Our Point of View, June 30th 2007

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Statistics of leading stock markets

A) Year to date

		in US dollar	in local terms
Switzerland	SMI	+ 2.07%	+ 2.73%
Germany	DAX Xetra	+ 20.45%	+ 18.26%
France	CAC 40	+ 9.21%	+ 7.22%
U.K.	FT-SE 100	+ 7.06%	+ 4.93%
Sweden	OMX Stockholm 30	+ 7.32%	+ 8.19%
Europe	STOXX 50	+ 9.08%	+ 9.79%
USA	S&P 500	+ 6.21%	+ 6.21%
	Nasdaq	+ 7.87%	+ 7.87%
Japan	Nikkei	+ 0.81%	+ 3.61%
Morgan Stanley World Equity Index		+ 7.05%	n.a.
Bloomberg Effas US$ Bond Index (5-7 years maturity)		+ 1.10%	n.a.
Balanced Mandate Index *		+ 4.07%	n.a.

B) Over five years

		in US dollar	in local terms
Switzerland	SMI	+ 82.85%	+ 50.94%
Germany	DAX Xetra	+ 142.09%	+ 78.01%
France	CAC 40	+ 107.31%	+ 52.43%
U.K.	FT-SE 100	+ 83.65%	+ 40.19%
Sweden	OMX Stockholm 30	+ 172.03%	+ 104.18%
Europe	STOXX 50	+ 91.50%	+ 40.81%
USA	S&P 500	+ 52.18%	+ 52.18%
	Nasdaq	+ 78.06%	+ 78.06%
Japan	Nikkei	+ 64.45%	+ 68.04%
Morgan Stanley World Equity Index		+ 74.95%	n.a.
Bloomberg- Effas US$ Bond Index (5-7 years maturity)		+ 21.96%	n.a.
Balanced Mandate Index *		+ 48.45%	n.a.

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

Doom? – Boom? – Gloom?

Today's stock market environment

Our rhyming headline has something of a jolly feel to it, but the same cannot be said of the views being expressed in the daily newspapers.

There has been a huge tide of prophesizing in recent months, and, unprecedentedly, journalists, analysts and other soothsayers have all agreed about what lies ahead as we have entered each stock market correction. They believe the only way is down, and in spectacular fashion. They say we are facing a crash and have likened the global stock markets to a bubble or vulnerable hot air balloon in which the pressure is building. There are charts everywhere for the years 1999-2000, and parallels are being drawn with the current environment. The end is nigh, and has been for some time.

Of course, if you forecast a downturn quarter after quarter you will eventually be right. Indeed, we have experienced a couple of marked corrections this year, but the foretellers of doom have on each occasion been silenced, as these have proceeded in textbook fashion and then taken a turn for the better again.

So far, we have held our nerve and not jumped on the negative bandwagon. However, it is wise to ask whether now is the time to take cover or not. It has repeatedly been the case that the final throes of a boom bring the biggest gains, and it is not much help to be right too soon, get out a year early and miss out on the best part of the party.

We will therefore take a few minutes to consider whether the end of the boom is already upon us, or whether there are still some good reasons to stay invested in equities a while longer.

Mania and Mammon

What are the factors causing concern?

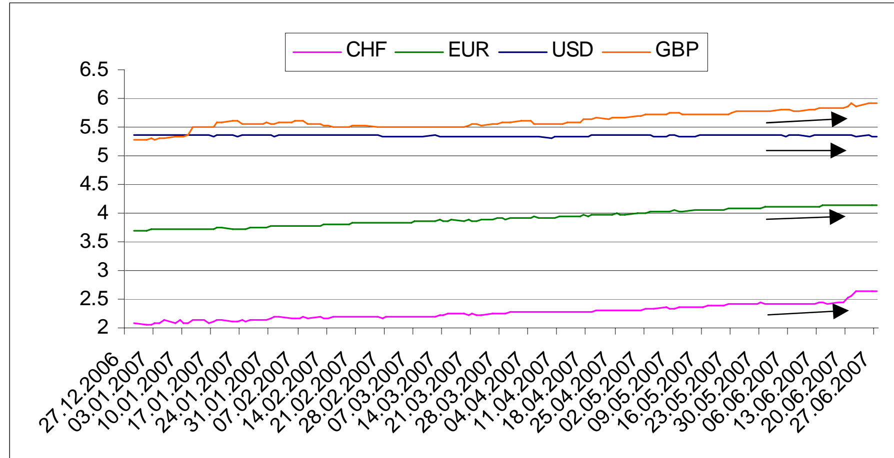
The first factor is the rampant M & A (Mergers & Acquisitions) mania. Colossal deals are being signed, and almost no company is today immune from a friendly, or hostile, takeover bid. And the moment an offer is announced, other bidders pile in and drive the price higher. Private equity firms, which are being entrusted with untold amounts of speculative money, hardly know what to do with all the cash they are swimming in. Investors almost "need" to be involved or else they run the risk of being dismissed as amateurs. We are steering well clear of this sector, where we do locate a bubble. Looking back over past decades and reflecting how such giant acquisitions have generated added value and how often they have failed to do so is a sobering experience. The Daimler Chrysler story acts as a strong cautionary tale...

