

Our Point of View, December 31st 2006

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Statistics of leading stock markets

A) Year to date		in US dollar	in local terms
Switzerland	SMI	+ 24.65 %	+ 16.09 %
Germany	DAX Xetra	+ 33.63 %	+ 19.39 %
France	CAC 40	+ 28.27 %	+ 14.65 %
U.K.	FT-SE 100	+ 25.76 %	+ 10.09 %
Sweden	OMX	+ 38.52 %	+ 19.76 %
Europe	STOXX 50	+ 26.32 %	+ 12.99 %
USA	S&P 500	+ 13.41 %	+ 13.41 %
	Nasdaq	+ 9.08 %	+ 9.08 %
Japan	Nikkei	+ 5.17 %	+ 8.02 %
Morgan Stanley World Equity Index		+ 18.17 %	n.a.
Bloomberg Effas US\$ Bond Index (5-7 years maturity)		+ 3.81 %	n.a.
Balanced Mandate Index *		+ 10.99 %	n.a.

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 88.34 %	+ 36.74 %
Germany	DAX Xetra	+ 90.63 %	+ 26.03 %
France	CAC 40	+ 78.30 %	+ 19.79 %
U.K.	FT-SE 100	+ 60.81 %	+ 18.08 %
Sweden	OMX	+ 35.80 %	+ 107.98 %
Europe	STOXX 50	+ 61.70 %	+ 7.02 %
USA	S&P 500	+ 22.90 %	+ 22.90 %
	Nasdaq	+ 22.34 %	+ 22.34 %
Japan	Nikkei	+ 80.60 %	+ 62.86 %
Morgan Stanley World Equity Index		+ 46.32 %	n.a.
Bloomberg- Effas US\$ Bond Index (5-7 years maturity)		+ 26.39 %	n.a.
Balanced Mandate Index *		+ 36.36%	n.a.

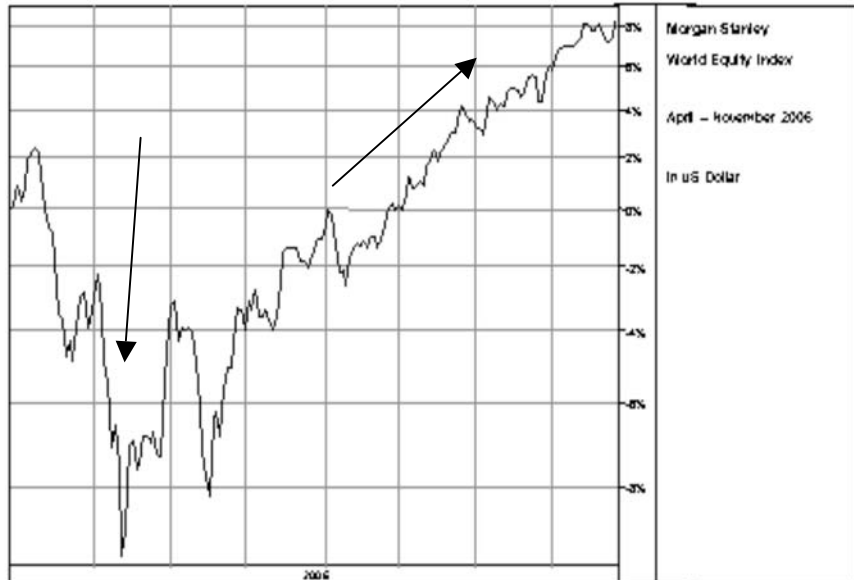
*50 % Morgan Stanley World Equity Index and
50 % Bloomberg Effas Bond Index (5-7- years maturity)

Rollercoaster Ride

The violent ups and downs on the markets in 2006

We generally don't spend too long looking at the past. After all, who in our business is interested in that? But this time we want to make a small exception, because stock market performance over the last 12 months has been anything but straightforward. When we composed our last report back in June, Switzerland's SMI was down 2 % over the first half but by the end of December it was up 16 % for the full year. This shows quite clearly how amazingly volatile the financial investment world has become. This example also makes clear how arbitrary the choice of the calendar year as a time-period is for measuring performance.

