Our Point of View, June 30th 2011

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Performance of the world's major stock markets

A) Year to date		in US dollar	in local terms
Switzerland	SMI	+ 4.72 %	- 6.74 %
Germany	DAX Xetra	+ 11.04 %	+ 3.71 %
France	CAC 40	+ 8.39 %	+ 1.24 %
United Kingdom	FT-SE 100	- 0.09 %	- 2.26 %
Sweden	OMX Stockholm 30	- 3.16 %	- 7.20 %
Europe	STOXX 50	+ 5.45 %	- 1.52 %
USA	S&P 500	+ 3.10 %	+ 3.10 %
Japan	Nikkei	- 5.03 %	- 5.40 %
Morgan Stanley World Equity Index		+ 1.28 %	+ 1.28 %
Bloomberg Effas US$ Bond Index (5-7 years maturity)		+ 4.38 %	+ 4.38 %
Balanced mandate Index*		+ 2.83 %	+ 2.83 %

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 15.76 %	- 21.56 %
Germany	DAX Xetra	+ 41.71 %	+ 26.17 %
France	CAC 40	- 12.88 %	- 22.43 %
U.K.	FT-SE 100	- 14.47 %	- 1.14 %
Sweden	OMX	+ 25.36 %	+ 12.11 %
Europe	STOXX 50	- 15.33 %	- 24.62 %
USA	S&P 500	+ 2.08 %	+ 2.08 %
	Nasdaq	+ 25.65 %	+ 25.65 %
Japan	Nikkei	- 11.94 %	- 37.77%
Morgan Stanley World Equity Index		- 1.78 %	n.a.
Bloomberg- Effas US$ Bond Index (5-7 years maturity)		+ 45.37 %	n.a.
Balanced Mandate Index *		+ 21.80 %	n.a.

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

A timid start

Before putting pen to paper, I sat quietly with the intention of formulating a few positive thoughts and topics to share with you – something uplifting about politics, business or financial events for once. That was my firm intent. Unfortunately, I couldn't come up with any, however hard I scratched my head. In sharp contrast to the brilliant sunshine that has been with us all spring in Europe, gloomy signals on the world stage are far overshadowing the few meagre good news stories that bring momentary excitement but ultimately are irrelevant to our profession. Perhaps it is a function of my age, experience or grasp on reality – or possibly a combination of all three – that leads me to conclude that the potential threats outweigh the hopes for better years ahead for the financial sector. Thus, I am afraid that this edition of "Our point of view" will sound more like a warning than an upbeat note. The essential fact is that we in the west will not be able to pay back in a few short years the debts racked up in living beyond our means for decades. The consequences are being covered up, pushed back, obscured, dismissed and denied. No one is willing or able to accept that growth at any price is no longer possible. Especially not the politicians. Their only concern is to stop the worst-case scenario from unfolding during their own term of office, leaving their successors to clear up the mess left behind by those before.

All that lies within our power is to once again highlight a few reasons why it is not so easy to maintain the status quo, and why that will remain the case. How much nicer it would be to be able to give you some upbeat growth forecasts. However, you do not pay us to tell fairytales, but to provide asset management and advice, and so we need to stick strictly to the truth. The systemic and financial crisis dating back to 2008 is sadly far from over, despite the immense sums of money snatched from the good citizens of western countries to pay for bailouts. So, let us zero in on the realities.

The refuseniks

Greece & Co. are teetering on a precipice

Those smart Finns are the leading voices among those unwilling to share in Greece's mess. That should come as no surprise; after all, the Finnish school system is rated the best in the world, so it is only logical that the citizens of this country will make rather brainier decisions than the rest of Europe. Perhaps that comment is unfair – after all, no one has asked the people of the EU how their taxes should be spent, or the rescue packages for Europe's ailing states would have been stopped in their tracks long ago. We in Switzerland are much better off in that regard, as our system of direct democracy means we can clip the wings of free-spending politicians when we are unhappy with their decisions, as has made many an EU politician (I am thinking of you, Peer Steinbrück) see red. Switzerland can be a prickly customer...

