Our Point of View, June 30th 2013

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Performance of the world's major stock markets

A) January 1, 2013 – June 27, 2013		in US dollar	in local terms
Switzerland	SMI	+ 8.61 %	+ 12.45 %
Germany	DAX Xetra	+ 3.48 %	+ 4.97%
France	CAC 40	+ 2.05 %	+ 3.33 %
United Kingdom	FT-SE 100	- 0.61 %	+ 5.86 %
Sweden	OMX Stockholm 30	+ 1.58 %	+ 5.09 %
Europe	STOXX 50	- 1.84 %	- 0.61 %
USA	S&P 500	+ 13.11 %	+ 13.11 %
	Nasdaq	+ 12.66 %	+ 12.66 %
Japan	Nikkei	+ 11.41 %	+ 27.11 %
India	Sensex	- 11.50 %	- 2.84 %
China	Enterprise Index	- 19.99 %	- 19.92 %
Morgan Stanley World Equity Index		+ 7.29 %	+ 7.29 %
Bloomberg Effas US$ Bond Index (5-7 years maturity)		- 2.69 %	- 2.69 %
Balanced mandate Index*		+ 2.30 %	+ 2.30 %

B) Over five years		in US dollar	in local terms
Switzerland	SMI	+ 20.69 %	+ 11.81 %
Germany	DAX Xetra	+ 2.93 %	+ 24.43 %
France	CAC 40	- 29.22 %	- 14.44 %
U.K.	FT-SE 100	- 13.63 %	+ 12.90 %
Sweden	OMX	+ 19.43 %	+ 34.59 %
Europe	STOXX 50	- 35.12 %	- 21.57 %
USA	S&P 500	+ 26.19 %	+ 26.19 %
	Nasdaq	+ 46.91 %	+ 46.91 %
Japan	Nikkei	+ 5.57 %	- 2.44 %
India	Sensex	- 2.51 %	+ 36.76 %
China	Enterprise Index	- 22.04 %	- 22.48 %
Morgan Stanley World Equity Index		+ 2.75 %	n.a.
Bloomberg- Effas US$ Bond Index (5-7 years maturity)		+ 30.44 %	n.a.
Balanced Mandate Index *		+ 16.59 %	n.a.

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

THE PITCHER GOES TO THE WELL…

…until the taxpayer has had enough

If the contents of innumerable political memoranda are to be believed (an approach we have of course always advised against), then the black holes that have established themselves as the permanent status quo in nearly all government budgets are attributable to one thing and one thing only: a phenomenon that falls entirely outside the responsibility of politicians and has absolutely nothing to do with the merry activities of these guilds who hold power as a result of the democratic process. So what exactly are we alluding to here? Well, the answer is obvious: it's the tax evasion that has been ongoing for a long time now, this rampant dishonesty on the part of countless companies and citizens. A seemingly almost limitless number of tax dodgers, with – it would appear – several politicians also among them.

Switzerland in particular is being bombarded with demands to lift bank-client confidentiality. It is certainly true that a number of banks were not exactly smart in the way they went about their dealings with US citizens, and the unpleasant consequences had been foreseeable for a long time. What seems downright odd, however, is that at no point has anyone ever posed the justified and logical question of why this world of ours contains so many people who are driven out by their own tax authorities and choose to stash a portion of their wealth away in a far-off land. Why does no-one on the myriad TV shows, all of them brimming with brainpower, never ask about the real reason why there are so many amoral, dishonest companies and citizens in the first place? Curious, no? The answer, quite simply, is that the tax burden in a great many countries is prohibitively high, without even mentioning all the hidden costs facing Mr and Mrs Average Citizen, particularly in Europe. In days gone by the king's bailiffs would claim one-tenth of each subject's harvest. Even one-third still seemed fairly reasonable and acceptable. But when the authorities confiscate well over half and

