

# Our Point of View, December 31<sup>st</sup> 2004

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# Realities of the 21<sup>st</sup> century

The sad facts about the past five years

## Statistics of leading stock markets

**A) Over one year** (January 1st, - December 27th, 2004)

		in US dollar	in local terms
Switzerland	SMI	+ 12.89 %	+ 3.60 %
Germany	DAX Xetra	+ 5.35 %	+ 6.81 %
France	CAC 40	+ 15.88 %	+ 7.30 %
U.K.	FT-SE 100	+ 15.83 %	+ 7.23 %
Sweden	OMX	+ 27.23 %	+ 16.97 %
Europe	STOXX 50	+ 15.17 %	+ 6.64 %
USA	S&P 500	+ 8.36 %	+ 8.36 %
	Nasdaq	+ 7.53 %	+ 7.53 %
Japan	Nikkei	+ 10.55 %	+ 6.42 %
Bloomberg- Effas US\$ Bond Index (5-7 years maturity)		+ 2.69 %	+ 2.69 %

**B) Over five years** (January 1st, 2000 - December 27th, 2004)

		in US dollar	in local terms
Switzerland	SMI	+ 5.34 %	- 24.90 %
Germany	DAX Xetra	- 17.73 %	- 39.13 %
France	CAC 40	- 13.40 %	- 35.93 %
U.K.	FT-SE 100	- 17.05 %	- 30,73 %
Sweden	OMX	- 20.28 %	- 37.93 %
Europe	STOXX 50	- 18.86 %	- 39.97 %
USA	S&P 500	- 17.99 %	-17.99 %
	Nasdaq	- 47.06 %	- 47.06 %
Japan	Nikkei	- 40.54 %	- 39.99 %
Bloomberg- Effas US\$ Bond Index (5-7 years maturity)		+ 45.27 %	+ 45.27 %

You may well have skipped this second table in order to go straight to our comments. We sympathise with your attitude, as virtually nobody likes ploughing through statistics. Today is an exception though, and we do feel that you should take a look at this table as it contains an important message. Reality. The reality of the 21<sup>st</sup> century.

We feel certain that you will have looked at these figures in disbelief and possibly with contempt at our mistake in tabling such heart and wallet-breaking figures. We are afraid, however, that these five-year performance figures are correct. Over the past five years, the Standard & Poors Index did fall 18 %, the Nikkei by 40 % and the Europe Stoxx 50 Index by the same whopping figure of 40 %.

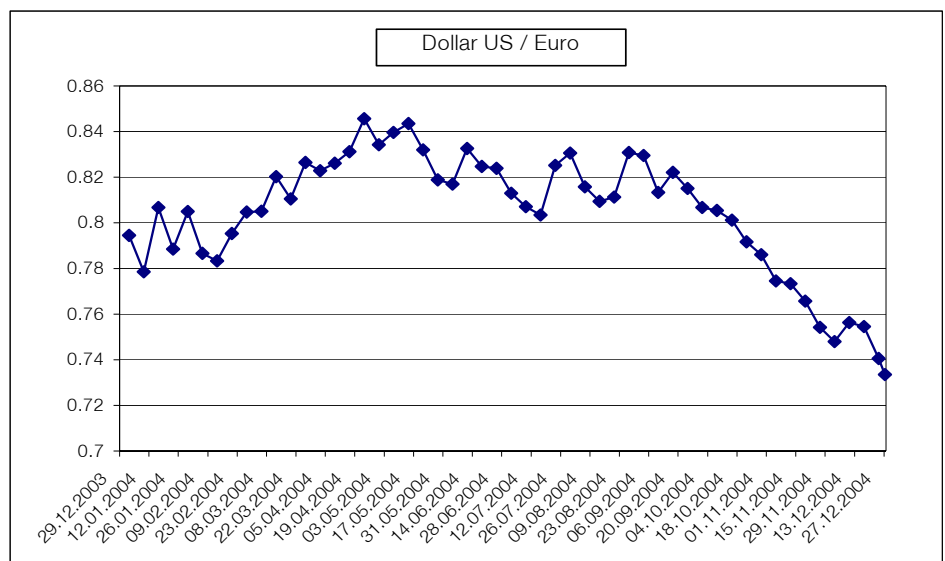
This is indeed sobering, but very relevant all the same. Performances are nowadays monitored almost daily. Many hedge funds report weekly figures - which is nonsense. A quarter or a year is too short a time horizon to establish investment success or failure. Five years is a more reasonable period to monitor an investment result, and although we have always held the view that absolute rather than relative performance is of relevance for private investors, it is nonetheless appropriate to compare one's own results with market indices. The above table provides a realistic yardstick in this respect. It is also a sober reminder that the investment environment has been harsh and that the markets' recovery following the outbreak of hostilities in Iraq was no more than a positive blip in a negative series of events.

