable strength of the bond markets, which performed completely differently from general expectations. For more than a year, non-institutional investors have had a clear aversion to medium to long-term bonds, an opinion we shared. However, that stance has proven too cautious: long-dated bonds have continued to post very impressive overall returns since the start of this year. We hardly benefited from this really surprising and sustained uptrend because of the relatively short duration of our bond holdings. Only pension funds (which align investments to forthcoming payment obligations) and central banks (which invest their currency reserves on the basis of economic policy considerations rather than potential returns) have benefited from the steady rise in bond prices.

Performance of Government Bond yields in %



No-one really understands why short-term US rates have tripled while the yield on ten-year US treasuries has declined by massively over the same period. We believe that the real reason is the massive surpluses run by some Asian countries, which are to all intents and purposes forced to invest these enormous sums in the US as it is the only really liquid market. This inflow of funds is driven by economic and exchange rate policy rather than investment strategy or profit motives. We see that as the cause of the contradictory US rate curve. There is, however, a danger that interest rates are about to “invert” in a number of countries. Excuse the use of technical jargon for once. Normally, we try not to bore our readers with financial jargon because we believe that is the best way of ensuring that our report lands straight in the bin. – Are we right? – We would like to make an exception here because an “inverted” rate structure is normally something

unpleasant. The principle is very simple: interest rates become inverted when short-term rates (e.g. the interest rate on say three-month fixed-term deposits) are higher than the rate on ten-year bonds. That is unusual and in the past has often heralded a recession. We have not yet reached that situation, but in the UK, for example, the return on one-month investments is almost the same as on ten-year bonds. We therefore have to keep a close eye on interest-rate trends in the next few months. Most investors - including us - completely underestimated the development of bond yields. Just because yields are low, there is no reason to rule out the possibility that they might fall further. That will be a key focus of attention in the next twelve months. If international yield curves invert, we would be forced to reduce our equity holdings, especially since inverted yield curves have always been accompanied by a poor stock market performance in the past.

We will be retaining the roughly 50 % equity exposure in our global “balanced” portfolios until further notice. As we explained in our last report, we will not be making any major changes to our geographical split. The only key changes relate to currency risk. We have gradually reduced hedging of the US dollar in our customers’ Swiss franc and euro portfolios. For US dollar portfolios we have taken the opposite approach. Above all, we have reduced exposure to euro risks.

Much has been written about Europe’s constitutional crisis in recent weeks. This has made it patently clear that people in the “old” EU member states have realised that fast-track enlargement is not good for their countries. The

votes have also made it clear that new members are prepared to say “yes” to anything, provided they are allowed to be members of the club. It is indisputable that the new EU means a transfer of resources to the new member states and that the “old” member states are facing serious social policy problems. That is one reason why we have adjusted our investment weighting in Europe and shifted investments from west to east. Austria provides an excellent example of the fact that growth prospects are better in the new EU states than in the established western states. Did you know that between 1990 and 2004 Austria’s GDP grew 25.3 % faster than Switzerland’s? The Swiss excuse that stagnating growth is due to low foreign growth completely misses the point. Perhaps it is time we turned our attention to the structural weaknesses in our country, but we will not do that this time round. However, it is a sad fact that people in rich countries (like Switzerland) tend to be complacent. The citizens in the new EU states are well-trained, hard-working and hungry for success and consumer goods. That is an excellent recipe for success and a clear indication that we need to modify our conventional investment strategy in Europe.

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