social security contributions reach astronomical levels, as they have in many EU countries, then of course citizens will start looking for ways to improve their situation. It wasn't all that long ago, remember, that maximum progression in Sweden stood at over 100%. Wasn't it an obvious step to either put one's company on half-day operation or to help oneself by discreetly arranging for some of the profits to accrue in foreign countries? As always, in the eyes of the EU any country that has not succumbed to a mania for spending and therefore has more reasonable tax rates is pursuing "practices that are harmful from a tax perspective", and woe betide smaller countries like Luxembourg, Austria or Switzerland if they do not comply immediately with the demands of the more powerful nations.
Brussels is putting incredible pressure on all these tax dodgers, who have – let's be honest – quite simply helped themselves reduce their own countries' expropriative practices to a more manageable level. Politicians are now demanding the automatic exchange of information between nations, with a view to making citizens everywhere "transparent". For the benefit of humanity and – according to Germany in particular – in the name of justice. We think Brussels should perhaps ask itself why it is that there are economic areas with a maximum tax rate of 17% – such as Hong Kong, for example – where no-one struggles to evade tax. Everyone there feels that the tax assessments are fair and reasonable. And if the dear EU bureaucrats really believe that the entire world is bent on implementing automatic information exchange, then they are sorely mistaken. While the US certainly demands all sorts of information about its own citizens, and is very aggressive in its approach, it is itself unwilling to provide even the merest snippet on the numerous foreign clients who have stashed their secret millions in Miami or Delaware. As the city of Zurich's finance chief said recently: "If you have a dog you can open an illicit offshore account in their name in Delaware or Maryland. But in the US they prefer to talk about Swiss banks." The world's powerhouse nations do precisely what best suits their own ends. Seen it all before? Of course we have – the history books are full of it.
In any event – and regrettably – it has to be said once again that it is humiliating to see how certain EU countries and the US abuse Switzerland as if we weren't a friendly nation but a mere vassal. To

make matters worse, our nation's leaders are so weak that it is a simple task to realise any demand within a very short period of time.
The sad conclusion, unfortunately, is that we are regularly compelled to ask our valued clients to sign all sorts of new forms, a state of affairs we deeply regret. Please accept our sincere apologies and thank you for your understanding.

THE MOTHER OF ALL QUESTIONS

The central banks' questionable experiment

We have already asked several times in this report whether the policy of quantitative easing pursued by the central banks – a multiplication of the loaves in the Biblical sense or perhaps even its academic reinvention – represents not just a way of eliminating the horrendous debts of the world's nations but is at the same time the perfect recipe for stimulating the global economy. As already mentioned on several occasions, this quantitative easing, or QE, is purely an experiment and has no precedent in the real economy. Although the central banks are juggling trillions, we don't actually know what the long-term consequences of this mania for printing money will be. Clearly, the massive increase in the money supply that has now been underway for some time will sooner or later lead to a loss of purchasing power, with the pleasant result for the many highly indebted nations that their debts will be devalued.
And even this is an essentially theoretical statement, as the world has no experience of the quantitative easing now practised by all major central banks. The biggest players to date have been the US, the UK, the EU (in a manner that is actually forbidden according to the statutes of the European Central Bank), Switzerland and Japan, which is currently breaking all records in terms of purchases of sovereign debt by the central bank.
Let's first of all look at the rosy side of printing money, because QE undoubtedly delivers in that respect! The bright side is that it creates a zero interest rate environment for the world. Zero interest, for you and us as investors, at any rate. Short-term investments that could

previously be deployed as a risk-free strategy in difficult periods currently offer no returns whatsoever. In fact, interest rates in the Swiss franc and euro areas are effectively negative if you are seeking to invest money for just a few months. We are downright embarrassed at having to make investments of this nature: our valued clients are not exactly eager to pay a management fee and various bank fees in return for a guaranteed loss. It makes more sense to simply leave the money sitting in one's bank account, provided there are no doubts over the institution's credit quality. In summary, then, the mania for printing money is brutal for both risk-averse investors and the army of savers, who are in actual fact being squeezed for every last drop.

So what about bonds? With these you are (almost) certain to get your capital back at some point. Even here, though, risk-return ratios have until very recently not been very attractive. Ten-year investments having dropped to yields of 0.6% (Switzerland) and 1.7% in the US or the UK. So it doesn't take much in the way of market volatility to lose an entire year's interest income within a single day. We tend to “park” cash in short-dated bonds, although it is currently impossible to achieve anything in this segment that has even a passing acquaintance with the word *performance*.