Some time ago, we expressed the view in this publication that Greece would be bankrupt by 2012. Perhaps that prediction was too conservative. Greece really ought to start preparing for default immediately. But all European and contractually agreed rules are being disregarded – disregarded by the European Central Bank, that is. There is a reluctance to allow Greece to restructure its debt, even though the EU charter says nothing at all about solvent member states having to bail out their less financially disciplined counterparts. Everything possible is being done to sweep the massive problems facing Greece, Portugal, Ireland, Spain, Italy and potentially Belgium under the carpet. Europe's senior policymakers are dismissing debt restructuring out of hand, even though the message from the financial markets is clear and, believe it or not, yields on Greek government bonds are 13 percentage points higher than on German Bunds. The free market began downgrading government debt from the PIGS countries (Portugal, Ireland, Greece and Spain) a long time ago, but the ECB is still diligently buying up these securities and keeping Greece's teetering system afloat. Restructuring effectively started long ago, but the politicians used arcane terms such as "reprofiling", thinking that this would enable them to pull the wool over the eyes of the ignorant public. The facts are often obfuscated in politics. To take just a few examples, printing money in America is called "quantitative easing", bombing raids in Libya masquerade as "kinetic military action", and a new Swiss tax is known as an "incentive levy". When they talk about "reprofiling", the top Eurocrats in Brussels mean that the maturity of Greek debts is quietly being extended by a couple of years and the interest charged reduced by a couple of percentage points. However, the word "restructuring" must not reach the ears of Europe's citizens. That would only result in unrest, and what politician wants to alarm his voters like that? The truth is that (to take just one example) Greece's government deficit as a proportion of GDP is not falling, but in fact rising (currently 10.5%), and the apparently tough savings measures are bearing little fruit. Greek government borrowing has gone up again and now stands at EUR 329 billion, or 143% of economic output. And for next year that figure is expected to reach at least 160%. Despite this, the stance in Brussels is still that the deficit will be brought back below the Maastricht limit of 3% of GDP by 2014. That is fantasy politics. Quite simply, the game is up. We are at the end of the line. This undisciplined way of running countries (and corruption) cannot continue. The EU's central and northern states cannot indefinitely keep on coming to the assistance of other wholly irresponsible countries that have benefited for years from the low interest rates in Europe's single currency area. But the European Central Bank in Frankfurt is afraid of confronting reality. If Greece were to slide into official debt restructuring, another crisis of confidence would inevitably be triggered and some banks would face severe difficulty. Those banks liberally borrowed cheap money from the central bank and invested it in high-yielding Greek government bonds, in a manoeuvre known as a carry trade – an apparently risk-free form of investment popularised by the hedge fund gang in the 1990s. Formerly, it was regarded as a mortal sin for a banker to borrow short-term capital to invest long-term, seen as the easiest way in which to go bankrupt. Today, the rules of the old guard are a source of amusement in the industry. There are indeed computer systems that can control risks at all times. But only as long as they do not fail – and then it is too late to act. The ECB is therefore seeking not just to avoid a crisis of confidence, but also to protect various large banks that have negligently invested in PIGS bonds on borrowed funds and are holding out the prospect of juicy interest rate gains to their shareholders. Welcome to fantasy land!

And so we all await the final outcome. The markets are continuing to price in eventual restructuring, the euro is sliding in value and the politicians are manoeuvring, not daring to make a show of strength, teasing, obfuscating and – we might almost be tempted to say – lying. Of course, you can't say that; it is politically incorrect. The truth is that the European Central Bank knows at least as well as (if not better than) we do that Greece has reached the end of the road. The problem is, however, that Europe's big global banks hold vast volumes of Greek (and Portuguese and Irish) government bonds. The central bankers say there is danger of another collapse if these banks are saddled with significant haircuts on this moribund debt, and that "private investors" must be protected. However, this attitude is gradually becoming hard to stomach, especially as we are not the only ones to find it distasteful that those very institutions that were rescued by the taxpayers of Europe are now being shielded from losses after embarking on a fresh round of speculation. Time will tell. However, we think it will be hard for the banking lobby to defend the argument that its members cannot possibly suffer a large-scale loss on Greek government bonds without again endangering the entire financial system.

It is clear that the pain of European over-indebtedness is the main reason for the unbelievable volatility in share prices and exchange rates at present. A storm is brewing and must eventually break. The longer the central bankers drag their heels, the more precarious the situation becomes and the closer the date looms when Greece will slide into a crisis of confidence, the more brutal the final reckoning will be.

So what does that mean for us?

The dilemma

How can people protect themselves in the current environment?

Sooner or later, the politicians will have to stop ignoring the reality of Europe's mega-debts and be presented with the bill, either in orderly, planned fashion, or in chaos, at the hands of the free market, which mirrors investors' decisions.