The prevailing wisdom in the financial press was that 2006 peaked in the fourth quarter with apparent historic highs everywhere. Analogies were drawn between golden sentiment on the markets and golden leaves on the autumnal trees, but in truth – and journalists are not always entirely truthful – the press very often wrote of “new five-year highs” which had been reached here and there. Within a quarter or indeed, ludicrously, 20 days, the world of market watchers and scribbling tipsters underwent a complete transformation. Whereas in July and August many analysts, economics gurus and their ilk were still shouting from the rooftops about crashes, destruction of value and the like, the view among the press rapidly switched to jubilation as market sentiment rebounded on an almost unprecedented scale.



The Euro Stoxx 50 Index (the 50 largest stocks in the euro zone) advanced 7.3 % in the first four months of 2006, then almost immediately fell back 11.25 %, before climbing again by 11.5 % in the following two months. In more volatile corners of the globe the markets fluctuated even more sharply. The Mumbai stock exchange lost a massive 23.5 % in the hot summer months and within no time at all disappointed the prophets of doom by bouncing back 26.6 %.

This may sound sounds a little harsh. And it probably is. In actual fact, every now and then it really annoys us to see how the same journalists, economic advisors, bank analysts and so on write about crashes and bear markets, only – as happened in 2006 – to report self-confidently a short time later about a “soundly based rise on stable foundations”, as if nothing had happened. At risk of saying “we told you so”, we unequivocally stated in July that the sharp downturn in the financial

markets did not constitute a trend reversal. Our assessment of the situation was that “a correction is not a crash”.

The fact is that the past year has seen self-confidence harshly tested and has been an unbelievably volatile period. In addition, it was by no means as easy for globally diversified portfolios to make gains as has been subsequently depicted.

Everyone gets their turn. Sometimes.

Not all stock markets shone

As investors, we tend to use our home markets as a benchmark for performance. If this market performs well, the standard reached sets the mark. But if it loses ground, a positive absolute return is welcomed, even if it's actually nothing special at all.

This outlook is thoroughly understandable. The difficulty is that sensible investors – which of course includes female investors, who always make decisions more rationally than men anyway – must not put all their eggs in one basket. In other words, global portfolio diversification is an absolute must. This doesn't mean that weightings should replicate individual market caps, but globalization cannot and must not be ignored. So, for example, despite the Swiss Exchange's impressive performance over the last four months of the year, it would be very risky to focus a portfolio solely on the Swiss domestic market and pay virtually no attention to the global picture. Each year there are, of course, a few stock markets that really stand out and on which one should have concentrated to the exclusion of the others. The only problem is that you can bet your bottom dollar that these exchanges will change every year. This means that global

diversification of equity portfolios is without doubt a sound, risk-limiting approach, which yields the best results in the long term.

Booby prize for 2006

Tokyo stock exchange massively disappointing

We had to use the word “disappointment” back in our last report when referring to our investments in Japan, although at the time we were not in fact concerned about our exposure to the country. We displayed patience, but this proved to be the wrong option, as the Tokyo stock exchange increasingly lagged behind other stock markets.

It wasn't just that prices headed south, as it's so sarcastically put, but that the yen also threw a spanner in the works and, contrary to economic logic, continued to depreciate.

Foreign investors therefore lost twice over last year: on share prices and on the currency – not nice at all. Overweighting Tokyo certainly cost investors money in 2006, and being in good international company wasn't much consolation either. The exuberance at the turn of 2005/2006 about the outlook for the Japanese stock market should have been a warning. All the newspapers were jammed full of forecasts that the best returns in Japan would be earned from Japanese equities. Well, we weren't too happy with all this advice, but to be honest we were confident that the medium-term prospects for Kabutocho were good. We still felt the same way in mid-2006 (after the significant global correction in share prices), although, to a small extent, we were already licking our currency-induced wounds.

