Our Point of View
December 31th 2015

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Performance of the world's major stock markets

A) January 1, 2015 - December 31, 2015		in USD	in local terms
Switzerland	SMI	- 1.93%	- 1.84%
Germany	DAX Xetra	- 1.67%	+ 9.56%
France	CAC 40	- 2.54%	+ 8.53%
United Kingdom	FTSE 100	- 10.10%	- 4.93%
Sweden	OMX Stockholm 30	- 9.17%	- 1.21%
Europe	STOXX 50	- 6.74%	+ 3.85%
USA	S&P 500	- 0.73%	- 0.73%
	Nasdaq	+ 5.73%	+ 5.73%
Japan	Nikkei	+ 8.03%	+ 9.07%
India	Sensex	- 9.34%	- 5.03%
China	Enterprise Index	- 19.35%	- 19.39%
Morgan Stanley	World Equity Index	- 2.74%	- 2.74%
Bloomberg Effas US$ Bond Index (5-7 years maturity)		+ 1.98%	+ 1.98%
Balanced Mandate Index *		- 0.38%	- 0.38%

B) Over five years		in USD	in local terms
Switzerland	SMI	+ 29.66%	+ 37.01%
Germany	DAX Xetra	+ 27.82%	+ 55.38%
France	CAC 40	- 0.92%	+ 21.87%
United Kingdom	FTSE 100	- 0.01%	+ 5.80%
Sweden	OMX Stockholm 30	+ 0.46%	+ 25.20%
Europe	STOXX 50	- 4.89%	+ 17.00%
USA	S&P 500	+ 62.52%	+ 62.52%
	Nasdaq	+ 88.75%	+ 88.75%
Japan	Nikkei	+ 26.11%	+ 86.08%
India	Sensex	- 14.05%	+ 27.35%
China	Enterprise Index	- 23.66%	- 23.88%
Morgan Stanley World Equity Index		+ 29.90%	+ 29.90%
Bloomberg Effas USD Bond Index (5-7 years maturity)		+ 18.01%	+ 18.01%
Balanced Mandate Index *		+ 23.95%	+ 23.95%

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

PARANOIA

The fear of rising interest rates

For over a year now, one single question has loomed large over the financial markets: when will the US Federal Reserve announce the first interest rate increase? Given the impressive economic recovery achieved by the US since the crash in 2008, and in particular the low rate of unemployment, which New York has always claimed is a fundamental prerequisite for an interest rate shift, it seems reasonable to ask why the Fed has repeatedly delayed the impending tiny ¼% increase. Playing devil's advocate, we would suggest that Wall Street is doing its utmost to maintain the benefits of the zero interest rate policy intact for as long as humanly possible. Did you know that four of the seven members of the current Federal Reserve Board of Governors are former Goldman Sachs executives? Is that not a little "unusual"? Does it not give rise to the simple, innocent suspicion that the interests of this powerful financial institution might occasionally be given at least as much consideration as the national interest? I expect you are thinking that this sounds like a *conspiracy theory*. Maybe. But then again, maybe not. The tentacles of the Goldman empire extend deep into the political world. But I digress. The fact is that a moderate increase in US interest rates is long overdue. Yet the international markets promptly slumped as soon as it became a virtual certainty that the Fed would take this one tiny step in autumn 2015. The Fed then took another tack, putting forward a number of flimsy arguments about not taking risks, not wanting to be overly hasty or stall the economy, and the decision was postponed once again. The stock market jitters promptly disappeared and the markets regained their good humour.

At the time of writing, we were still not certain whether the Fed would finally decide to apply the long-awaited rate hike at its December meeting. We assumed that it would happen, however, as has clearly been anticipated by the US dollar gains in recent weeks. When a flu outbreak is imminent, it is always best to discuss the prospect every day, then when fever strikes it seems almost par for the course. The same rule applies to interest rates. The world has been haunted by the prospect of a minimal US interest rate hike from ¼% to ½% for so long now that the reality will almost be a relief. Done. Nothing more to worry about. After all, the next round of hikes is unlikely to be imminent. We actually believe that the outbreak of this 'flu' (a.k.a. a tiny rate hike) will leave the stock markets unmoved, causing interest rate fears to subside and ushering in a joyful

January. All of which would be good news. The question is whether central bankers in the rest of the world will also see reason in the near future.

