

Our Point of View  
December 31st 2014

# Our Point of View, December 31<sup>st</sup> 2014

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## Performance of the world's major stock markets

A) January 1, 2014 - December 29, 2014		in USD	in local terms
Switzerland	SMI	- 1.12%	+ 10.14%
Germany	DAX Xetra	- 8.33%	+ 3.93%
France	CAC 40	- 11.28%	+ 0.51%
United Kingdom	FTSE 100	- 7.91%	- 1.71%
Sweden	OMX Stockholm 30	- 9.01%	+ 10.95%
Europe	STOXX 50	- 9.56%	+ 2.45%
USA	S&P 500	+ 13.10%	+ 13.10%
	Nasdaq	+ 15.09%	+ 15.09%
Japan	Nikkei	- 6.28%	+ 7.12%
India	Sensex	+ 25.37%	+ 29.18%
China	Enterprise Index	+ 9.14%	+ 9.19%
Morgan Stanley	World Equity Index	+ 4.25%	+ 4.25%
Bloomberg Effas US\$ Bond Index (5-7 years maturity)		+ 4.45%	+ 4.45%
Balanced Mandate Index *		+ 4.35%	+ 4.35%
B) Over five years		in USD	in local terms
Switzerland	SMI	+ 44.71%	+ 38.02%
Germany	DAX Xetra	+ 41.45%	+ 66.63%
France	CAC 40	- 6.83%	+ 9.69%
United Kingdom	FTSE 100	+ 17.80%	+ 22.55%
Sweden	OMX Stockholm 30	+ 42.24%	+ 55.40%
Europe	STOXX 50	- 8.76%	+ 7.43%
USA	S&P 500	+ 87.48%	+ 87.48%
	Nasdaq	+ 111.84%	+ 111.84%
Japan	Nikkei	+ 27.28%	+ 65.47%
India	Sensex	+ 14.32%	+ 56.60%
China	Enterprise Index	- 7.74%	- 7.69%
Morgan Stanley	World Equity Index	+ 48.20%	+ 48.20%
Bloomberg Effas USD Bond Index (5-7 years maturity)		+ 24.60%	+ 24.60%
Balanced Mandate Index *		+ 36.40%	+ 36.40%
*50% Morgan Stanley World Equity Index and 50% Bloomberg Effas USD Bond Index (5-7 years maturity)			

## CASH LAUGHS

Why larger account balances do actually make sense

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It is wholly understandable that from time to time clients ask why their bank has so much money in its current account. Money that's just sitting there, mark you, doing nothing for its owners. And what's more, management fees are even payable on the balances. This is a perfectly justifiable question, the answer to which is as follows: holding liquidity is always the result of a management decision rather than an oversight or even an error, as a conscious choice has been made not to invest certain funds. It therefore represents a deliberate decision not to allocate account balances to a short-term investment. In the past, liquidity was invested in short-term time deposits or short-dated bonds. This approach now brings with it negative interest rates and additional charges – a very unpleasant consequence of the current zero interest rate policy.

This would be another reason for choosing cash, however, for example as an alternative to further expanding a bond portfolio. Such asset management decisions give preference to idle money over interest-bearing investments. You are perhaps wondering how that can possibly make sense? Surely a little bit of interest is still better than none at all? The answer, unfortunately, is no. Let's take Swiss government bonds as an example. A ten-year bond is currently yielding 0.25%, if you hold the paper until it matures in 2024. As sure as night follows day, however, yields will not stand still in the meantime. Perhaps the yield will rise over the next half-year and return to where it was at the end of 2013, namely 1.27%, leaving you with a capital loss of almost exactly 8.6% within six months.

Larger account balances can therefore make entirely logical sense, particularly in deflationary periods when the purchasing power of cash in hand is constantly increasing and no investment risk is created. Even cash in a bank account is not totally risk-free, however, and may only be held with institutions with a first-class credit rating. The creditor nevertheless bears the house bank's quality risk.

