Our Point of View, December 31st 2009

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Statistics of leading stock markets

A) Year to date		in US dollar	in local terms
Switzerland	SMI	+ 22.58 %	+ 19.09 %
Germany	DAX Xetra	+ 29.20 %	+ 24.80 %
France	CAC 40	+ 26.99 %	+ 22.66 %
U.K.	FT-SE 100	+ 34.38 %	+ 20.73 %
Sweden	OMX	+ 60.52 %	+ 46.44 %
Europe	STOXX 50	+ 25.95 %	+ 21.66 %
USA	S&P 500	+ 24.86 %	+ 24.86 %
	Nasdaq	+ 45.28 %	+ 45.28 %
Japan	Nikkei	+ 15.91 %	+ 17.18 %
Morgan Stanley World Equity Index		+ 27.83 %	n.a.
Bloomberg Effas US$ Bond Index (5-7 years maturity)		- 2.86 %	n.a.
Balanced Mandate Index *		+ 12.49 %	n.a.

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 27.31 %	+ 15.77 %
Germany	DAX Xetra	+ 49.33 %	+ 41.04 %
France	CAC 40	+ 9.37 %	+ 3.30 %
U.K.	FT-SE 100	- 7.31 %	+ 11.20 %
Sweden	OMX	+ 19.56 %	+ 29.80 %
Europe	STOXX 50	+ 7.00 %	+ 1.06 %
USA	S&P 500	- 6.94 %	- 6.94 %
	Nasdaq	+ 5.32 %	+ 5.32 %
Japan	Nikkei	+ 3.49 %	- 7.44 %
Morgan Stanley World Equity Index		+ 0.60 %	n.a.
Bloomberg- Effas US$ Bond Index (5-7 years maturity)		+ 29.87 %	n.a.
Balanced Mandate Index *		+ 15.24 %	n.a.

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

Turning Japanese?

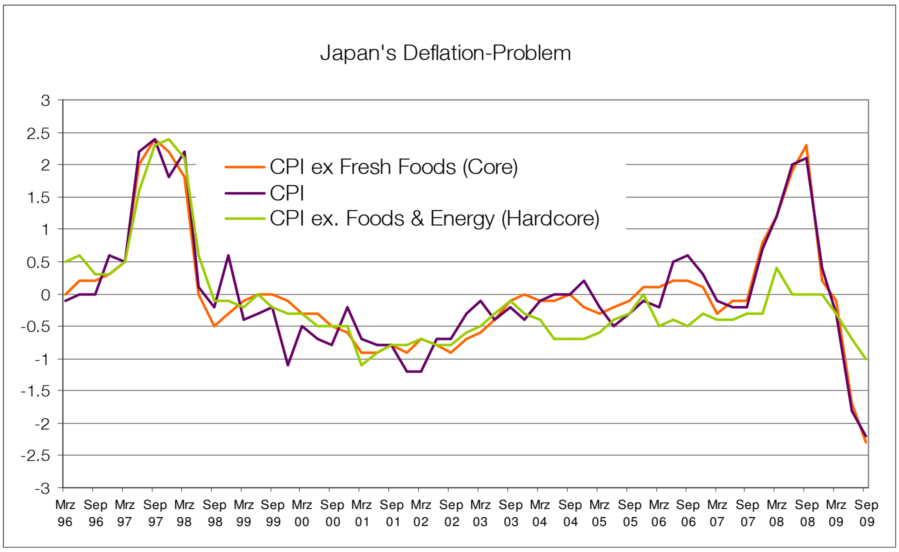
Lending at no cost has been a failure

You might be wondering why on earth we are beginning our report with Japan. Surely it is a country whose glory days are over, where the stock market was almost 20 years ago than where it is today(!), where the population gave up on consumption long ago, and where nothing under the sun has managed to revitalise the economy? Japanese equity valuations are cheap on almost every count, but still the market refuses to climb.