THE ECB STEPS ON THE GAS AGAIN

Mario Draghi is stepping up stimulus measures

The President of the European Central Bank recently indicated that he intends to continue buying up bonds and debt in order to boost the Old World economy, even though these are now in short supply on the market. Yields on debt instruments have slipped to almost nothing, pension funds are bemoaning the zero rate environment and citizens are slowly but surely losing all entitlement to income.

At the risk of repeating ourselves, we continue to proclaim loud and clear that we believe the years of quantitative easing and zero interest rates have been a failure. Time and again, the central bankers claim that their solution is the only way to prevent deflation and that the zero interest rate policy will sooner or later (probably later) lead to the Holy Grail of 2% inflation, which – according to their preachings – will generate sustainable consumption. But what is actually happening? Deflation is being fuelled by misguided theory. Take the case of global commodities prices, despite seven years of extreme stimulus measures. It is not just oil, the price of which has fallen by almost two-thirds; wherever you look, commodities prices have slumped. This is hardly the precursor to inflation. The constant decline in the velocity of money (which reflects the absence of a money multiplier) is nothing less than deflationary, whether you like it or not. The ongoing monetisation of government debt (I am looking at you, Mr Draghi!) is a massive gamble, even setting aside the fact that citizens are being deprived of virtually all income on savings. And yet the textbooks tell the proponents of quantitative easing that the questionable activities of the central banks will stimulate consumer spending.

Japan has the most extreme approach to monetary easing. The national deficit is financed by the central bank, with the Bank of Japan paying out more than double the value of new government bond issues by printing

money for bond purchases. Theoretically, this should generate inflation. But it hasn't. Deflation continues to rule in Japan.

Only one sector has benefited from the zero interest rate policy (quantitative easing), and that is asset prices. The wealthy have constantly expanded their asset portfolios, buying more assets with ultra-cheap money. Real estate financing is dirt cheap, making it easy to acquire new properties. Just take a look at property prices in London or New York. They are way out of Mr and Mrs Average's league. The real estate sector is the preserve of the world's wealthy, who are laughing up their sleeves at the fact that anyone with a good credit rating is now inundated with offers to borrow money for next to nothing. But will making the world's richest people richer increase inflation? Do these blessed individuals then eat two steaks instead of just one or spend their holidays in two places at once? This is of course a ridiculous question, but it demonstrates that the one social group to have benefited hugely from the zero interest rate policy can contribute virtually nothing to boosting consumer demand.

Banks' net interest margins are also declining, which in turn reduces lending – surely we should feel sympathy for the banking fraternity? The outlook is most atrocious for personal pension provision, however. Our pension funds are cheerfully investing in long-term bonds that offer zero or even negative returns. They have no other choice: they are compelled to invest the monies entrusted to their care in line with their own payment obligations. It's a case of every man for himself – and the devil take the future pensioners. Do any of the champions of the zero interest rate policy ever think about our young citizens, who are currently funding our pensions while their own pension assets are "invested" at zero interest? We believe it is a socio-political crime to wantonly invest retirement savings in government bonds that are guaranteed to consistently generate losses year after year. Would you not agree that such behaviour is highly unlikely to stimulate growth?

In conclusion, the sooner the zero interest rate policy ends up on the rubbish heap of economic blunders, the better. And the better the prospects for a healthy economy. A quick glance at the balance sheets of our leading central banks is enough for any observer with even a modicum of common sense to see that the all-too enduring stimulus policies constitute folly of the first order. The most alarming case is that of a nation which is repeatedly held up as a model pupil. A land known for its rock-solid stability. I am talking about Switzerland. Sad but true. The total assets of the Swiss National Bank have increased more than sixfold since 2006, and the monetary "reserves" of our bombproof bank currently represent a whopping 90% of national economic output. That has to be a record. Some of the massive revenues generated by bond and share purchases

are then distributed through the national budget and to the cantons. The cantons in turn cheerfully build cycle tracks and roundabouts with the free Monopoly money. It really is like magic.
Zero interest rates continue to be the main problem for us investors. We think that this bizarre economic period is not yet over in Europe and Japan. Quite the contrary, in fact. The European Central Bank is frantically trying to get the weak countries in southern Europe back on their feet. We predict that, rather than tightening the reins, Mario Draghi will actually loosen them even more in the new year, even though the draught horse of the EU – Germany – really needs exactly the opposite treatment, namely higher interest rates. It is becoming ever clearer that the European single currency is not sustainable. Euro exchange rates will almost certainly remain unstable and volatile, quite irrespective of the fact that EU enlargement has brought more countries into the club, all of whom are committed net beneficiaries. And now the EU is resuming accession negotiations with Turkey in return for keeping refugees out. Ah, Ms Merkel! Do you really want to make your political bed with someone like Mr Erdogan?