In "local terms" 2004 was not much to write home about, although the picture looks better in dollars on account of the dollar's weakness in the fourth quarter of 2004. We were particularly disappointed in Tokyo, where we expected the best performance of all markets.

# The True Joker

## Foreign exchange rates

Year after year, foreign exchange rates prove to be one of the rather crucial aspects of investment management. One year ago we wrote in this report that we would not be surprised to see an upturn in the dollar's external value shortly after New Year. We were wrong by a margin of about 10 days. In mid-January 2004 the dollar rebounded strongly from its oversold level and then traded in a narrow range against the euro for most of the year, until it suddenly succumbed to another bout of weakness immediately after President Bush's re-election:



America's twin deficits were suddenly in the limelight again after the presidential elections, although the US current account and trade deficits have persisted for years. The prospect, however, of another four years of aggressive US foreign policy and further costly war adventures without

any realistic chance of containing these conflicts suddenly turned sentiment against the dollar in early October. Once again we are reminded that America lives beyond its means. The US debt limit has ballooned since George W. Bush came to power. From \$ 6 trillion to more than \$ 8 trillion (=8'000 billion dollars!) That is indeed scary, but it is not something that we did not know about. The prospect, however, of another presidential term under a stubborn (and in fact Christian fundamentalist) US administration that shows not the slightest regard for the cost of such reckless financial (and political) policies has jolted financial markets in recent weeks.

We have previously voiced our opinion that Alan Greenspan should have resigned while he was still globally respected as the greatest of all chairmen of the board of governors of the Federal Reserve. We still believe that Mr. Greenspan is responsible for the most reckless monetary expansion ever witnessed on this planet. We certainly think that history's assessment of Alan Greenspan's achievements will be more critical than those today. The Fed turned into an accomplice of the Bush administration, and its responsibility for managing monetary stability was sacrificed in favour of managing financial markets. Alan Greenspan is partly responsible for America's indiscriminate debt explosion, but now this inner circle has realised that it is dangerous to maintain a course that allows debtors to borrow at no cost. In real terms (that is after deducting the rate of inflation) interest rates have been negative for a considerable amount of time and even today, after interest rates have gone up from 1 % to 2 ¼ %, short-term interest rates are still below zero in real terms. That is not exactly sound policy when the economy is growing at well over 3 %. If it were not for the fact that the dollar is the world's leading reserve currency, America could not possibly play this sort of game. Japan, China, Taiwan – to name the largest holders of dollars – have been ploughing their staggering surpluses into US Treasury notes to the tune of some two billion dollars per day. Should one of these governments suddenly decide to diversify their reserves into Euro or – worse – should these surpluses

dwindle on account of a recession, America would have a problem. Mr. Greenspan and the US finance minister are playing with fire when they say – as they recently did – that the dollar has to find its own level in the free market place. That is tantamount to saying “We don’t care”. Nobody knows what the fair value of the dollar is. Recently Mr. Greenspan rightly said that predicting the dollar’s exchange rate has identical odds to throwing a coin and predicting heads or tail. A weaker dollar has fewer repercussions for America than for Europe or Japan. For many of Europe’s export nations, though, an exchange rate of 1.30+ is a qualified disaster.

