Statistics of leading stock markets

A) Year to date		in US dollar	in local terms
Switzerland	SMI	+ 3.46 %	- 3.05 %
Germany	DAX Xetra	+ 35.02 %	+ 21.85 %
France	CAC 40	+ 12.76 %	+ 1.55 %
U.K.	FT-SE 100	+ 5.82 %	+ 4.04 %
Sweden	OMX	- 1.24 %	- 6.73 %
Europe	STOXX 50	+ 18.24 %	+ 6.91 %
USA	S&P 500	+ 3.46 %	+ 3.46 %
	Nasdaq	+ 10.10 %	+ 10.10 %
Japan	Nikkei	- 6.04 %	- 9.63 %
Morgan Stanley World Equity Index		+ 6.99 %	n.a.
Bloomberg Effas US$ Bond Index (5-7 years maturity)		+ 9.40 %	n.a.
Balanced Mandate Index *		+ 8.19 %	n.a.

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 127.71 %	+ 86.23 %
Germany	DAX Xetra	+ 296.28 %	+ 183.05 %
France	CAC 40	+ 161.59 %	+ 86.85 %
U.K.	FT-SE 100	+ 110.69 %	+ 69.68 %
Sweden	OMX	+ 194.58 %	+ 116.61 %
Europe	STOXX 50	+ 160.75 %	+ 86.24 %
USA	S&P 500	+ 68.64 %	+ 68.64 %
	Nasdaq	+ 98.53 %	+ 98.53 %
Japan	Nikkei	+ 87.77 %	+ 78.62 %
Morgan Stanley World Equity Index		+ 102.80 %	n.a.
Bloomberg- Effas US$ Bond Index (5-7 years maturity)		+ 22.15 %	n.a.
Balanced Mandate Index *		+ 62.47 %	n.a.

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

A passing phenomenon – or something more?

Today's problems

Our most recent report last summer painted a very ambivalent picture. While identifying problems – mainly of a technical nature – in various places, we also expressed the opinion that viewed on fundamentals, most equity markets were not overvalued. Nevertheless it was again correct to counter rampant takeover euphoria with caution. Without exception, one can assume dangers are on the way if bankers blindly shell out their shareholders' funds to finance mergers and acquisitions with no limits on transaction size. The big banks again come off badly in our report, but our criticism gets harsher still.

Our feeling last June that there could be an imminent trend reversal as soon as the financing of a few mega-deals fell through, has come true all too quickly. Countless mergers and acquisitions have since been called off – probably to the benefit of the companies concerned, as in the long run major takeovers almost always mean the destruction of value. Yes Daimler AG, we're thinking of you...

However, the real difficulty in the second half of 2007 lay elsewhere, and this will remain the case in future. It lay not in the fundamental prospects for the global economy, but instead in the very framework of the US financial and banking world, where unbelievable events have occurred over the past few years, completely contrary to the tenets of basic economics. In our job we don't always automatically want to get hung up on academic wisdom, but what has piled up in the US banking world should baffle anyone with a rudimentary grasp of financial economics. At this point we cannot resist quoting a few sentences from our *"Point of*

View" which we sent you a long time back – two years ago in fact. At the end of 2005 we wrote:

"Taking on debts has become endemic. No wonder, when loans are being offered at virtually zero percent interest and house purchases are being entirely financed by the banks (2004: 70% of new acquisitions in California). Bankers never seem to learn."
End of quotation.

How is it possible that our little company was tearing its hair out years ago over US banks' careless, rash, and irresponsible financial conduct and that the US supervisory authorities failed either to carry out their duties (as in "supervision") or to rein in the exorbitant, entirely greed-driven granting of sub-prime loans? Not only were hundreds of billions of dollars disbursed to totally uncreditworthy borrowers, but these sub-prime loans were repackaged with almost dizzying imagination into new instruments and sold to banks worldwide. They then passed these fantasy-based investments on at huge profits or, better still, included them in their own portfolios and financed them with short-term (and therefore cheap) borrowing. And the really clever banks leveraged these investments, as sub-primes were considered the last word in financial ingenuity. The term "sub-prime" is itself fraudulent. What does sub-prime mean? It suggests that the credit quality is not the best. Scrap is also not the best, and this is precisely the trick that was played in naming these junk mortgages. Scrap was simply called "sub-prime". However, the name was not actually a lie – just a distortion of the facts, which apparently nobody picked up, including the US Treasury. Imagine your bank approached you and recommended you to buy a product with the credit rating "best low quality". We expect you would either ditch your advisor or even change banks. But ironically you might have been recommended a better-positioned investment than a sub-prime product! It is all a question of how you define things. **However, the packaging of hundreds of billions of dollars of mortgage debt of the**

most pitiful quality was and is the fraud of the century, which the entire world is now exposed to.