The current economic cycle is already fairly advanced, and yet interest rates in western countries are still hovering around zero. That is not normal; nor does it correspond to any sort of economic logic. Very few countries are flourishing in Europe: Germany and the Nordics are the exceptions. Germany, the world's champion exporter, is enjoying economic success on the back of the weak euro. No one in Berlin is saying that the euro is too low – it would be foolish to raise the issue, when Germany's current competitiveness is so unbelievably great. France is doing reasonably well, and the rest of the continent is struggling, with the bad outweighing the good. As for Switzerland, its currency has appreciated by 10.5% against the dollar and 5% versus the euro since the start of the year. This massive over-valuation is being absorbed almost unbelievably well, confounding all those detractors who said the Swiss model had run its course, its banking system was on the brink of collapse and the country would soon be going cap in hand to Brussels. Nothing of the kind has happened. Geneva, Zurich and Zug are being deluged with companies moving their registered offices there. Of course, this is all happening because of Switzerland's "unfair tax competition". It seems as

though today any regime that does not squeeze its citizen for every last drop is “unfair”.
Swiss franc investors have made scant gains on the country’s stock market for some time now, but those lucky investors from other countries have enjoyed impressive currency gains by investing here.

The signal from defensive sectors (particularly pharma) is that the economic cycle is well-advanced. In the USA, investors have to worry not only about the ability of the world’s largest economic power to pay its bills, but also about the economy. The latest economic data provide little cheer: consumer sentiment is slumping, car sales are down, initial claims for unemployment assistance remain high and, above all, house prices are continuing to decline, causing giant headaches for the country’s central bank. The purchasing managers’ index – another key leading indicator – is also on a downward trajectory (falling from 60% in April to 53% in May). Although the latest reading still points to a degree of growth, the momentum has been lost. New orders are stalling and cannot go any lower without signalling a pronounced slowdown.

None of this sounds too positive. And of course, if interest rates were at a level that would normally be found in the latter stages of an economic cycle, then we would today have a large part of your assets invested in safe fixed-income securities. Unfortunately, that is far from the case. As a consequence of the central banks’ money printing frenzy, short-term rates are still hovering around the 0% mark. This is where the current big dilemma lies. If you want to behave like a sensible, logical investor, you are confronted with the prospect of close to zero interest. You get no interest on your investment. Take off bank charges, take off management fees for the work involved in decision-making, and you are guaranteed to lose. That is not an appealing prospect. As such, investors are effectively forced into maintaining relatively high exposure to equities, in an attempt to hold high-yielding, top-quality stocks, many of which are generating more income than medium-term bonds, on which yields are now largely symbolic. This is a truly a state of emergency.

We are quite open about the fact that, for the reasons outlined above, we are more heavily invested in equities than our assessment of the outlook ought to justify. In addition, we prefer shares in top-quality companies to government bonds, whose security is illusory. A share in Nestlé is today safer than any bond, which should come as no surprise at a time when the world's leading economic superpower, the USA, is on the verge of being unable to meet its payment obligations. The USA's credit quality should have been downgraded from AAA long ago, but that could not be tolerated. It would have been politically incorrect. America is first class – but only on paper.

To sum up the dilemma, people are being forced to remain over-invested against their better judgment and their own fairly conservative economic analysis. A lack of alternatives makes this the only rational, prudent, common-sense decision. Who would really want to entrust their money to an ailing state or leave it sitting in a bank earning zero interest?
Which brings us onto the next topic...

"Credit is a system whereby a person who cannot pay gets another person who cannot pay to guarantee that he can pay."

Charles Dickens

We are the champions

Switzerland's brazen, boastful big banks

The quotation from Charles Dickens may seem a little impenetrable at first, but the penny quickly drops and we realise that despite the seeming absurdity of the statement, he has hit the nail on the head.