While there are any numbers of explosive topics in the financial world today, your common-sense investors – Burgauer Huser Aman & Partner, that is – are choosing to open their report with boring old Japan.

But there is a good reason for that; an impeccable one, in fact. Let's take a step back: in our last report, we focused on quantitative easing (or in plain English, printing money), which was the burning issue of the day. This was regarded as the panacea that would fix the financial system, which was in tatters, and was being liberally deployed. Trillions of dollars, pounds, euros and francs were created, with the main aim being to slash interest rates to zero in order to keep the banks supplied with a constant flow of free money, and the expectation being that interest-free lending would fuel consumption and investment. The politicians and the conjurers at the central banks seemed to view the doling out of these trillions almost like Harry Potter's latest feat of magic. What was less trumpeted, however, but rather whispered by serious-faced besuited figures in the hallowed halls of the central banks, was the real reason behind all this intervention: to avoid deflation. So far, they have enjoyed some success. Stock markets are rising, kindling hope for the future. That is hardly surprising, with time deposits bringing negative returns and bond yields at historic lows. There is barely any option but to buy shares. We say there has been only "some success" in avoiding deflation, as there is little prospect of the opposite (a couple of percentage points of inflation), and some European countries have indeed reported negative inflation (the politicians' term for deflation) in the last few months. This news was not announced in a blaze of publicity – one shouldn't tell the people everything! Especially not that consumer prices are likely to fall and so it would be no bad idea to postpone spending plans. And that is where Japan comes in. During the 1990s, Japan engaged in quantitative easing (printing money) on a grand scale, due not least to pressure from the USA. For years, a zero interest rate policy was pursued. And for years the central bank bought up government bonds in order to flood the market with liquidity, in the constant aim of tempting consumers out of the woodwork with free credit. But no-one took the bait. TV sets were becoming ever-flatter, ever-better and yet ever-cheaper. The metaphorical Mr and Mrs Watanabe therefore sat back and waited. By hanging on for a year, they could get a better TV, and for 20% less. Deflation raged for years, and after a brief and probably over-hyped return to price growth, the country is clearly mired in deflation once again. Just take a look at the chart below, which paints a nightmare scenario for any economy:

Here is why Japan's consumers are on strike:



Note the green line, which represents the consumer price index excluding food and energy. You will observe that Japanese consumers lived in a deflationary environment for more than ten years! And you may well be asking what happened to the Japanese miracle. In simple terms, when prices fall for years, consumption is stifled. Virtually everything is cheaper tomorrow than today. This is best illustrated by the fact that homes are some 40% cheaper to buy than they were 20 years ago. Deflation is the greatest poison that can afflict our economic system.

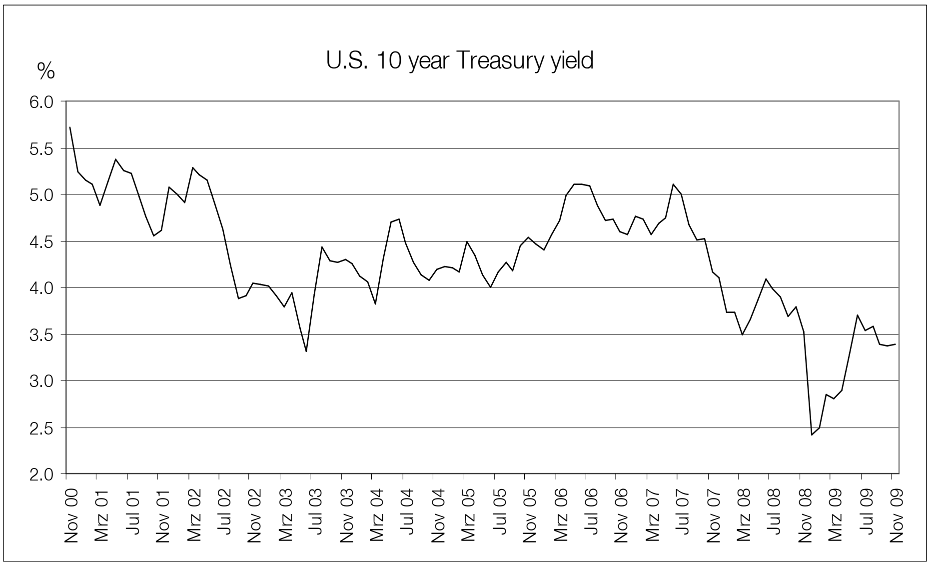
Quantitative easing – the answer to all our prayers in the eyes of politicians – has driven Japanese national debt to 220% of GDP – a world record, if we spare Zimbabwe's blushes.