Treating cancer with antibiotics

The difficulty of mastering the problems we face

Our description of the current underlying malaise was on the simplistic side – we didn't want to get bogged down in technical details that would have bored you and made you throw away this reading material. We just wanted to say as concisely as possible that the ills of the financial markets are chiefly attributable not to an impending global economic recession, but primarily to the US sub-prime woes. We are therefore dealing with a US-made cancer, and the question now is whether and to what extent the rest of the world may get infected too. We believe that further potential infection risks can be identified, principally in the USA.

One such risk is consumption, which historically has always been very heavily financed by borrowing. Falling house prices, an inevitable consequence of the sub-prime fiasco, will curb consumer spending. There will also be increased numbers of credit card defaults, and these debts have been packaged into clean credit instruments, with volumes running into hundreds of billions. This means that many investors have bought bonds secured by credit card claims – or not secured at all if Mr Jones stops paying his American Express bills, simply unable to meet his obligations any longer. Nobody is talking about this problem yet, but we fear it is bound to surface. And who will that mainly affect? Our friends, the banks. Of course, the heads of this industry earn hundreds of millions a year, so they can easily put in a few hours' overtime, which looks as though it will definitely be needed.

So, another banking problem, and a virtual guarantee that the US Federal Reserve will lower interest rates further, almost as a dose of antibiotics against infected balance sheets.

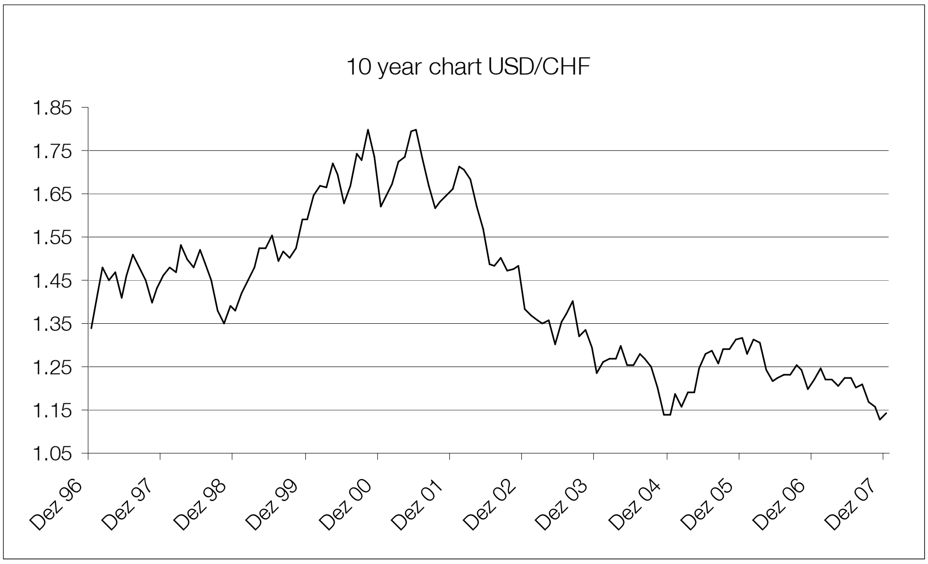
In short, bank (and probably insurance) investments are risky at present. Don't believe the interviews you read. Bankers are only telling a fraction of the truth. The big question now is whether the markets can decouple themselves from the US-induced problems or whether it is no longer possible to sort the wheat from the chaff and all investments are spinning out of control. We don't know the answer. No one knows, because we are not facing concrete economic issues but a quite specific banking sector problem.

But there's something else that's a worry...

The dollar

Crisis of confidence possible

We all know that the USA has for some time been living off the rest of the world's surpluses, which have been mainly invested in US government paper. But this is changing, and fast. The Russians, Chinese, Brazilians and the rest are no longer content to see their reserve dwindle, and the message everywhere is that they want to diversify the investment of their surpluses, not only on the currency front, but also as regards asset classes. Many countries with surpluses want to invest at least part of their currency reserves entrepreneurially, which is entirely understandable, but not great news for the USA. Imagine if the savers of this world suddenly realised that a savings book was no longer exactly what they wanted (as inflation of course continually eats away at savings interest) and from now on wanted to put their savings into gold or similar investments and – hey presto – the basis for banks' funding would have disappeared. That wouldn't be at all pleasant for borrowers. But this is precisely what countries with surpluses are now doing, which means that the Americans almost certainly need to improve the attractiveness of dollar investments. Dollar interest rates have to rise to make continuing to hold these ailing investments more appealing, and this is totally out of the question given the sub-prime shambles. Quite the contrary, in fact: US interest rates will come down further, which in principle is good for the stock market, but which is thoroughly bad news for dollar exchange rate.