Europe's citizens should also be a tiny bit alarmed at some of the statements being made by its politicians. Cyprus recently confiscated a portion of larger client credit balances at short notice for restructuring purposes, while Spain announced last July that it was to levy a new 0.03% tax on all savings deposits. And in April 2013 the IMF (International Monetary Fund) discussed a one-off wealth tax of an incredible 10% on all private-sector assets. Of course, this is only in the unlikely event of a

renewed banking crisis. Even the German Minister of Finance has indicated that bank creditors could not emerge from the next major banking crisis unscathed. In other words, it would then be necessary to dip into citizens' savings boxes. All expressed wholly in terms of could, would and might, but the eventuality has nevertheless been discussed.

Holding major cash balances in an account can therefore make perfect sense from an asset allocation perspective, provided you stay on your guard as regards the bank's creditworthiness and never forget just how long the state's reach can be. The events of the past can most definitely be repeated in the future. Never believe the absurd adage that everything is different "this time".

## COCOS

Too good to be true?

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No doubt you, too, have already been captivated by the unbelievably wonderful sounding coupons on certain bonds issued by internationally renowned companies. Some offer annual yields of six, seven or even eight percent, and the issuers are well-known firms, mostly financial institutions. And you will already have asked yourself the following question: *“So why isn’t my cash invested in such attractive investments?”* Well, cocos are neither tropical nuts nor overlooked investment tips, and they are certainly not a bargain. Rather, these contingent convertible securities are a ploy designed to ensure better protection for taxpayers in the event of a future banking crisis. Politicians and supervisory authorities have learned something from the 2008 banking crisis. New rules were introduced stipulating that losses are in future to be allocated initially to holders of equity capital and subordinated debt capital before tax monies can once again be used to shore up the banks. If you buy a coco bond, the issuer is not necessarily required to repay your capital. Investors very often do not realise this. If the core capital falls below the required minimum ratio, for example, coupon payments cease and your bond is converted into shares. Your coco is cancelled and overnight you become a shareholder of the institution, in all probability incurring a massive loss as a result. The financial supervisory authorities may also suddenly take the view that the company does not have sufficient equity capital, leading to your coco bond being converted into share capital. Then it’s farewell to your lovely coupon and any prospect of your capital being repaid! If you are considering buying one of these instruments it is vital that you read the issue prospectus very carefully and make sure you have understood it. A coco bond is certainly not a free lunch, and the apparently high yield entails a considerable risk.

# THE NEVERENDING STORY

## The suffering of the euro

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Two and a half years ago Mario Draghi, the President of the European Central Bank (ECB), calmed the nerves of everyone who would listen with his assurance that he would do “whatever it takes” to ensure the stability of the single currency. And when he concluded his verbal guarantee with the words “and believe me, it will be enough” to prevent any possibility of a new euro crisis flaring up again, the financial world was reassured that all the problems of the single currency would in future be swept away. And even that going forward there would no longer be any differences in credit quality between the government debt of individual EU member states. The financial world was particularly enthusiastic about the quasi-guarantee provided by the ECB, which continued to buy up eurozone bonds and other debt securities of all kinds on a large scale, meaning that yield trends would only move in one direction: downwards. Up to now the programme launched by the Italian ECB chief, dubbed the “Draghi put”, has stood strong in the turbulent interest rate seas. Canny hedge funds and investment bankers didn’t wait to be asked twice. They immediately initiated new carry trades, borrowing money from the banking system at more or less zero interest and investing the funds in high-yielding sovereign bonds issued by fragile EU countries such as Greece, Portugal or Italy. The conviction in the financial world that the European Central Bank would even take additional monetary policy steps was balm for the markets, although in October we had to overcome a sharp correction on the stock markets within a very short space of time.

Mr Draghi began buying up debt securities very assiduously. As a result, European taxpayers became the proud co-owners of private mortgages, consumer loans, car leasing contracts and the like in order to further reduce eurozone interest rates. One is entitled to ask whether there is really much merit from an economic perspective in lowering interest rates from “zero point not much” to “zero point next-to-nothing” in order to stimulate investment activity and lending. Almost more than reducing interest costs, the aim seems to be to weaken the external value of the euro, something that has now effectively been achieved – not least due to the prospect of US interest rates rising next year, which would boost the yield differential in favour of the greenback.