In our last "Point of View", we argued that the change of mood on the floors of stock markets had come about for the wrong reasons. It was triggered not by an impending global economic upturn, but primarily by the unlimited supply of cash rolling off the central banks' printing presses. In other words, the equity market gains of recent months could prove fragile should consumption continue to falter, private construction activity remain weak and industrial investments fail to materialize. If the Japanese mentality spreads to the West and people turn their noses up at credit offered at zero interest rates, then even the most generous money supply imaginable will achieve nothing.

Full steam ahead anyway?

Outlook for the months ahead

It is not normal for equity and bond prices to be rising at the same time, and this situation cannot last. Bond yields have stabilised and are trending sideways at a low level. Ten-year US Treasuries are yielding around 3.55% and UK gilts some 3.85%. This is astonishingly low, given the frenzied printing of money and the economic logic that this massive increase in money supply should almost automatically spell inflation. But the real world does not always follow the textbooks. Japan is once again the prime example to consider: all the money creation there failed to work, and the country has fallen right back into deflation.



All those trillions pumped into the system and still being dished out today should in principle fuel inflation. That much is clear. But, oddly enough, investors have not turned their backs on bonds, which they would have to do if the orgy of money printing were translating into inflation as normal logic would dictate. But there is no sign of that. In all honesty, we are rather concerned that inflation is showing not even the smallest evidence of being rekindled. We can live happily with a couple of percentage points of inflation, and even double-digit rates are preferable to a brief bout of deflation. We are today even less confident than six months ago that the manic printing of money is sustainable and that it can give global economic growth a new spurt, with the side-effect of a boost to inflation that the central banks are almost begging for.

The minutes of the central banks' meetings also show a clear intention to bring the orgy of quantitative easing to an end before long, and then to take the necessary steps to reabsorb the trillions that were "temporarily" made available. In Japan, no thought has yet been given to the central bank buying back a single yen. We are curious to see what the Americans and the Europeans (and we include the Swiss in that category!) actually do – or are able to do – to avoid destabilising the financial system. We have our doubts as to whether it will be possible to mop up these giant emergency sums that were doled out. Politicians are quick to speak out and make promises, as they have always been. The surprising part is that some people still believe what they say. We prefer to draw lessons from world history and therefore trust in common sense rather than in people who purport to be acting in the interest of the people but are in fact more interested in furthering their own careers.

Consequently, we are very cautious about future economic prospects. That does not mean, however, that there won't be more good news on equities. The central bankers' experimental actions have thrown the logic that our profession has always followed out of kilter. This means that the unprecedented money creation efforts could backfire, but perversely equity prices could still go up in defiance of any logic of economic reality. In Japan, the first country to attempt quantitative easing, the flood of cheap money was to no avail. There was no economic recovery and no joy on the equity markets. Let's not forget that the Tokyo stock market is 70% lower today than it was 20 years ago. No one really understands why Japan's huge-scale stimulus brought such little success. The country's demographics were probably the main part of the problem, with a massive ageing population and minimal consumer spending among pensioners. Babies are a rare commodity; in fact the demographic pyramid was inverted. Compared to this ageing nation, we in Europe, the USA, Latin America and the rest of Asia are at a big advantage on that score. Interestingly, birth rates are on the up again in Germany and Switzerland, whereas in southern Europe the weaker sex (i.e. women, although these days that epithet could perhaps be applied more accurately to men) are increasingly concentrating on careers over child-rearing.