It is impossible to foresee the dollar’s development. Purchasing power parity is an interesting tool to look at a currency's ongoing “value”. Historically, this analysis had proved to be too academic, though, and it often takes years for a currency’s under- or overvaluation to correct in terms of its purchasing power parity. The same goes for America’s twin deficit. It is ignored at times and suddenly it finds the world’s attention again. We have taken certain precautions in this respect in the form of an investment that is nobody’s IOU:

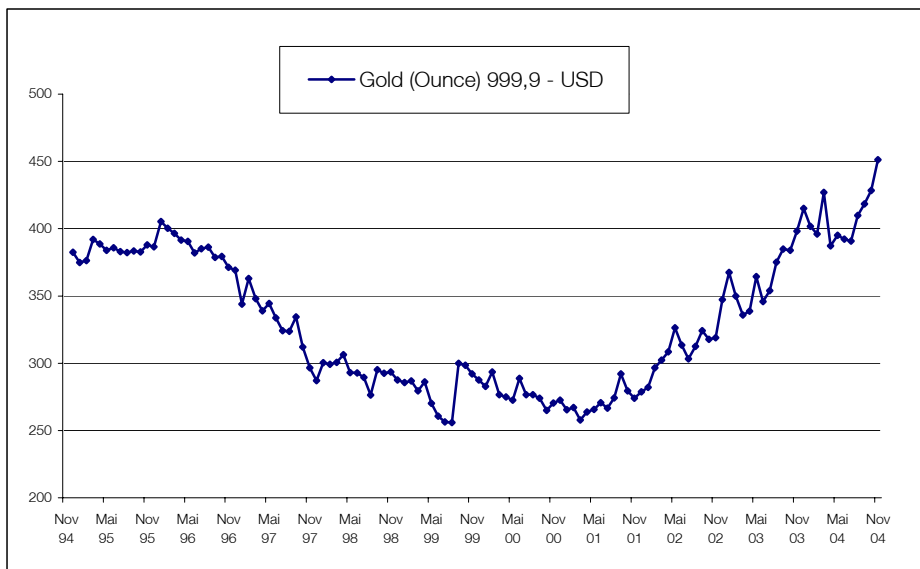
## Gold

The insurance against unforeseeable events

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Yes, we admit it: gold is an archaic investment, a relic of the past. And yet gold is trusted by millions of people as an investment of last resort, as the ultimate safe haven, a reliable asset that has survived wars, revolutions and crashes of all sorts. We do not think that analysts’ predictions of next year’s gold price are of any relevance, nor do we think that demand and supply forecasts are terribly relevant in predicting the future course of the yellow metal’s price. Rather, we think that the gold price is a barometer of

investors' trust in paper money. And that is primarily trust in the US currency. We hope that all goes well as far as America's debt situation is concerned, but it would appear to us that it is currently appropriate to take out some sort of insurance policy against a less optimistic course of events. On the occasion of a recent presentation in Zurich, our friend Marc Faber – who is very bullish on gold – was asked whether he really thought the price of gold could continue to rise. After all, that person argued, the majority of central banks had decided to sell most of their gold reserves. “Well”, Marc Faber replied, “do you really think that heads of central banks are cleverer than you and I?” That sounded rather high-handed, but it was probably a realistic reply. Most of these gold sales by central banks were initiated at the very bottom of the price cycle – the Swiss National Bank included, which has recently completed the sale of some 90 % of its “unnecessary” gold reserves. It goes without saying that the average sales proceeds per ounce were fairly close to the long-term “low” of the gold price. Marc Faber's cynical comment seemed most appropriate.



We do not have a price target for gold. One thing is sure, however: should America be serious about monetising its debt, more and more investors may well think it necessary to diversify some of their cash reserves into gold. Remember: gold is the only asset that is nobody else's obligation. There is no counterpart on whose financial standing you depend as owner of gold – quite the opposite of owning government bonds, not to speak of hedge funds. Common sense tells us that it can't be wrong at this time to hold some part of our assets in gold. In the light of current dollar short-term interest rates, the opportunity cost is minimal.

## The Key Nation

Everything depends on developments in the U.S.

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America rules the world. You may find it ironic that following our many critical comments about the United States we now say clear and loud that nothing goes without the world's superpower. In economic terms, that is. If America's economy goes on growing, the rest of the world is okay. But if America coughs, Asia gets the flu and Europe loses consciousness.