The ECB has now realised that simply buying up debt securities achieves very little. Mr Draghi has informed the public on an ongoing basis about

forthcoming corporate bond purchases and – somewhat against applicable law – also about purchases of EU sovereign bonds. The German judiciary has long opposed this course of action. The case is now with the European Court of Justice, which is being rather coy about reaching a verdict. Despite all the scepticism, there has never been any official suggestion from German economic circles that the ECB is up to anything untenable. It must have occurred to the captains of the German flagships that as the top sea dogs in the continental fleet they are no longer dealing with a constantly appreciating Deutschmark but are now in the same currency basket as many wholly uncompetitive EU member states. It is no coincidence that Germany loves European unity. The euro is a gift from God, and Berlin will carry on making major concessions going forward in order to secure the continued existence of the single currency. Separate northern and southern euros would not suit Germany at all, and so it has to send a few subsidy cheques to the south every so often in order to keep its weaker comrades on board. Who knows whether this can continue over the long term. The new EU member states from the Balkans, Romania, Bulgaria and soon even Ukraine (?) will become professional supplicants. Poor euro. Lucky Germany. Hopefully this will go on for a long time yet.

It certainly appears that the ECB has decided to pursue a path of increasingly aggressive quantitative easing (QE). The investment bankers will be happy, as will the hedge funds. The US is slowly losing its enthusiasm for QE, whereas in Japan an identical game is in full swing. And now Europe too is lining up to take part in this mania. But that still isn't the whole story. Beijing is also gradually getting cold feet and recently made it clear that China also wants to bring interest rates down. These are still well above zero, but the fact that even Beijing is bringing out the big guns in order to prevent deflation is worth more than just a footnote. The central banks' stimulus orgy has turned the global financial market into a gigantic global carry trade, with investors buying up risk-free bonds regardless of price for as long as the income from them exceeds the minimal financing costs. While money is still available at zero interest, buyers are indifferent about the valuation of the bonds they buy. As soon as the difference between costs and interest income shrinks, they dispose of these speculative exposures. – Will we never learn? Do all these investors and buyers on an unimaginable scale really think that the exit from the speculation dance hall is going to be big enough for the stampede of sellers who all want to leave the party at exactly the same time. In the meantime sovereign bonds will be raised into a free-floating space, without any actual economic benefit being generated. The only ones to profit will be speculators (hallo there investment bankers), while

savers are left out in the cold and receive no income on their savings. But this is precisely what is happening in extremis. For four years in the US, almost two in Japan, and now probably in Europe as well. And China may be about to go down the same road. We do not believe that the economy will benefit noticeably from it, but the flood of liquidity will undoubtedly continue and even grow, which will be no bad thing for the stock markets going forward.

## EVERY MAN FOR HIMSELF, THEN?

Time to finally say goodbye?

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There are not one but two question marks above. And quite right too, because what has happened in the financial world over the last few years – primarily in the realm of the central banks – is actually extremely difficult for economics and investment experts, wedded as they are to fundamentals, to comprehend. Since 2008 the financial world has been marching to a different beat. Very different! Quantitative easing, making zero interest rate policy an objective, is a new invention in economists' and analysts' textbooks and has turned all previous benchmarks on their head. Many tried-and-tested valuation criteria have become obsolete and have been cast into the waste paper basket of economic logic. The rethink that has become absolutely necessary is causing us all a lot of trouble, as it requires us to ignore established financial analysis criteria. Six months ago we wrote that a bubble was indeed forming. Not in the equity market, the accepted view among the financial press, but in the world of bonds. This bubble has since become rather larger and is set to continue growing apace, particularly in the eurozone. We were overly cautious about buying longer-term dollar bonds during the very long period of QE in the United States, missing out on a few opportunities as a result. We do not really reproach ourselves for this, but it did make us realise that the zero interest rate policy implemented with such brute force has turned the entire financial sector on its head.