Apparently some of my tolerantly minded readers have suggested that I should not be so harsh or rebuking towards the banks. Well, it would be nice and uplifting to put a stop to the criticism, but unfortunately that's not going to happen. One might have imagined that so recently being rescued from the abyss by taxpayers would have made the banks a little more modest, or at least grateful for their bailout. Nothing of the kind. The two big Swiss banks – UBS and CS – are doggedly defending themselves and presenting flimsy arguments as to why the sizeable strengthening of equity capital being demanded by politicians (at long last the politicians are doing something right) would completely destroy their competitiveness and – read it and weep – would force them to relocate to another country. That's not all. They also claim that the calls by the Swiss National Bank chairman in any case lack credibility – that all one needs to do is look at the currency interventions that the SNB has made, with giant sums poured down the drain. They argue that the calls for greater capital backing are just as unprofessional. The banking lobby is certainly investing heavily in attacking SNB Chairman Philipp Hildebrand, who in the wake of the banking disaster of 2008 told the unvarnished truth: the big banks need to de-risk, and investment banking activities, the root of all evil, should be hived off altogether. Hildebrand, the guardian in chief of our stability, was right! Investment banking operations by the Swiss big banks represent an unacceptable risk for our country, our taxpayers and the entire system. Even more importantly, the bulk of investment banking activity is without any economic benefit whatsoever. It is rather like a casino, which also contributes exceedingly little to national well-being. Back in our last report, we posed the question of why anyone should invest in such unsustainable companies at all. How about some arguments? No problem! Let's take a look at the earnings and influence of UBS's investment banking business. The unit generated profits of CHF 1.19 billion in the first quarter of 2010, just CHF 100 million in the fourth quarter and then CHF 835 million in the next three months. So much for consistency. Investment banking profits fluctuate wildly and remain far and away the greatest determinant of the big banks' bottom lines. The Financial Times reported on 10 March 2011 that the big US banks use almost twice as much borrowed capital for their own trading activities as the average hedge fund. Indeed, more risk is being run today than before the financial crisis! And what does this bring the country? Nothing but overpaid traders and systemic risks of mammoth proportions.

It is absolutely calamitous how powerless we are to do anything other than sit back and watch events unfold. Almost nothing is more powerful than the banking lobby, in its desperation to continue its casino activities unbridled, regardless of the cost. It goes without saying that companies will continue to operate with huge balance sheets – the bigger the better, in fact, as it makes you too big to fail, adding up to an implicit state guarantee.

We don’t like to say it, but we would not be surprised if there were another financial crisis in the course of this decade. The conditions are in place, and the quality of some states has become decidedly wobbly. Dickens’ words seem very apt.

The big banks not only lack any form of sustainability; they also play an active role in ensuring that our financial system cannot be healthy. We must hope that the banks will be made to substantially increase their capital coverage or that they will follow through on their threat and relocate abroad. To the British Virgin Islands, perhaps? Hardly; there would certainly be no scope for a too-big-to-fail guarantee there. These threats are all bluff. But steer clear of investments in this sector, which make no sense and do not promise well. If things work out well, then the bankers win, and if it goes wrong then *you* will pay. That’s not a great set of possibilities.

Keep calm and carry on!

China is more than a passing trend.

We increasingly read in leading financial newspapers such as the Financial Times or the Neue Zürcher Zeitung that something is amiss with China. The housing boom in particular is causing alarm. It is reported that too many homes are being built, that new properties are standing empty and that the end is nigh. And if that's not reason enough, human rights are being trampled underfoot, wages are derisory and people will soon be taking to the streets. What is forgotten (or not listened to) is that during our own industrialisation in the 19th century, the working classes did not enjoy fantastic labour conditions, the environment was polluted, large swathes of land were deforested and life expectancy for the struggling masses was barely 40. Managing 7 million Swiss folk is certainly easier than one and a half billion Chinese. There is also a lack of understanding about the extent to which China is still (although this should have changed long ago) centrally managed. It is a communist dictatorship. We were recently in "Greater China", in order to keep our knowledge and opinions up to date. The most interesting thing was just how unbelievably high the level of self-belief is among the Chinese people. People don't care a jot for the opinion of and most definitely not for recommendations from countries far away. You must simply be grateful if anything is explained in English at all; it is high time that the gweilos (us foreigners) learned Mandarin. And if someone starts up a conversation, we westerners start to sweat. After all, where are the problems of the modern day? Where are countries up to their eyeballs in debt? Who is financing the hole in America's budget? Where did the systemic crisis of 2008 originate? Where is the turbo-charged economy that is effectively subsidising global economic growth these days? As a westerner, you are left stumped for words. And when you realise a week later that in China an entire flat can be refurbished no problem in a single weekend, that a skyscraper can be ready to move into in less than a year, that people are prepared to work 80 hours per week and do not know the meaning of social security, then you quickly conclude that it is misguided, if not stupid, to invest chop-chop in China, make a couple of percentage points' profit, pocket the money and scuttle back home to reinvest in the tired old west. Perhaps in those bank stocks that are so cheap at the moment... It is true that China's leading indicators are heading south, but they remain at a high level. The story is that everything is overheated and we are facing a sticky end. The financial magazine Finanz & Wirtschaft even splashed the question "How can China be tamed?" across its front page recently, as if we had any right to do such a thing. A better question would be to ask China "How can Europe be brought back from the brink?"