So what is up for America's economy? An important question. Currently, US economic leading indicators are not predicting a boom. In October the index of leading indicators fell for the fifth month in a row, the first time that has happened since 1995. Hence, we must assume that US economic growth will slow down in the coming year. However, a quick glance at the empirical record shows that a drop in the index of leading indicators does not necessarily mean that America's current expansion is over. An analysis of all economic slowdowns since the launch of what is probably the world's most closely watched index reveals that economic contraction was always preceded by an annualised drop of at least 3.5 %. Over the past six months, the index of leading indicators has fallen at an annualised

rate of just 1.4 %. According to all objective criteria, America is in a healthier state than Europe – "old" Europe, that is, without the more dynamic new EU member states. Nor should we overlook the fact that the actual currency constellation puts the traditional European exporting countries at a disadvantage.

After recovering in the first quarter of 2004, the dollar remained stable until late September. Immediately after President Bush's re-election it plummeted. The market appears to take the view that Bush's new team will take an even harder line in foreign policy, and that the trade deficit and associated problems are obviously not on this administration's agenda. Both the Treasury Secretary and Mr. Greenspan have publicly stated that it should be left to the markets to establish the value of the dollar. At the same time, President Bush drivels on about his administration continuing to follow "a strong dollar policy". When we hear such obvious non-sense in the literal sense of the word, we cannot help wondering whether we should believe anything the president of the United States ever says. Be that as it may, a weak dollar has more advantages than disadvantages for the US economy, and Bush's team has obviously not taken to heart Greenspan's warning about the risk of loose talk undermining confidence in the dollar. In our view, the greater danger is not the United States' economic expansion (although private household debt is still at alarming levels), but the stubborn crusader mentality in the White House, which obviously attaches greater weight to spreading democracy in the Middle East – a traditional bastion of autocratic rule if ever there was one – than to the economic prosperity of the country it is elected to govern. However, we must be careful that we do not let European dislike for the Bush administration lead us into the wrong investment decisions about America. The USA is still the world's alpha economy, and its free enterprise system is still our ultimate standard.

Conclusion: Despite a declining index of leading indicators, there is no sign of recession on the horizon in the coming year. The Fed will continue

to tighten monetary policy until interest rates return to a "normal" level of 3.5 % – 4 %, which should put a damper on the stock market. The ballooning trade deficit and the enormous costs of geopolitical developments (lengthy war in Iraq, conflict in Iran?) may overshadow the attractions of continued low interest rates. The dollar will remain volatile and increasingly dependent on the goodwill of its "bankers", China and Japan. On the whole, US equities are not cheap. The USA markets will offer a number of opportunities in 2005, but it will take some subtle stock-picking to benefit from them.

## The Disappointment

### Meaning Japan

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At the beginning of the year we were convinced that in 2004 Tokyo would be the performer of the year among the major markets. The first quarter seemed to confirm our assessment. Then, as elsewhere, Tokyo stalled in May and never really got back into its stride. As so often in the past, the trigger in this case was rising oil prices. Subsequently, Japan's outlook deteriorated as commodity prices rose across the board on the back of surging demand from China. An unexpected complication is the unpleasant fact that wages and salaries in Japan have not stopped falling, despite initial signs of economic recovery. Not surprisingly, this continues to inhibit consumer spending. Another constraint that reinforces this development is uninterrupted growth in part-time employment. At the end of 2003 it appeared that the deflationary forces in the economy had finally been defeated. While they have not actually reappeared, the possibility that they could is all too real. The CHF/JPY exchange rate was also of great relevance for investors in Switzerland. Whereas 100 Yen cost 1.24 Swiss francs in April 2004, by mid-December the price had fallen to about 1.10 Swiss francs, which translates into a Yen devaluation of about 10 %.

That hurts. The performance of the Japanese bourse in 2004 was much in line with that of other major markets, which is not much of a consolation. We had expected Japanese equities to outperform most markets in 2004. This has not been the case. For Swiss investors, this disappointing market development has been compounded by an unfavourable exchange-rate trend. For an extended period the Japanese central bank spent unprecedented sums on buying dollars to hold the Dollar/Yen rate stable. This explains why the Yen – one of the best currencies in the world – fell more sharply against the Swiss franc than justified by economic factors alone.

The weighting of Japanese Yen in our clients' securities accounts is relatively high and a drag on performance. Like many Anglo-Saxon financial institutions, we took the overoptimistic view that Japan had finally managed to throw off its shackles and embark on a new economic future. External factors, however, have led us to lower our expectations.