The league of the big banks is to blame for all this. Honestly! We may sometimes exaggerate a little, but not in this case. Huge amounts of funds are made available and balance sheets of soundly financed companies mutate to a precarious state following the attacks of private equity sharks. The latter offload the debts they take out onto the victims of their takeovers, and the leverage massively increases cyclicality. Rising interest rates can then quickly have a nightmarish effect, and formerly healthy companies can swiftly turn into junk cases. The banks don't seem to worry. Well, they did not worry either when they advanced staggering amounts of money to first time U.S. homebuyers without a penny of own capital. The speculative financing of Spanish condominiums, thousands and thousands of which are still looking for buyers, is another example of foolhardy aggressiveness of banks. The banks are so focused on short-term profits that we really have to question whether their risk management departments have learned anything from past experience. We think there is a simple explanation:

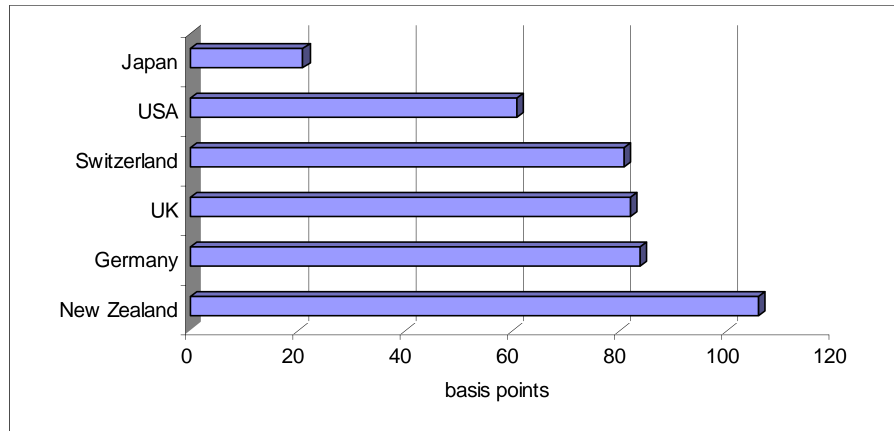
executive's option plans virtually assure short-termism, as senior managers put their own prospects for the next couple of years ahead of the interests of shareholders. Whatever. Back to our main argument…

The current M & A fever is not a good sign. We have seen it all before; all it needs is for the financial model of one of the upcoming major deals to fail because some bankers get a touch of cold feet, and today's fun could quickly end. So far though, the effect of the tidal wave of takeovers has been to fill the pockets of untold thousands of shareholders in these bought-out companies with vast sums of money, which then had to be reinvested in the market. In other words, the private equity mania is a price driver. It is removing many large companies from the market, and the proceeds need to be reinvested. In short, the private equity casino will remain positive for the markets as long as the house of cards remains standing. The end is in sight, but there is uncertainty over the timescale.

Global interest rate trends also make caution advisable. Interest rates are slowly but surely rising across the board. Central bank bosses are proceeding very cleverly and have for some time been factoring market psychology into their commentaries. They gently nudge the markets into readiness for the next interest rate move. But the fact remains – as anyone with a passing interest in financial affairs knows – that higher interest rates are bad for the stock market. The charts below show interest rates over the last six months.



Increase 10-year government bond yields, last six months



Another far-from-positive point is that inflation is on the rise everywhere. The politicians fail to admit this, as they exclude key components, such as food and energy prices, from their indices, claiming they are too volatile to be included. The truth is naturally rather different, as so often when affairs of politics are at stake. Inflation is actually significantly higher than we are led to believe, and the interest rate rises we are seeing are a reflection of this. One should therefore continue to remain wary of bonds, which we have been avoiding for a long while.