We are therefore highly sceptical about claims that printing money is an infallible strategy. Nevertheless, we are not abandoning the equity markets either, contradictory though that may sound.

We sum up the reasons why in our final section, “Crystal-ball gazing”.

Is the sun rising in the West?

We ask whether the US economy is in recovery

The third quarter of 2009 delivered the pleasant surprise of 3.5% growth. So did that mark the turning point? No. This growth spurt was a temporary phenomenon, with consumer spending very much inflated by government measures such as extraordinary unemployment benefits, food stamps (harking back to wartime days), car scrappage premiums and so forth. Total US wages are continuing to shrink, and true unemployment is not in the region of 10%, but bang on 17.5%. That is the figure under the U-6 measure, which is currently at an all-time high. It includes people who have become discouraged and stopped looking for work and part-time workers who want to be working full-time. But politicians are a cunning bunch. They prefer to use a more flattering measure of unemployment, in exactly the same way that they opt for consumer price inflation that ignores the basics for survival: food and energy costs.

Personal consumption still accounts for more than 70% of US GDP. There is scant scope for growth here, especially with the savings ratio holding firm at a low 3%. As such, the USA will over the coming quarters be heavily reliant on industry’s appetite for investment and hoping that the cheap dollar will bolster exports. Time will tell. Everyone wants to export;

somewhere along the line, someone will be disappointed. In any event, the government stimulus package of close to a trillion dollars has succeeded in stabilising the economy, but at a high price. The annual budget deficit is likely to run at a trillion dollars for a decade. Figures that deep in the red are, however, inconsistent with a healthy economy and do not speak well of the world's leading nation and its reserve currency. Sorting out the public finances probably requires tax hikes, but just 4.5% of US citizens earn over USD 200'000 a year, and this relatively small group is responsible for more than 30% of US annual consumption. Putting these two facts together, it is plain to see that "tax the rich" is a dangerous strategy. US share prices (watched by eyes all over the world) can therefore go up only if there is a lasting improvement in corporate earnings. Healthy growth can only come about in the USA if a) consumer credit is granted and b) this credit is affordable for private households. Neither is the case at the moment. Personal defaults remain high, and banks are extremely cautious in their lending, even though they can obtain money at virtually zero interest. Consumer confidence is no longer ultra-low, but remains disappointing, as net assets have been battered, the debt to income ratio has risen, job insecurity is high, house prices are continuing to fall, and higher taxes could be on the way. Recent surveys suggest that few US citizens are inclined to increase their spending in 2010, and that has to change if share prices are to keep going up.

We therefore conclude that the Standard & Poor's Index is unlikely to continue to rise unless the above conditions are met. Consequently, the only winners next year will be investors who are able to cherry-pick from the vast array of US equities on offer – no mean feat.

The same old story

Investment bankers are more arrogant than ever

In the past, we have frequently bemoaned the actions of the big bankers in clear language no uncertain terms, and it seems that we must do so once again.