## China

Update on developments in the Middle Kingdom

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The Middle Kingdom gets a lot of stick nowadays. If the dollar falls, blame China, because apparently it has stopped buying US bonds. If the mood worsens in Japan, blame China, because it has marginally raised interest rates to cool its own economy and prevent it from going off the rails.

In our opinion, the guessing game about China's growth in the next quarter – 5 %, 6 % or 7 % – reveals a fundamental misunderstanding of China's position. The fact is that it is almost certain that even in the event of the Chinese economy "collapsing", it would still be growing two or three times faster than the economies of e.g. Switzerland and Germany. And

those criticising Chinese balance sheets, Chinese government figures and many other Chinese data, deliberately overlook the dubious behaviour of many leading companies in our part of the world during the recent past. People who live in glasshouses should not throw stones. And definitely not at China, for the Chinese are financing America's spending boom.

Let us look at the facts. China has raised interest rates in the past year to curb an investment and building boom that threatened to boil over. The leadership in Beijing continues to give priority to the consolidation of the banking system and is slowly making headway. We do not share the view of the prophets of doom who maintain that the burden of bank debts could undermine China's development. A lot still has to be done to clean up the system. But China's situation is not comparable with other "banking crises" for the simple reason that China is not a free-market economy. This may sound absurd, but it leads to a logical conclusion: China is gradually developing into a free-market economy, but for the moment the country still has a centralised system of government. Beijing decides what is and is not possible, and we cannot believe that it will allow a leading banking institution to close its doors. At present the government is still in a position to inject capital where and when it so chooses.

We are also sticking to our view that it is only a matter of time before the Yuan starts to appreciate steadily – much as the Yen did in the 1970s, when it gradually rose from 360 to 100 to the dollar. However, China will not be rushed into any ill-considered currency revaluation. After demanding for months that China let the Yuan float, the USA has suddenly fallen silent. Perhaps a self-confident China sent Washington a casual memo with the words: Should we revalue or finance your deficit? You decide, one or the other. America chose the other.

We are extremely satisfied with our Chinese investment through our "China Strategy Certificate": the investment has posted both absolute and

relative gains. The performance of our investment compares favourably with those of the world's leading institutions:

		31.7.03 – 30.11.04	31.12.03 - 30.11.04
Hang Seng China AFF. Crp (Red Chip)	HKD	32.35 %	6.87 %
→ <i>China Strategy Cert.</i>			<b>8.46 %</b>
JP Morgan China Fund A	USD	43.17 %	-4.77 %
UBS Equity Greater China	USD	38.41 %	9.23 %

## Frank and Honest

We have just lived through the worst investment period of our lifetime

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There is no use to beat around the bush. The past five years have been years (possibly with the exception of 2003) one does wish to forget and a lot of investors have done just that. The pressure to perform has increased recently on us poor investment managers, but the honest facts of the table on page 1 are undisputed proof that the past five years have not exactly been the easiest period in the history of asset management. As a matter of fact, they were the most difficult years ever in our business. Let us be frank and honest though and say that we have just closed out the worst such period in the past seventy years. In other words, we have all just lived through the toughest investment environment of our lifetime. Too many investors extrapolate their investment results of the nineties into the twenty-first century, thinking that double digit returns can be taken for granted indefinitely and without risk. Well, it is frank and honest to assure you that this is a fallacy. An impossibility. We are currently in a phase of

realignment, overshadowed by major imbalances as far as political balance and economic dominance is concerned. We feel this is the wrong time to be aggressive in our business. The wrong time to insist that double-digit returns must be secured at all cost. What we try to achieve is to invest in areas which are likely to produce rewarding returns during the next cycle and we are afraid that "Old Europe" will not be the place that is best suited for that endeavour. Our emphasis will be on Asia, Eastern Europe ("New Europe") and America. For the time being though our portfolios are certainly including a variety of "Pièces de résistance" to insure against the unforeseeable. Short term notes. Gold. Common sense tells us not to stick out our head too bravely at this time. It is unwise to be brave at the wrong time. Heroes die young and the same goes for entrepreneurs and investors, for you and us. That is not only frank and honest. It is a fact.

MAB