In the meantime, however, we have developed a few fundamental concerns. First of all, there's Mr and Mrs Watanabe; Japanese consumers simply haven't wanted to buy. This is disquieting. The consumption figures for the last few months have not been anything to write home about. Then there are the numbers for new orders in the machine tool industry, with domestic orders down. Not good. And it has to be seriously asked whether the Bank of Japan has taken leave of its senses in considering an interest rate hike at the present time. Despite the sluggish environment this is in fact a genuine possibility; a few years back the central bank managed to strangle an economic recovery at birth with its eccentric behaviour (a rate rise). The gentlemen concerned should take note, but these aging bureaucrats still carry on acting contrary to the laws of economics. The reason why is plain to see: they want to give a crude signal that deflation has been defeated (which unfortunately is by no means the case) and indicate that there has been enough carry trading. "Carry trades" are actually the reason why the yen has been, contrary to economic logic, almost in freefall. So what are carry trades? For some time, half the world (please note, including Japanese institutions and private investors) has been borrowing in yen at rates of less than 1 % in order to immediately resell the borrowed yen. The proceeds are then invested in dollar, sterling or euro-denominated paper, raking in a juicy 3-4 % interest rate spread. This practice has continued happily for many years and, as it is unlikely that Japanese interest rates will rise by more than a fraction of one per cent, the equivalent of some 400 billion Dollars in the form of borrowed yen is currently outstanding. We share the Japanese central bank's reservations that the whole affair is a mid-ranking catastrophe, since threats that it will all end in tears are of little use. The spread against other currency investments will remain huge, and carry traders do not care one iota about the threats by the Bank of Japan. The approach of these arbitrageurs is, of course, highly speculative and dangerous. The greatly esteemed earliest mentor of the writer of these lines – I refer to Sir Siegmund Warburg – said time and again to the young trainees at his bank that the easiest way to go bust is to borrow money

short-term and invest it long-term. And this is essentially what carry traders do. Most of the money borrowed in yen is used to buy dollar, euro and sterling bonds – exposing carry traders to both interest rate and currency risk. In principle, it should all end in tears at some point and the yen would then inevitably shoot up because of the need to buy back all these vast amounts of yen that have been borrowed and then resold. So far no one has believed this, which may be a recipe for the opposite to occur. Timing is everything, but it is impossible to predict when this will happen. It is clear, however, that this borrowing spree cannot go on forever. Carry trades are highly speculative and risky. You can be sure that when the music stops, there will be a few chairs missing.

So what should we do? Our Japanese exposure has not been especially successful in the past year. Others are in the same boat, but that is no consolation. We have gradually reduced exposure to Japan in those client portfolios, which were overweight in Japan at the start of the year, and the allocation within these portfolios will remain modest at the start of 2007. The picture is too opaque for us to be stubborn, because what the market says, goes. The equity market and the external value of the yen are not actually expensive. But there's no point in swimming against a tide that apparently contains sharks in the form of carry traders. The over-exposure to Japan has eaten into returns in some of our portfolios and, while this approach bore fruit in 2005, this year we were simply caught on the wrong foot in this market. It is entirely conceivable that the yen will display considerable upside at some stage. However, for the reasons above, the timing of this upside is impossible to foresee, so we prefer to be frank, admit an understandable error of judgment and make reallocations. Sometimes things turn out differently from how you expect. You can't win every game.

Gifts could come at a high price

Many capital protected products are not without risk

There is a fashion at the moment for banks to package a vast array of investment ideas into certificates, which often come with full or partial capital guarantees and large coupons. One smart product in Austria has been designed to neutralize rises in heating oil costs for investors; by buying a capital-protected energy certificate, energy cost increases can be turned to their benefit, virtually guaranteed.

But the age-old rule that there can be no return without risk cannot simply be jettisoned by the creation of ever more inventive products. Capital protection comes at a price, and it would be dangerous to believe that you can suddenly have your cake and eat it. The terms and conditions of such issues should always be read very closely.

We think that capital-protected products based on share indices (e.g. on the Stoxx 50 index) can certainly have their place within a portfolio. But the protection of course limits upside potential; investors cannot expect to enjoy both capital protection and full participation in index gains.