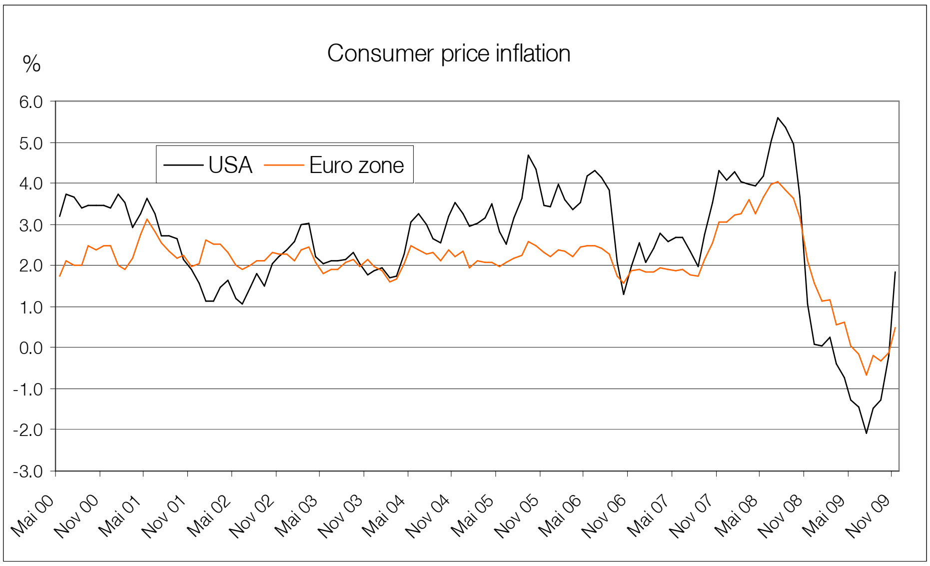
One could only imagine and expect that the managers of the great number of big banks that owe their very survival to enormous bailouts using the money of the taxpayers of the world would demonstrate a little humility, or at the very least fundamentally rethink their business policy. But no, nothing of the sort. No lessons have been learned. Quite the contrary, in fact. They are thumbing their noses at their beleaguered shareholders and brazenly boasting of making hundreds of millions of dollars per day (we will refrain for decency's sake from naming the institution that made that particular claim), and countless millions are being put aside to reward the consummate skills of their investment bankers in the form of juicy bonuses. The saviours of these impudent institutions (you, me and every other taxpayer) are being made a laughing stock of. Our fine politicians are debating how this thievery can be prevented, while the shrewd socialists of the world have already proposed that no one should be allowed to earn more than 20 times as much as the person who cleans their office. But political interventions of that kind are hard to make in a free market economy. Politicians should concentrate on their own shilly-shallying, and the parliamentarians that do the least damage are those who take the opportunity to snooze on the backbenches. The blame for the swift return of the investment bankers' unbridled greed lies elsewhere: with you (if you will forgive our boldness), us and all the other shareholders out there! Shareholders are the bosses and owners of these banks. It is laughable to debate whether they should have a say over executive pay; of course they should! And why does this not happen? Because we, you and most other individual shareholders do not make the pilgrimage to the AGM and rarely even vote.

Institutional investors, on the other hand, such as large firms' pension funds, are regularly represented, to say nothing of the large pool of internal votes. We might find, for example, that UBS's workforce holds some 6% of the voting rights. And it is self-evident that institutional representatives consistently vote for management's proposals. After all, they ultimately want an easy ride at their own AGM in return. And so nothing changes, independent shareholders despair, and the smash-and-grab goes on.

The truly abominable part, however, is that the big banks have had unlimited access over the past year to money at zero cost and have not passed this on to consumers and small businesses, but have used it for their proprietary trading. The big banks have ceased to merit the title of "banks". They have become casinos, or hedge fund-like entities at best, using each dollar made available to them at no cost 40 or 50 times over. If all goes well, then the bulk of the profits will go to the brainy traders; if it goes badly, then the shareholders or even the tax-paying public will foot the bill. When the central banks publicly announced that they would be buying up trillions of bonds to ensure the liquidity of the system, traders did not need to be Einstein to predict that the prices of these instruments would be going up rather than down. The trick was to borrow the money that the central banks were eager to lend, buy the instruments that the state was buying up at (quite literally) any price and sell them right back to the very body that provided the financing. The bank then wants to distribute the profits to the crafty traders, while those who had just bailed it out (you, us and all the other taxpayers) are left out in the cold. That is just bare-faced cheek. And what is the lesson that we can draw? That the quality and sustainability of such bank earnings are so weak that the valuations of their shares deserve to be truly low. A P/E ratio of two or three is all that appears justified. We honestly see no reason why anyone would want to be a shareholder of an investment bank like this. The whizzes employed by these banks are skimming off the bulk of the trading profits in the form of bonuses – and if there is anything left it goes graciously to small shareholders. It is pretty much a case of "Heads, the banks win – tails, the shareholders lose". We therefore think there is still no case for investing in such companies. "Investing" doesn't come into it; it is Las Vegas but with loaded dice. This does not mean that one should never buy shares in a bank from time to time, opportunistically and as a short-term trading play. But that is all.