The consensus view everywhere is that the dollar is cheap, undervalued, and a buy. Now, you know we have been sceptical (hedged) against the dollar for a long time. The Americans have argued for ages "The dollar is our currency, but your problem". Until now, the USA has paid no attention to the dollar's external value – but vigorously demanded that the big bad Chinese immediately and massively revalue their strange currency. The IMF and the mighty G8 echoed that message. They all lost sight of the real problem – the weak dollar – and demanded that successful countries in surplus revalue their currencies instead. But that simply won't work. China will (like Japan 25 years ago) revalue its currency continually but modestly, and nothing more – leaving the Americans without the time and the means to get a grip on the value of the dollar. In principle, the USA has the advantage that most trade flows are conducted in its currency and all commodities are traded in dollars. A dollar is a dollar.

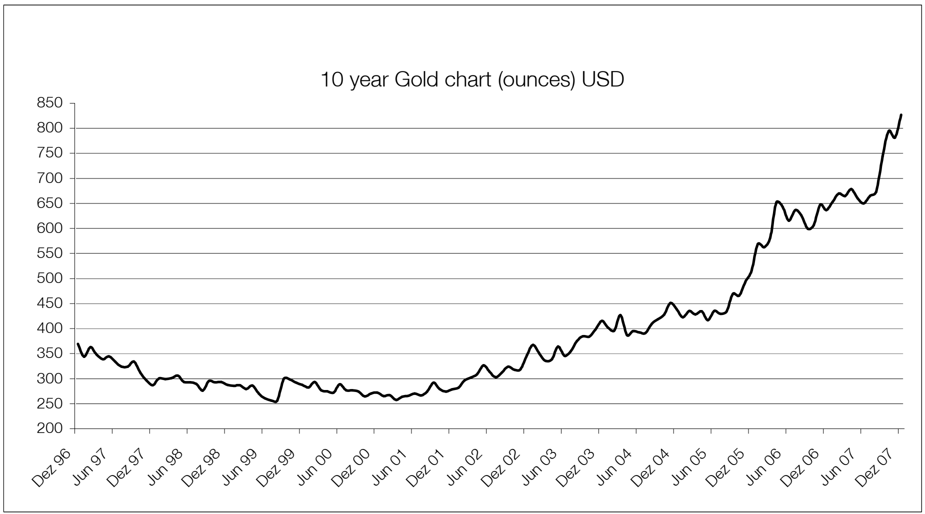
But the danger is that the crumbling dollar price could spill over into a currency and confidence crisis. We do not think this is especially likely, but we must nevertheless flag it up as a possibility. For investors thinking in terms of Euros or Swiss francs, it is not currently worth buying dollars for purely subjective reasons, just because the greenback looks cheap. Catching a falling knife can be life threatening.

However, a positive factor in favour of a trend reversal is that the shrinking value of the dollar is now frequently coming up as the cover story in leading financial magazines (e.g. The Economist, 1 December 2007, entitled “The panic about the dollar” and the recent Spiegel cover story “The Dollar Nosedive”). Although we generally admire these publications, journalists have often managed to depict key trends as a looming catastrophe shortly before the trend reverses. So let’s hope that we have been dealt a contrarian indicator this time as well.

An alternative

Gold

Two years ago we touched on this subject under the heading “. Well, the timing of that piece of advice was not bad at all, and gold quietly and discreetly turned out to be an extremely attractive investment. In this report we have (once again) been rather sceptical about the banking world, but if you consider the timing at which Europe’s central bankers threw their gold onto the market, then we really have to ask whether these gentlemen waited for the absolute cyclical low in gold prices to jettison their “surplus gold” (as the Swiss National Bank called it).



Contrary to general expectations, the price of gold has soared. So is gold expensive again today or not? It’s impossible to judge. Gold has historically been regarded as the safest of investments and, in the event of a crisis of confidence in the dollar, it may reach levels previously regarded as impossible and unrealistic. It is therefore entirely appropriate to hold some liquid funds in gold or first-rate gold mining stocks, but stay away from coins.

Gold is the only financial asset without a corresponding liability item in any balance sheet in the world. That situation is and will remain unique. However, forecasting gold prices is another matter. You can consult a variety of statistics on supply and demand, but nobody actually knows where the price will end up in a few years’ time. What is certain is that gold has proved itself countless times in previous crises. Investors who fear a worsening dollar problem are finding a real alternative in gold.