Consequently, there is actually only one investment sector left with the potential to satisfy investors' return expectations. That's right, the equity market. The dividend yields of most blue chips significantly outstrip returns on any fixed-income investments, so it is actually no surprise that this sector is generally performing very well (albeit not worldwide). Markets with extremely low interest rates in particular have posted gains, which again is not surprising given the current desperate need for investments. We are entitled to ask, however, whether buying equities simply because the alternatives (fixed-income investments) have vanished is a sound investment strategy. These alternatives have been swept away by the central banks, pulverised in an orgy of quantitative easing. Is it really a smart and sustainable approach to acquire stakes in companies – i.e. shares – just because you can't actually do anything else? As long as the flood of liquidity continues and the associated volume even increases, we can probably live with this approach – a little high-wire act – and generate a halfway decent performance. But to reiterate, is it a long-term decision or perhaps a purely opportunistic strategy

driven by the prevailing consensus that with interest rates as they are the equity markets appear to be utterly risk-free? Or should we not be gradually starting to wonder whether economic logic, the course of economic history and perhaps even good old common sense are in actual fact consistent with the central bankers seemingly having found an infallible way of cleaning up the hopelessly indebted world at no cost and by miraculous means? Is it really possible to quite simply conjure up endless amounts of money out of thin air in order to repay the world's gigantic debts, without risking even the most minor consequences? And to applause from the equity markets, who can scarcely believe their luck? A heretical question. But for you, us and the whole of humanity, a small and innocent statement holds true: If something doesn't make sense to you, then it's probably nonsense. Unfortunately, though, we are condemned to take part in the famed game of musical chairs. There is currently no way of bypassing equities. Whether we want to or not, we simply have no choice. As long as the outlook for the global economy remains positive, this tactic shouldn't actually cause us any sleepless nights. So let's now take a look at how the world's economies are faring at the moment.

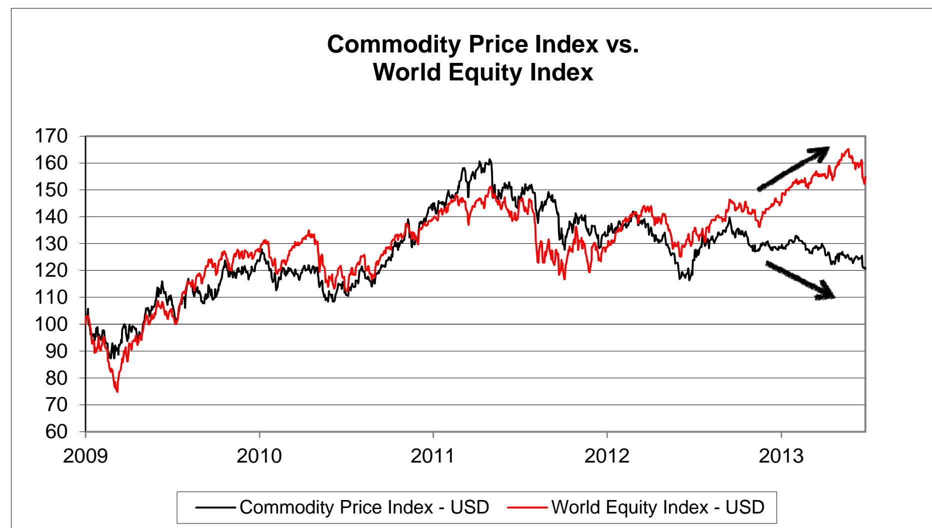
MOTH HOLES IN CASHMERE

Things could be better

The Standard & Poors Index, which is the bellwether for all stock markets, has clearly shown that the pace of quantitative easing has a definite impact on stock market trends. Whenever Mr Bernanke steps on the accelerator, the index rises. When he tries to be more sparing with the stimulus elixir, momentum slows immediately. When he took his foot off the gas slightly at the end of 2010 and again at the end of 2011, the markets instantly lost stamina and began to stagnate. For some time now the Fed has once again been buying hundreds of billions in government and mortgage securities each month, and Wall Street seems to be happy with this. But hang on a moment. We equity investors invest in the economy. In companies. We cannot rely primarily on daddy central bank pursuing a zero interest rate strategy ad infinitum. Or even being able to do so without at some point damaging investor confidence. Now as long as the global economy is expanding, everything is basically fine, although we are entitled to ask why, if economic performance is so promising, the authorities are using all the means at their disposal to implement a zero interest rate policy.