The sunny side

The reasons why the end is not necessarily nigh

Most stock markets are fairly valued on fundamentals; they are not cheap, but neither are they over-priced. This may sound banal, but it forms the very foundation of our view. Below we compare price/earnings ratios – after all an important valuation yardstick - with the long-term average valuation:

Price-earnings ratios

	expected 2008	∅10 years		expected 2008	∅10 years
Switzerland	13.80	17.10	Hong Kong	17.60	15.40
Germany	13.00	17.90	China	15.10	13.10
UK	12.50	17.40	India	16.00	13.10
USA	14.80	18.90	Taiwan	11.90	16.50
Japan	17.20	26.40	Russia	9.80	8.20
Sweden	14.20	18.20	Poland	14.70	12.90
Emerging Europe	10.50	11.10	Brasil	9.40	7.00

In our opinion, the major markets are not really over-valued, and it would be wrong to talk of a bubble. The bubble is not in share valuations, but in M & A, some real estate valuations and probably the art market.

At the same time, we should note that stock markets are not pricing in significantly higher interest rates, and this is definitely a cause for some concern. The world's interest rate environment is still very much influenced by the Greenspan effect, through which the US central bank boss unleashed a flood of money at the start of the century in order to

forestall a period of deflation. We are therefore on the alert regarding interest rate developments. The age of the inverted yield curve (in which short-term rates are higher than those at the long end) seems, fortunately, to be drawing to a close, although we should be clear that interest rates are still low by long-term standards. The adjustment phase of unusually low interest rates, which prevailed early this decade, is still in the process of being adjusted.

We have already mentioned the huge amounts of money being generated by private equity takeovers. However, the vast currency reserves being held by countries with surpluses (such as China, India, Taiwan, Russia and Japan), which are expanding month by month, are even more significant and are positive for the equity markets. China had currency reserves of around a trillion dollars (USD 1,000,000,000,000) at the end of 2006, and this figure has since soared some 30%. Like its fellow countries with big surpluses, China has recognized that it is not that fun or financially advantageous to act as America's banker indefinitely. These states want to avoid snubbing the US (and so hurt themselves) by diversifying their reserves and moving into euro, yen and sterling. Instead, we now see them preparing to follow Singapore's long-established lead, investing at least part of their currency reserves more aggressively and adding large equity investments. This trend is not yet underway, but it is coming. The countries in question have taken on dozens of investment experts, who are busy picking out investments that offer good prospects and above all make strategic sense. China will not be dragging its heels, and we would not be surprised to learn one morning that it has made a bid for one or more of the commodity giants, such as BHP. Russian companies have been eagerly buying up foreign competitors, and India in particular is expected to follow suit. And the sums in question will be substantial. China is talking of at least 40-50% of its currency reserves, i.e. some USD 600 billion, with around another USD 50 billion or so added to this each quarter on current trends. Let's not forget that we are only talking about China here. India, Taiwan,

Russia and all other Asian surplus countries are not about to keep meekly investing in US Treasuries either.
These new, technically driven factors are beginning to take shape and will significantly alter the balance between supply and demand, not to the detriment of the stock market environment.

Globalization is also continuing to bear fruit for adaptable companies. The list is endless and ranges from traditional Swiss companies, like Holcim, which have carved themselves outstanding positions in fast-growing markets such as India and Brazil, to the myriad outsourcers in the consumer goods sector, e.g. H&M, Adidas, Walmart and thousands of others. We have often said that it makes no economic sense whatsoever to argue that the naughty Chinese are successful only because their currency is grossly undervalued. The fact is that labour costs in China are a mere fraction of those in the West. The Yuan could be revalued by 10%, 20% or even 30%, and that would do nothing to stop the offshoring of production to Asia (and not just China). Perhaps President Bush should prohibit jogging shoes from being produced in China for four dollars a pair, so there would be more jobs in the US and no trade deficit, the smart-alecks might conclude.