So when we all (once again) ask ourselves whether it is time to say goodbye to any investments, we must first of all be certain that we are looking to get out for fundamental reasons such as an imminent recession or the threat of a turnaround in interest rates. The economic outlook is

mixed. While the situation in the US is by far the most promising, Europe is stagnating. This is due chiefly to the fact that its engine, Germany, has ground to a halt. In a few years' time it will be asking whether the current coalition government has not perhaps overreached itself with its redistribution gifts, and in particular whether it made sense to take on Russia through an economic boycott that does at least as much damage to the West as to Putin's empire.

Southern Europe continues to limp along, and even Switzerland is showing signs of consumption fatigue. It seems almost impossible that there will be any kind of interest rate increases in Europe in the foreseeable future. The same goes for Japan, where the central bank – at the government's behest – is stimulating the economy like there's no tomorrow and the country has gambled everything on monetary expansion. Despite this, the Japanese economy simply refuses to pick up. The Asian markets are heavily dependent on the prosperity of China, which continues to achieve enviable growth but is starting to show clear signs of overheating in the infrastructure and real estate sectors. China is primarily preoccupied with itself and leads a veritable life of its own. However, the fact that it is rethinking its interest rate policy clearly indicates that far from simply dealing with a cyclical downturn, Beijing is concerned about general price trends and consumption, the conclusion being that even Chinese interest rates will fall. The Shanghai stock exchange, which has not attracted any positive attention over the past few years, will be delighted at this news. There is likely to be an influx of new, cheaper money into this financial market in the near future.

## SENSE OR NONSENSE?

Does the zero interest rate policy actually have any benefit for the economy?

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This is a question we have asked ourselves on numerous occasions in these pages. The central banks have created billions in new money in order to push interest rates down to near zero, stimulate the economy and boost inflation. But does this policy actually work? We have serious doubts. The chief effect of the ultra-cheap money has been to inflate the world's capacities to an incredible level. Since it cost next to nothing to obtain financing, many companies have "stockpiled" new production facilities across the landscape. There is an excess of everything, from factories to oil production facilities to freighters. And don't even get me started on real estate supply. Even the last remaining farmer has been cajoled by the banks into paving over his green fields. The financing was very cheap, you see, and interest rates would soon be on the rise again. No sooner said than done. Residential developments have sprung up all over the world like mushrooms in a damp late September. China has millions of empty apartments, in Zurich the market no longer has any idea who is actually meant to be moving into all the new office blocks (which are nevertheless still being put up at a rate of knots), and the US is voraciously gobbling up the cheap money to mine shale oil. And what happens when there's excess supply everywhere? That's right, prices go down. However, politicians everywhere are astonished and unhappy that prices are falling (despite the creation of oh so much new money) and that the inflation everyone has been praying for stubbornly refuses to materialise. In our view the zero interest rate policy is to blame for deflationary forces now being much stronger than their inflationary counterparts, and if – as appears likely – the mania for printing money continues, then Mr Draghi and co. should not be surprised that capacities continue to swell left, right and centre, while the prices of all goods and services continue to fall. This means a consumer strike, because everything is cheaper tomorrow than it is today. Precisely the opposite of what they were seeking to achieve. We still believe, therefore, that the forced zero interest rate policy is very much an experiment – and one that has the potential to go horribly wrong.

## A BRIEF REMINDER

Have the banks cleaned up their act?