So let's stick with common sense. China is not going to become a consumer nation overnight, even if Coca Cola is drunk there and McDonalds does its worst among young people. But investments in the consumer sector will pay off. Our core investment in this area – Arisaig Asia Consumer Fund – has performed well. In contrast to the weaker trend for share indices this year, its net asset value has continued to rise in 2011. So the message in relation to China is to keep calm and carry on. We are not here for a one-night stand, but for a decade or more. But the investment bankers of this world do not understand this approach. Constant to-ing and fro-ing is better for (the bank's) coffers. They claim that buy-and-hold is outdated; we say, don't trust anyone under 40! ☺

What is happening in the world's driving force?

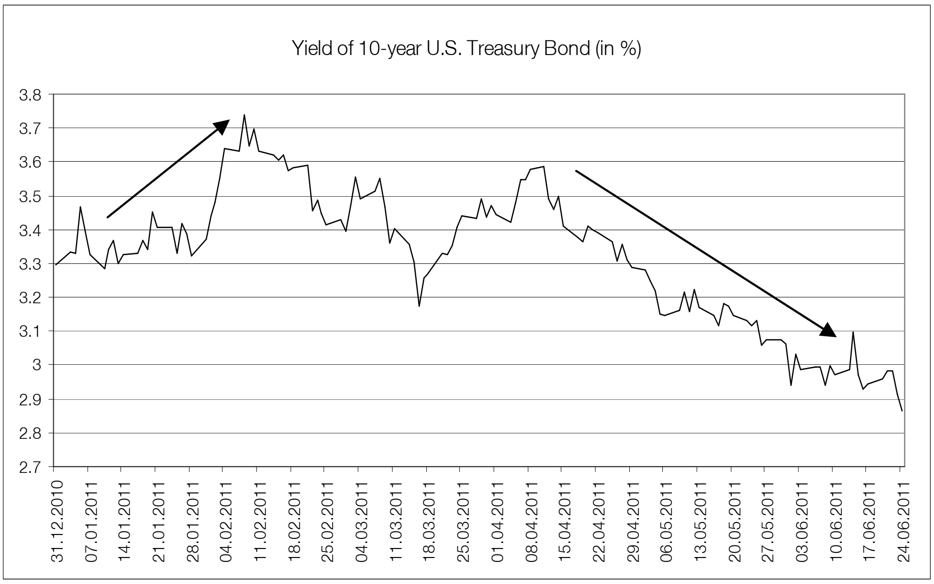
The outlook for the US is gloomy, to say the least.

America has long been and still is the undisputed global superpower. Indeed, the USA remains the benchmark in all matters, as its entrepreneurs continue to enjoy a freedom unknown to us in Europe. There can also be no questioning the country's enviable power of innovation, however much one might wonder to what extent humanity really benefits from the new social networking sites that have quickly become indispensable to young people. Facebook, Twitter and the like have turned into mega-companies worth countless billions in a very short space of time. The big, successful ideas are still coming from the States, and young people from emerging countries still prefer to study at the top US universities. Unfortunately for the USA, these ambitious students then return to their homelands, qualifications in hand, to apply their newly acquired knowledge there.