Persistence ultimately pays off

Asia remains the yardstick

At risk of repeating ourselves as far as Asia is concerned, we want to take the same line as before: the press consensus is that a recession is brewing in the USA and that Asia will be on the receiving end of something nasty.

We are not so sure, however, and would not be surprised if the Asian markets developed a life of their own, independent of the trend in the West. It is true that the Chinese and Vietnamese markets are overheated and the Mumbai stock market is currently not exactly a place for the faint-hearted. Large caps are also expensive at present, but many smaller companies are being traded at prices that are certainly not overvalued. In a bear market everything falls, of course, almost regardless of fundamentals. But we don’t really see a looming bear market in Asia. Aside from economic momentum, technical considerations (liquidity, surpluses) also support this region.

Granted, China has a few obvious problems: soaring food prices, overly low rates of savings interest – they are well below inflation (one reason why so much money is pouring into the stock market) – and low renminbi exchange rates, which are attracting ever more hot money, etc.

The fact is that genuine investors in Asia will earn very substantial returns over the long term. To exit now because of the apparent dependence on America is quite simply wrong. The Indian market has shown us over and over again how impossible it is in practice to “time” such a stock market correctly in the short term in such a favourable environment. The market has looked very expensive for well over a year, repeatedly quickly correcting itself before rising again. Doom-merchants have come badly unstuck there. It is psychologically difficult to take a profit in a seemingly expensive market – and hence buy back into it later on at a much higher level. One looks a bit stupid doing that.

The 21st century is and will remain the Asian century, and we are staying on board. If Asian equities fall in the new year “in sympathy” with the unresolved problem in the West, it will be unpleasant for us investors, but merely a question of time until the fundamental aspects of valuations regain the upper hand.

The one small worry we have about Asia is the fact that sooner or later a hostile takeover bid will be launched from there – for a beleaguered US bank, for example. That would prompt bad blood and protectionist cries in the US Congress – perfect in fact for an election year.

Everyone for themselves?

Today you need to have decided whether to be an investor or a trader

Our assessment of the investment outlook for the western hemisphere does not appear to be as reassuring as it should be. But as early as halfway through last year we made it clear it was time to concentrate on genuine investments and time to eliminate opportunistic positions. We trust we have now thoroughly reinforced this view. That means quite plainly that portfolios currently should contain equities only in leading or niche companies and regions rated as offering above-average promise (chiefly Asia ex Japan). There is definitely no longer any place for gambles or flavour-of-the-month stocks.
We do not think the current stock market jitters are a harbinger of trouble for the global economy, and a wholesale sell-off of equities looks rather

inappropriate to us. Fear and panic are always poor guides in our profession.

However, the credit quality of balance sheets is of cardinal importance, and not just for entrepreneurial investments (equities), but also specifically for fixed-income investments. This is not the time to be greedy as regards interest rates and to extract a little extra interest at the expense of quality. Capital protection should be granted absolute priority in the fixed-income portion of portfolios. Unfortunately there are hardly any financial institutions that still have AAA credit rating, and the lists of fixed-income investments are teeming with bank borrowers. We prefer to buy corporate bonds as the opportunities arise. There are companies that are swimming in money (Toyota, for example). And we favour bonds from such firms.

So we are not lapsing into panic. Yes, the financial sector is facing serious problems. Will this lead to a global economic crisis? We tend to think not, although we can’t avoid having to adjust ourselves to the fact that we are likely to face considerable volatility for some time to come. Good news will be ignored for the time being, and neutral or bad news will probably be punished. This means that you have to believe in your investments. You have to be a long-term investor prepared to overlook the published share price at times. One example from Switzerland is Geberit. In no time at all, the price of this niche company has plunged 30% in the wake of the US construction malaise, although there is no reason for this on fundamentals. In such cases one is advised sticking to one’s own basic assessment of a company’s future instead of imitating consensus. The grass frequently looks greener in our neighbour’s garden. Exactly the same applies to investment decisions: it is hard to resist the pressure from the herd – but it is almost always right to do so.

And on a final note:

The writer of these lines enjoys occasionally preserving for posterity the forecasts of the great experts. There follows an interesting, if not exactly profitable, prediction from a well-known source:

On 10 May 2006 the Financial Times published the following:

Simon Hayley, Senior International Economist at Capital Economics predicts that the price of oil will fall to USD 45 by the end of 2007.

Who said our job was easy?

MAB

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to inform you
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has been changed to
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Mit freundlichen Grüssen
Kind regards
Burgauer Huser Aman & Partner AG