We are no longer so certain

Are we facing inflation or deflation?



In our last report, we argued that the extraordinary money creation (quantitative easing) being practised by the central banks and the resulting flood of liquidity onto the global markets would sooner or later fuel inflation, and that aggressive interest rate tightening would logically be needed. This money creation has since been stepped up further, but we can still discern no signs of inflation anywhere, even though inflation-linked bonds have enjoyed strong demand. Our recommendation of using gold to shield the portfolio against the trials and tribulations of the financial markets has proved very successful to date, with the price per ounce going up by more than 30% over the past year.

But there are still no concrete macroeconomic indications of inflation ahead. There is scant prospect of higher pay demands in view of the high unemployment, which is still rising in the USA. Given that Europe tends to lag the USA by around a year, we do not see wage inflation as a problem here in 2010. We need to distinguish between the financial market debacle and the real economy. Alan Greenspan and Ben Bernanke directed their bailout actions mainly at the former, as that was where the danger of systemic collapse lay. The financial system is still far from healthy, but it is no longer on life support. It will be much harder, however, to stimulate the real economy from recession to recovery, and the malady will drag on for some years in the USA and Europe, unlike in Asia (ex Japan) and Brazil, where we have seen that decoupling is much more advanced than the emerging markets' naysayers choose to admit. It looks today as though much of the emergency liquidity made available by the central banks has not ended up supporting the economy or consumer spending, but has instead been hoarded. We have already stated that US consumers do not have the scope to spend more in the shops, despite the seemingly cheap credit. Here in Europe, the environment looks more favourable in this regard at present, but we always tend to lag behind trends on the other side of the Atlantic.

We are therefore more ambivalent about the inflation outlook than we were six months ago, and think that a big rise is not inevitable, despite the central banks' frenzy of money printing. In fact, we now also need to include the scenario of a period of deflation (see introductory article on Japan) in our deliberations, which is why we have not reduced our bond allocations as yet. We should all hope that deflation does not materialise, as it would mean a slump in consumer spending and is essentially poison for a free market economy.

The same old story

Exchange rates will be critical once again in 2010

The US dollar plays a key role in investment portfolios all over the world. It is not possible to avoid the greenback in a diversified account, and what is more, all Asian currencies are virtually pegged to the dollar. In 2009, the dollar's exchange rate against the Swiss franc and euro was once again a decisive factor; as it is every single year, in fact. You can look as far back as you like – fluctuations in the value of the greenback have always been hugely significant.

As such, it will be important to gauge the dollar's trend correctly in 2010, being a crucial factor that will meaningfully influence the performance of our portfolios. You can bet your bottom dollar on that. On fundamentals and from a political standpoint, all is not well with the US dollar. The press is of course getting it wrong when it keeps jubilantly proclaiming that the euro has hit new highs: the euro, yen and Swiss franc have been driven to such dizzying heights purely by the weakness of the greenback. That suits almost everyone, especially the Americans, who see little harm in the dwindling value of their currency. The world's most important import goods, including oil, are traded in dollars, and Americans are not opposed to dollar weakness making their own export industry more competitive. However, the world's leading exporters, such as Germany and Japan, are being especially hard-pushed by the dollar depreciation and right in the middle of a cyclical downturn as well. But there is not much anyone can do to halt the slide of the dollar, particularly given that the US authorities have actually talked the dollar down. Free market interventions have never accomplished anything, even though the central banks have repeatedly taken eccentric measures and broadcast to the world that enough was enough and they would now be buying up dollars in order to bring about a trend reversal. This never comes to anything. The market is just too big for a couple of billion spent on supporting a currency to achieve an impact.