Globalization is a real cost-killer for globally active companies, but it is undeniably associated with social injustice. The workers struggle to get by, while the rich get richer. The gulf between haves and have-nots is getting wider. Although we may frequently find this distasteful, from a purely business point of view it is undeniable that globalization is boosting profits and that many new countries are benefiting from the tide of offshoring. We are in a new era, in which textbook comparisons with the past cannot be made. Such comparisons used to be much easier, and we often saw the same patterns repeating themselves: Three or for years of an upturn, hence overheating of the economy. Central Banks then apply the brakes (spelling higher interest rates) and finally a recession. These traditional cycles are no longer so easy to

discern, and it is a little naive of so many advisors to be using their proprietary charts to tell investors that the stock market boom (dating back to the start of the Iraq war) has now lasted four years, compared with an average since 1945 of just 36 months, and that they should therefore get out as soon as possible. Globalization should have consigned such homespun theories to the dustbin of history.

And there's more...

Entrepreneurs or gamblers?

Money attracts money
To and fro, and your money will go

These stock market sayings may sound simple and even trite, but aphorisms are sometimes close to the mark and really can express perennial truths.

It is incredibly difficult to time the market correctly – i.e. to buy low and sell high. The financial markets are becoming ever-more volatile, and whereas a 10% fall would once have been seen as the start of a bear market, such corrections are now commonplace. In other words, volatility is much greater than it used to be, which leads to exaggerations in both directions. As asset managers, we often find ourselves having to act on our convictions and try not to be swayed by the consensus of the press, analysts and strategists. Journalists are the worst culprits in this regard. They do not care whether the crashes of which their headlines scream actually materialize or not; what matters is grabbing readers' attention and maximizing sales.

Our investment strategy makes a clear distinction between strategic investments and opportunistic short-term trading. With regard to the

former, something fundamental must change or the price target must be reached in order for us to sell. Opportunistic investments, on the other hand, disappear from the portfolio as soon as we think that a lengthy correction/fall is in store. This means that the main pillars of our portfolio (such as our main vehicle in the US, Amerequity, or our China Strategy Certificate) are affected by cyclical downturns, but (and this is a critical "but") we are sure to be there from the very first day of the next upturn. If, however, the entire portfolio is subjected to market timing – i.e. these pillars are sold if a cyclical downturn looms and not because the fundamentals have changed – one is confronted by the impossible task of getting the right timing to repurchase such investments - success in this endeavour is rare, or at best irregular. The upshot is that if our basic assessment of the market takes a turn for the worse, we will sell our opportunistic investments, and reduce our equity exposure that way. When you next see your BHA advisor, why not ask which positions form our main pillars and which are short-term, opportunistic investments? This information is very important and will help you gain a better understanding of our strategy.

Don't panic

This is Asia's century

The writer of these lines is at the risk of repeating himself. But if one persists, the message eventually gets through, and this is precisely the intention – namely, to keep repeating that it is a "must" to be invested in south and north Asia (Japan is a special case in all respects). If there is one portfolio component that is absolutely essential, then it is this spectrum that includes Greater China, India, Vietnam, Indonesia, the Philippines, Malaysia and so on. We are dealing with a mega cycle and, as a historic turn of events is unfolding that dwarfs everything since the

industrial revolution in the 19th century, we shouldn't worry whether investments will be up or down in three or six months' time. A parallel can be drawn with the proverb that you cannot see the wood for the trees, except that in this case pure fear is blinding the West to reality.

In our general, detailed end-of-year report we will comment more fully on Asia again, but at this point perhaps we should drop in a few statistical eye-openers that show in compelling terms the extent of the Asian century that is upon us:

- You certainly won't have heard of the firm Quanta yet. It produces 16 million computers a year – more than anyone else. It is based in Taiwan.
- The USA currently turns out 70,000 engineering graduates a year. But India produces 200,000 and China 500,000. And the salary costs of one engineer in the USA would pay for ten (!) engineers in India.
- US corporations currently spend more on liability claims than on research and development. In Asia they shake their heads in disbelief.
- A US study predicts that in 2010 more than 90% of the world's scientists and engineers will live in Asia
- In 2015 Vietnam's population will exceed Japan's
- Half of India's population is under 25 years old. Each year India grows by the same amount as the total population of Australia
- In 2050 there will probably be around three billion Indians and Chinese – while Europe's population will have shrunk to 500 million

Further questions? - The 21st century belongs to Asia.

So don’t panic about cyclical market setbacks in these countries. To our mind such temporary corrections are effectively irrelevant. Think back to the sixties, when we condescendingly smiled to ourselves in our paradise that the Japanese weren't capable of doing much more than copying a crystal radio. The future is here now. With best wishes from China, India, Vietnam.

MAB