The truth is that, sadly, something is rotten in the state of Denmark. Sure, China appears to still be growing at a rate of more than 7%. This is great news, and thank goodness for the growth engine. Curiously, though, the country's exports and imports are both falling. Demand for commodities has dropped significantly (see falling commodity prices!), and there has been a marked decline in electricity consumption – a very reliable indicator of economic performance. These are sobering statistics. The US is enjoying a revival of sorts, but we shouldn't be fooled by the apparently wondrous recovery in house prices. We are comparing the figures with absolute low levels. Europe as a whole is in recession. It is rarely reported, but it is a fact. Both in southern Europe and in France there are no pink rays of sunlight whatsoever apparent on the economic horizon, and for once Germany cannot carry the entire EU through the growth rounds. The falling commodity prices,

certainly no indication of excess demand, are definitely cause for concern.



Price-earnings ratios on the key western stock exchanges have now reached ambitious levels. They are high from a historical point of view, but this is understandable given the prevailing zero interest rate environment and should give no further cause for concern. But what if the global economy continues to weaken despite the unprecedented stimulus measures, or the central banks can quite simply no longer justify continuing their (in our view exorbitant) purchases of their own sovereign bonds over the long term. Interest rates would doubtless rise immediately, calling the equity markets' current valuation criteria into question. Japan is the best example of the miraculous effect of quantitative easing. The new prime minister has essentially decreed the appointment of his own central bank chief, a puppet-like figure who is currently knocking all the world's previous attempts at central bank-controlled monetary stimulation into a cocked hat. And what has happened? The Tokyo stock market rose by 70% in the space of seven months until a recent sharp correction. Were Japan – for whatever reason – to suspend its purchases of Japanese sovereign debt tomorrow, the market would

be guaranteed to crash. So we shouldn't underestimate the opium of our central banks, which in all probability cannot be administered in perpetuity without destroying confidence. Nor should we forget, however, that current stock market valuations do not primarily reflect the economic performance and growth prospects of private companies, but are overwhelmingly attributable to the zero interest rate environment. Interest rates in many countries are effectively in negative territory at the moment. Zero interest rates minus inflation results in de facto expropriation. Which brings us onto the next topic...

THE POISON OF CONSUMPTION

No deflation please

Have you bought a car recently? Or a shirt, a blouse, an electronic device, an Apple computer? We assume the answer is "yes". And what have you found? We think we know the answer to that too – most consumer articles are getting cheaper. And even better, this trend is not yet reflected in the official inflation figures published by the authorities, even though Switzerland has officially been experiencing "negative inflation", in other words deflation, for some time. While this is pleasing for consumers, it is most definitely no laughing matter for the firms that actually produce the goods our society wants. Mr and Mrs Average Consumer are very quick to notice when general price levels fall. Purchases are deferred in the expectation that the price of almost any article will soon be lower. As mentioned above, commodity prices are also falling, again allowing manufacturers to reduce their prices. While falling prices may appear to be good news, they are absolutely toxic for the economy and for company profit margins. Consumption accounts for two-thirds of economic output in the developed world. Japan's last two lost decades have clearly demonstrated just how catastrophic deflation is for the wellbeing of a consumer-based nation. No wonder, then, that Mr Bernanke, head of the powerful US Fed, implemented the famous quantitative easing policy with the primary aim of doing

absolutely everything possible to prevent deflation. And despite the now long-running megalomania for printing money, inflation absolutely refuses to set in. Astonishing. Terrifying. Surprising. Baffling. Absurd. We simply don't know whether the experiment of unlimited quantitative easing is working. It is the most incredible apparently academic and logical experiment ever conducted in the whole of economic history. Are these lines putting your mind at rest? Ours neither.

The fact is that despite all the attempted stimulus measures, inflation refuses to set in. And yet it is claimed that the respectable performance of the stock markets means all is well with respect to global growth. Or maybe not. Supply appears to be stubbornly outstripping demand.