There is certainly much about America that is impressive, even today. Millions of Americans still have boundless confidence in their country, and its educated classes undoubtedly work very intensively and determinedly, in the faith, if not the conviction, that there is nothing to stop anyone from becoming a millionaire. Unfortunately, the day of reckoning has arrived for the US system of unbridled consumption. Taken together with the rather hegemonic direction of the country's politics, it is now at a point at which it would not take much in the way of bad news to trigger a crisis of confidence. Surveys show that the majority of Americans think they are in a recession. Consumer confidence is weak, unemployment is persistently high (currently over 9%) and house prices, which are absolutely critical to confidence about the future, are continuing to fall. Millions of Americans are in negative equity, living in homes worth less than the mortgages on them. Banks are trying to wriggle out of putting their customers out on the streets and repossessing properties. That would lead to further massive writedowns and would worsen the supply situation on the residential property market still further. But it is not just the American people who are struggling with debts. The almighty USA itself and many of its states are not far off an apparently hopeless financial position. Insolvency could soon threaten if the debt ceiling is not raised soon. Cynical Republicans are making political capital out of the situation, doing all they can to delay this step in order to hurt the Democrats. Strikingly, the rating agencies are now seriously considering removing the USA's top AAA credit rating, which objectively ought to be done right away. However, we advise against placing too much trust in these ratings! One need just think back to 2007, when these fine institutions were giving every sub-prime mortgage top ratings, even though it then emerged that these loans were of junk quality.

By the time you read this, the US Federal Reserve's policy of quantitative easing (buying up bonds with freshly printed dollars) will have officially expired. We are not so sure whether that will be the case in reality. We think there is a strong possibility that the US monetary authorities will keep pumping money into the market in order to continue its zero interest rate policy. The housing market in particular demands further artificial support and would be unable to tolerate "normal" interest rates without ruining countless homeowners. The economy is also worsening at present and, even more importantly, elections are looming. If the economy does not rally, then it is quite conceivable that even a clueless Republican candidate (step forward, Sarah Palin) could end up as president.

The shift in sentiment on the US bond market is also food for thought. Rates on long-dated US government bonds went up early in the year in line with the economic and monetary logic, but this trend suddenly reversed and now 10-year governments are yielding about 20% less than they were three months ago.



This is a bad omen for the economy, and unfortunately one must conclude either that this trend is misguided or that share prices are too high. Wall Street has indeed lost some ground in the last few weeks, which suggests that the bond market may have reacted more swiftly to an impending economic slowdown. We are currently fairly cautious and recently scaled back our equity exposure. Wall Street still acts as something of a bellwether, and the global markets are hardly likely to perform well if New York crumbles. As so often, the summer months could prove rather cheerless.

The joker turns nasty

The exasperating dollar

We were unfortunately correct when we predicted at the end of 2010 that exchange rates would again be the joker in the pack for performance.

Swiss franc-based investors found it incredibly hard just to break even in the first half of this year, as the major currencies depreciated heavily against the franc. The dollar has fallen by 10.5% and the euro by 5% versus the franc year-to-date. It is not hard to see that even with smart hedging, it has become very difficult to preserve the value of capital. America is playing a dangerous game in its nonchalant exchange rate policy. It is actively seeking to use dollar depreciation to boost the country's competitiveness, overlooking the fact that the countries running surpluses (primarily China) may not be content to sit back indefinitely and watch the value of their reserves being eroded. We continue to think that franc-based investors should hedge against exchange rate risk in relation to the dollar where there is any doubt (as is the case today), especially as the costs involved are negligible. In the current zero interest rate environment, it costs almost nothing to hedge currency risk. It is highly logical, therefore, to eliminate the exchange rate risk associated with gold in particular.

These days, hardly anyone is daring to sell the dollar any longer (or to hedge against it). Many investors keep on believing that the greenback is now is now cheap and must almost inevitably start to rise. But this view keeps on being proved wrong. European investors should eliminate the unwanted dollar exchange rate risk which, as we have repeatedly said, is involuntarily entered into whenever they invest in Apple or in an Asian fund. Such investments are made in expectation of higher share prices, not of currency gains. This very basic point is repeatedly overlooked!

No, we can’t!

Performance promises are almost impossible to meet

Perhaps we should bring our report into line with the general tenor of bank commentary. That would simpler. We could kid you that we are positive about the long-term outlook, acting as a source of consolation. But that would not serve any purpose. We have to look reality in the face, and, viewed objectively, we are not exactly living in a land of milk and honey at the moment. There are times when as an investor you just need to hang on to what you have. At a time of war, you would not stroll blithely through former holiday resorts, ignoring the possibility of stepping on a landmine at any moment. That much is obvious. And that is why this report is heavy on realism, with a dash of scepticism thrown in, particularly in relation to the western world, which has lived beyond its means for way too long. There are some major problems in Europe and the USA that need to be resolved and that we cannot postpone forever, unlike the politicians. The decisions that politicians take are always in their own interests, and not those of the people they represent. The fact that this has not yet dawned on the population at large is a true mystery.

God helps those who help themselves. So let’s do that then.

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