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For some time now the author has kept his counsel about the goings-on at the world's big banks. One could almost have surmised that these mega institutions had now found the path to purification. Far from it. New offences have been uncovered on a grand scale since we last wagged an admonitory finger at the big banks, with new fines in the millions being imposed on a non-stop basis. The banks pay up and promise (as they have done so often) that everything will now be better. Until the next time. Such as the manipulation of foreign exchange rates, for example, the latest chapter in the unspeakable history of the banks. The gigantic fines are paid immediately and without complaint, using money they had previously earned unfairly. They offer an apology (as they have done so often) that a few bank employees unfortunately exceeded their authority and have of course been dismissed. Countless secret chats were found (why only now?) in which traders at the big banks conversed in the most primitive gutter jargon, for example "dont want other numpty's in mkt to know". A generally obscene use of language that we would prefer not to inflict on you here. Have the banks cleaned up their act? Not yet, unfortunately. So what else can we still expect to see on the fines table? Perhaps dishonest stock market transactions, use of insider knowledge, new trader collusion? It is always to be hoped that all possible aspects of the offence have now been uncovered, but some new threat always comes along. Switzerland's own big banks are always in on it too, and one has to question why no-one here is complaining that the supervisory authorities never respond with fines or criminal prosecutions. The explanation given is that the Swiss financial market regulator is not allowed to impose fines. Great. If someone steals a bunch of bananas they'll wind up in prison. But if a big bank manipulates foreign exchange rates and channels billions into its own trade flows, then the Swiss authorities remain silent. And people wonder why Switzerland, which has previously functioned so smoothly, is now swamped with envy-driven initiatives from the political left. The big banks have still not grasped the principles of business ethics, and a certain CEO of one institution on trial maintained (under oath) that he did not even know that the bank employed a department of client advisors who had served US clients and travelled regularly to the New World in order to acquire new clients. And this man is nevertheless allowed to remain in office, even though he (apparently) doesn't know what is going on in his own organisation. A few shareholders get annoyed, but the major shareholders

(hello there pension funds) rubber-stamp the discharge of the Board of Directors. These things happen. Let's face it, a boss can't be everywhere at once. We think this is outrageous, and while it is entirely possible that certain big bank shares will not fare badly at all going forward, we are sticking to our view that the big banks' business model remains unsustainable and is still not good enough for a directorship. The chair of a big Swiss bank – a personality with a magnificent professional career behind them – was for a long time able to trot out the line that “all the unpleasantness” happened before their time with the firm. This argument no longer holds water. The front line, i.e. the trading room, is still a hotbed of ethical effrontery that has nothing to do with sustainability. Meanwhile executive management notices nothing or looks the other way. We are a little bit ashamed of some of our financial institutions, and still prefer to steer clear of investments in this sector.

## SCEPTICISM ON ALL SIDES

The trend is likely to continue despite the concerns.  
Or perhaps precisely because of them

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Based on what we have said above, you can clearly see that given the monetary situation there is no need to run for cover. There is something of a question mark as regards the United States, where a fairly definitive decision has been taken to suspend the monthly purchases of Treasury paper. A turnaround in interest rates simply has to be expected here at some point, and those in charge are also clearly anticipating this. The timing of the turnaround remains unclear, however. The signs from Washington are currently rather ambiguous, and those in charge cannot agree on whether or not raising interest rates would stifle the economy. In any event, the dollar has the advantage over the euro in terms of fundamentals, with the relative strength of the greenback set to continue.

In Europe, the glut of money now scarcely knows what direction it should flow in. People in some quarters are even toying with the idea of negative interest rates on bank deposits. And those who urgently need money or perhaps want to build up a new business still rarely receive it, in line with the age-old banking rule that you should only lend money to people who don't actually need it. Bonds with good credit ratings are offering yields that a while ago were unimaginable. Germany is paying 0.7% for ten-year paper, Switzerland scarcely more than a third of one percent per annum. It is therefore no surprise that the stock markets are trending positively when shares such as Nestlé or Roche are offering a dividend yield almost ten times that of a ten-year government bond. A wholly unimaginable scenario just a short while ago. And while the press has long been peddling gloomy predictions that shares are too expensive based on long-term valuation levels, they are comparing apples with oranges. It goes without saying that current price/earnings ratios cannot be directly compared with those achieved when a ten-year Swiss government bond was yielding three or more percent per annum! That is clear for all to see, and we think that many current market estimates are too short-sighted as they do not adequately adapt valuation benchmarks to today's ultra-low interest rates. It is for precisely this reason that we have been reading for some time about "overvalued stock markets" and an imminent rude awakening. A genuine slump is unlikely to start while there are so many warning voices.

We are currently skating not on thin but on new ice. The risks simply cannot be measured with past valuation criteria, as there has never been an environment even remotely comparable to the one we are in at present, and likewise there has never been a market situation that can be compared to the current scenario. The world will continue to be amazed that nothing at all is as it used to be and that the new year may also bring a host of developments that are at odds with consensus expectations. Keep your seatbelt securely fastened. The journey continues.

Marcel A. Burgauer