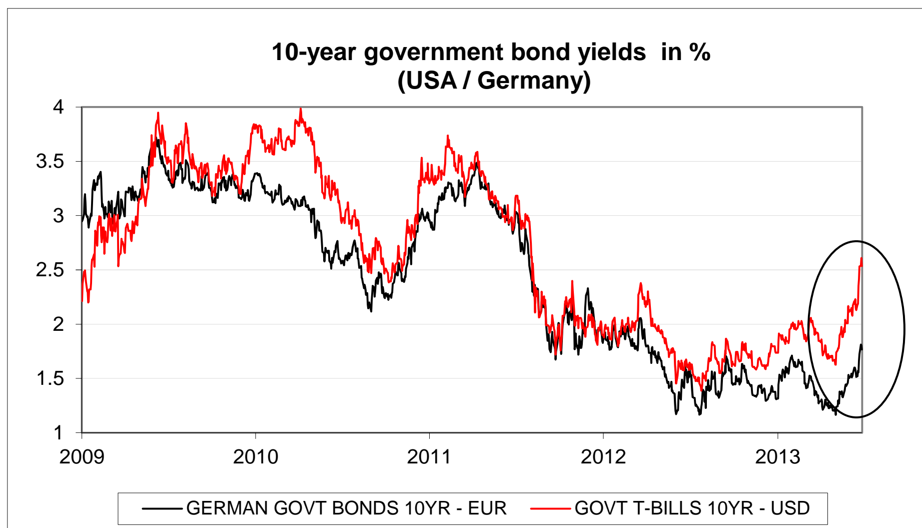
Nor do we know, of course, whether Japan's poisonous deflation will also infect the west. Given the present situation this unfortunately cannot be ruled out, however, and one would be well advised to keep a very close eye on developments in this regard. From a long-term perspective, deflation does not agree with the stock market.

THIS TIME IT'S DIFFERENT

The interpretation of time

At least once every ten years we hear the well-intentioned claim that "This time it's different", with the suggestion that the established valuation criteria used by the financial markets are no longer valid. This is exactly what is happening at the moment. The zero interest rate policy pursued by our central banks has turned everything we have seen to date on its head. The silent expropriation of savers' wealth is continuing almost insidiously. The half-way decent investment that could offer reliable income for us as investors is now a thing of the past. And it is for precisely this reason that the entire financial advisory industry holds the view that everything really is different now. The feeling is that there is simply no alternative to the equity market. This has in fact been the case for a long time, although surprisingly the stock market indices of many highly

promising countries such as Brazil, China (!), India and Russia have stagnated disappointingly.
But if we now look to the future and as Europeans consider how unemployment is rising constantly in the EU, then there is a real divergence of logic – at least as far as European stock markets are concerned. The extremely positive market situation is inconsistent with the facts, quite simply because everything currently appears to be different to how it was before. Many people are currently predicting that in the US at least – which is and remains the trendsetter when it comes to the mania for printing money – there are now clear indications that a number of key Fed figures are seriously considering whether it isn't perhaps time to tiptoe quietly away from the frenzy of quantitative easing. We aren't the only ones to have noticed this – the bond markets have clocked it too. A trend reversal seemed to be taking place as early as the first quarter, but was then corrected again.
There has been a major wind shift over the last few weeks, however, and yields have risen significantly. The details are set out below:



It seems to us that the era of Bernanke's bondage is gradually coming to an end, and as soon as the next debt crisis involving an

EU country hits the headlines – which is undoubtedly just a matter of time – it will be very difficult for the European Central Bank to pull any new rabbits out of the stimulus hat. Perhaps the market is slowly but surely losing faith with all the free gifts being presented to our moribund governments and their desolate-looking banks. One interesting – or more to the point worrying – development is undoubtedly the fact that the recent rise in bond yields was clearly accompanied by a general weakening across all stock market indices. In other words, maybe everything is still as it was after all. Higher bond yields simply mean that there is an investment alternative again. Conditions are still a long way from what could be called attractive, but the key thing for stock market assessments is the trend, the direction.

So we should be wary of believing the Pied Piper who tells us that things are different now. OK, so certain things have been "different" in the financial world over the last four years, but even central bankers can't fight the laws of gravity forever. The coming summer months will show us whether there are grounds for greater caution. It would not surprise us if, with hindsight, May 2013 proves to be the point at which a rethink took hold. And that we have to accept the worrying truth that, once again, things aren't actually different after all.

Marcel A. Burgauer

”For a small, open economy like Cyprus, Euro adoption provides protection from international financial turmoil”

Jean Claude Trichet, January 2008