As a zero interest rate currency (due to the stimulus measures), the dollar has become unattractive, and smart investment bankers have switched from the yen to the US dollar for carry trading, borrowing at ultra-low (virtually zero) interest rates, selling the borrowed dollars and investing the proceeds in the Australian dollar (for example), at a 6% yield. This leads to a stream of dollar sales, which will of course have to be bought back at some point in the future, but which in the meantime leads to substantial imbalances. This has all given rise to a situation in which everything is loaded against the dollar and almost no one (with the obvious exceptions of Germany and Japan) has any interest in dollar appreciation. In our view, the dollar is an unwanted risk for euro or Swiss franc-based investors. This means that they have no choice but to be exposed to the dollar when they invest in Asia, for instance, but the currency risk should be neutralised where possible. It is almost impossible to predict when and under what conditions the dollar will turn around. There are too many unknowns in play to be able to make a reliable prediction. Certainly, it makes no sense for European investors to hold US dollar fixed-income paper or cash; the dollar should only come into play if the outlook for a US or Asian equity far exceeds the currency risk.

Crystal-ball gazing

How we see the future

Let us stick for the moment with the topic we discussed above: the creation of liquidity on a huge scale. That is without question the central issue for both 2009 and the new year that lies in store.

So far, so good. The central banks have rescued every institution (with the exception of the unfortunate Lehman Brothers) that found itself on the brink of the financial abyss. In order to achieve this, immense sums of money were printed and doled out to the financial system at virtually zero interest rates, as we described above. We all shared a stroke of good luck, as this unprecedented action saved the world's banking system and avoided the worst of all possible scenarios – a systemic meltdown. Right then. One financial system saved, so all is well with the world? Sadly not. The US and European economies and their consumers have not been "restructured" like the large number of banks whose casino-style shenanigans have had to be stomached in order to prevent the unimaginable. The central banks' intention was naturally not just to bail out the banks, but at least in equal measure to revitalise the world economy by lending at zero interest rates. The only problem is that hardly any of this money made its way out into the real economy. Now, trillions of dollars, euros and every other currency under the sun are floating around, with the consequence that we find ourselves in the midst of a new bubble. Much too much liquidity is swamping the system. This is only trickling through to the economy and scarcely reaching consumers at all (as they are seen as a bad risk), and so the main beneficiaries are the banks, which are able to make virtually sure-fire profits, and the stock markets, which are sucking in as if by magic all this money in search of a home, given that money market rates are close to zero and bond yields unappealing. These are, however, unappealing only if we assume that we are about to face inflationary times. In the event of a dose of deflation, however, they are not all that bad: yields on ten-year government bonds in Japan have been hovering around 1% for a decade now!

Whether people care to admit it or not, we are already back in a kind of bubble. Investors have little choice but to be corralled back into equities – some of which are now offering dividend yields that are well above fixed-income yields – and it is very likely that stock markets will continue to move up. So what are the arguments against that? The first is a resolute about-turn in central bank policy. If (as they have repeatedly said of late) central bankers start to sterilise the trillions they have spent on stimulus and withdraw the money from the system, then the situation will look quite different. Interest rates will naturally go up, and the relative attractiveness of equities will decline. But we think this is just sabre-rattling on the part of the central banks, as the economy in the West is still too frail to withdraw the oxygen of these measures. On pure fundamentals, we still believe that Asia (ex Japan) harbours the best economic prospects for true investors. Given that the central banks will once again wholly dominate events on the financial markets in the new year, our current view must be taken as literally just that. Circumstances have simply – yet again – created an equity bubble. It is not possible to forecast when this will end, and so it would clearly be a waste of time to try to look too far ahead. As Albert Einstein once said, “I never think of the future. It comes soon enough.”

For the time being, we too will concentrate on the present day, which is a tough enough job by itself.

MAB