We are using more and more certificates ourselves, mainly reverse convertibles offering attractive rates of interest. Expressed in simple terms, a reverse convertible stipulates, for example, that the bond need not be converted into a given company's stock until the price falls to a specified level. This makes them ideal for situations where you can be quite confident that the risk of one (or more) stocks is limited, but the upside potential is considered fairly low. Most of our portfolios contain an allocation to these instruments. Unfortunately, the descriptions of such securities given by banks lack transparency and are hard to understand, full of abbreviations that are double Dutch to most readers. Investments of

this kind are classed as structured products, and we would be pleased to hear from you at any time if you would like to learn more about the background and reasons to invest in such products, which offer high regular income.

Generally speaking, you should beware any investment products that promise an unbelievably high coupon, as interest is still directly correlated to risk!

Snapshot

How we see the world today

The title of this section sounds like a grand tour and a challenge to readers' stamina. Don't panic. We always try to say something of significance on every line and so this section, which we regard as the report's core message, is intended to pack in as much as possible.

The general consensus is currently more or less as follows. The Federal Reserve has successfully slowed the US economy; the US real estate market is ailing; prices are falling; Americans are no longer feeling as wealthy; and consumption is suffering. This is the story in a nutshell, although it could be elaborated with statistics and stretched out to fill a small book saying the same thing...

The prevailing view is that this is really bad news for Asia, because all Asian countries depend totally on exports, steal our jobs and collapse if US imports fall. Or do they? This belief, which, it should be noted, is readily and seriously held in the West, is naturally a simple-minded, false and somewhat stupid assertion that completely ignores reality.

Let's take a closer look at the facts.

We share the view that price excesses in the US real estate market are being corrected. We have probably seen only the first phase of a cooling-off period. Fortunately, energy prices have declined significantly in the last few months and unemployment has stayed low. The “I am rich” feeling is nevertheless being affected by the continuing house price falls, and here and there consumers are cutting back on trips to the supermarket. America will hopefully avoid a recession, but a slowdown in consumption is certain. Now the cardinal question is whether this will drag the world into a global recession.

The answer straightaway is no, because the widely held view that the American consumer is the lifeblood of the global economy is quite simply wrong. The International Monetary Fund’s findings clearly show that in the last ten years **Asia**, and not the USA, has been the greatest driver of the global economy. And not because the hard-working Asians only produce what the West will buy, but because they also consume furiously – and in unprecedented quantities – everything from washing machines to Gucci handbags. **Asia** is in actual fact the world’s undisputed champion of consumption. Consumer spending advanced a healthy 3 % in the USA this year. But in Asia the rate was far higher, at 7 %, and rising. It could be objected that US consumption is higher than Asia’s in absolute terms. This is true, but adjusted for purchasing power, Asia already consumes more than the USA. This is the right comparison to make, since fixed expenses such as housing, services, etc. are far cheaper in Asia, leaving a relatively higher amount available for consumption. China’s consumers are opening up a land of milk and honey for supermarkets and the like, so it is not surprising that European and US chains are fighting tooth and nail to grab market share as fast as possible. Forecasts are always risky, but it is by no means far-fetched to predict that China’s consumption could take little more than a decade to match or even overtake that of the USA, again expressed on the basis of purchasing power parity.

This is the first reason why a downturn in US consumption will not bring the world grinding to a halt. For our next reason, the question is whether the world is generally so dependent on US consumption that any downturn here would automatically turn the traffic lights to red in Asia. The answer is no, although it must be conceded that they would go to amber at least for countries such as Thailand and Taiwan. However, the growth of the Asian giants, above all China and India, in last few years has been heavily characterized by domestic demand. China certainly has been running an enormous balance of payments surplus and US imports have contributed around 2 % to economic growth of 10 %. Lastly, the USA is not the only country that imports from China. Five years ago US imports accounted for more than 20 % of the global total but this proportion is now down to one-sixth.

One objective thing is clear then: if US imports do indeed fall, Asia's economy will certainly be adversely affected. However, the net impact on Asian growth is likely to be far less than one would believe from reading the financial press. European export statistics provide the same message: Europe now exports approximately 20 % more to Asia than it did five years ago, whereas there has been hardly any change in exports from Europe to the USA in the same period.

Asia has completely changed the face of the global economy, and certainly for the better, since dependence on the US economy has been reduced massively as a result. We used to say that when America sneezed, the rest of the world caught a cold. But this is no longer the case, and it is of the utmost importance that we recognize this, adjust our mindset and structure investment portfolios accordingly. Quite simply, it can no longer be correct to accord Asia a lower weighting than that granted to the USA and Europe – that would really be to misread reality.

The exception that proves the rule

A soft landing is possible

We live in a cyclical world, in which every economic upturn is sooner or later followed by a slowdown or recession. A couple of years ago, the US showered the world with almost unlimited liquidity, making it possible to borrow at virtually zero cost. A consumption and construction boom followed close behind, and banks eagerly fed the appetite for debt. House buyers in the US did not need to put down a single cent as a deposit to secure their own home. Once the threat of deflation had been averted, the US central bank then started to worry and hiked interest rates with the regularity of a Swiss watch – no fewer than 17 times in all, from 1 % to 5.25 %. It was apparent that this massive increase in the cost of borrowing would have implications for US consumers and above all for house building. Rates were going up all over the world while this was happening, and as far back as 18 months ago we reluctantly highlighted the prospect of an inverted yield curve (in which short-term yields are higher than those at the long end). This is generally a precursor to a recession. The yield curve has now been inverted for some time, but there are still no objective signs that the world is about to slide into recession. There were fears that the much-increased interest rates might make the beleaguered (and savings-adverse) US consumer cut back on spending and even force some homeowners to sell up, which would not be good for the global economy at all. Now the US housing market has indeed slumped, and new builds are proving tough to sell. The US economy has weakened overall, but not to the extent that was feared. It would be presumptuous to expect an imminent recession, but interest rates are unmistakably rising worldwide. Although the tightening cycle is probably over in the US, further rate hikes cannot be ruled out in Europe, Asia or Japan, which is fundamentally not that encouraging. That said, global liquidity is vast, and the search for investment vehicles is frenzied.

Globalization may have provoked many social injustices, but from a purely economic perspective it has certainly unlocked a huge amount of potential, and it almost beggars belief at times how the established markets have benefited from the new global trends just as much as emerging economic regions. Ultimately, the Asia factor, which we described in depth in the “How we see the world today” section, is preventing a consolidating US economy from dragging the world into recession. There is a lot wrong with the new global growth engines, China and India: environmental damage (like that we caused during our own industrial revolution!), the exploitation of unskilled workers, dispossession of farmers, child labour and much more that can leave a bad taste in the mouth. But the fact is that the mood is unprecedentedly upbeat, and this should remain the case for a long while to come. That does not mean that these countries’ stock markets are going to keep constantly surging upwards. We saw last summer how a stock market like India’s can correct by 30 % in the space of just a couple of weeks, and that is unlikely to be an isolated event. In fact the way that sentiment is bubbling away in Mumbai we would be astonished if there was not soon another shake-out. Corrections of this kind do not have much to do with the fundamentals of the economy or above all with the new paradigm, which these giant countries have created, for the world economy. The monumental upturn in Asia is overshadowing everything else we have experienced, and their resources in terms of highly educated engineers, mathematicians, doctors and businesspeople are enormous. Above all else, consumption is booming at a tremendous pace, and consumption is the lifeblood of the market economy. Unfortunately, European investors are negatively affected by currency exposure; Asian investments are largely dollar-based, and the greenback is.

We therefore believe that that very rare thing, a soft landing for the global economy, is in fact likely this time. From a fundamental standpoint, we do not think that the signs are about to all turn negative, which is not to say that the stock markets will get away scot-free, as summer 2006

illustrated. The new growth momentum coming from Asia is strong and relentless. But new inventions and markets in their infancy are like children; both are susceptible to childhood illnesses and can become feverish at times. Still, better mumps than decrepitude!

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