THE CURRENT PANACEA

Europe is committed to redistribution

In the last “Our point of view”, we talked about liquid assets, or rather the plans to eliminate them. The zero interest rate policy is essentially a measure designed to enforce consumer spending, but politicians feel that it has not yet borne sufficient fruit. In reality, the zero interest rate policy is destroying vast quantities of savings, ruining our pension funds and creating state disincentives, causing our beloved governments to put urgently needed labour and economic reforms on hold in light of the virtually interest-free financing available.
We fear that political plans to marginalise cash and then abolish it in the medium term have by no means been shelved. Our valued readers in Switzerland will doubtless respond with cries of "Never!" But think back to the time, not so very long ago, when our Finance Minister Hans-Rudolf Merz proudly and confidently declared that the Swiss tradition of bank-

client confidentiality was not negotiable. And what happened next? Within two years, Swiss bank-client confidentiality had been eroded, and shortly thereafter Switzerland signed the agreement on the automatic exchange of information (AEOI). So we shouldn't be overly confident about the future of cash. It is now abundantly clear that politicians want to introduce interest rates that are several percent negative, and with the best will in the world that can't happen while holding liquid assets is still "allowed". If cash is abolished or limited to small amounts, however, politicians will suddenly be at liberty to introduce an interest rate system genuinely based on expropriation, essentially ordaining that consumers must consume and increase their personal debt. For now, let us simply remember that in line with Keynesian economics, lower interest rates have in the past always been used as a means of combating recession. And in most cases this approach has been successful. But what on earth will we do in future if faced with a cyclical recession? Interest rates are already pretty much nil. So just how do you generate additional monetary stimulus? Why, through nothing less than negative interest rates, of course! As sure as night follows day, we will experience another cyclical recession in the coming years. Let us hope that it is still some years off. But what will happen if the recession starts soon? Interest rates will have to descend even lower into the red zone, forced down by political decisions. There won't be any other choice. And as a corollary, cash will go out of the window and we will have one more liberty stolen from us. Take the example of the debatable and wholly inaccurate predictions about Swiss bank-client confidentiality. Nowadays, events often pan out contrary to expectations. And if you think it would already be catastrophic enough for savers to be hit with interest rates that are several percent negative, then perhaps you haven't thought everything through. Europe's mania for redistribution could easily extend to wealth taxes, if the monetary stimulus from the zero interest rate policy fails to materialise. After all, how can you expect to put a struggling economy back on its feet without conventional measures like cheaper lending? Abolishing cash would be almost the last step towards achieving total financial transparency for citizens. And that is what the state is aiming for. The author recommends returning to read these comments again five years down the line.

SWEETENERS THAT LEAVE A BITTER TASTE

The dodgy distribution boom

It is a proven fact that sustainable dividend payments have a significant impact on long-term share performance – particularly when the dividends are reinvested. Some companies have increased dividend payments to shareholders for decades without affecting the health of their bottom line. For example, Nestlé has not reduced dividends since 1959 and has actually increased payments every year since 1996, while Roche has reported higher dividends every year for a quarter of a century. The list goes on. This behaviour is sustainable and in the interests of shareholders. The dividend practices that have emerged among many US companies in recent years are less sustainable, however. Taking advantage of laughably low cost of credit, many companies are engaging in large-scale borrowing so that they can distribute the money immediately in the form of higher dividend payments and share buybacks. By way of example, McDonald's – a recognised blue-chip company that fully embodies the American way of life – recently took this step in order to increase the rate of distributions from the current level of USD 10 billion to three times (!) that amount by the end of 2016. It should be noted that this increase includes share buybacks, which automatically increase the earnings per share. Some companies with falling earnings use additional borrowing and assiduous buybacks of their own shares to proudly publish higher earnings per outstanding share, which can easily wrong-foot the unwary investor. It goes without saying that the balance sheet quality of these companies has taken a nosedive. In the case of McDonald's, this reckless approach will increase the company's debt to 350% of EBITA (earnings before interest, tax and amortisation) by 2017. Obviously, the company's credit rating will plummet. This short-termist approach will come back to bite these companies as soon as interest rates return to relatively normal levels.
Close to USD 1 trillion (1,000,000,000,000) was paid out in US dividends and share buybacks in 2015. Incredibly, this means that total distributions have doubled in just four years, all thanks to the clever central bank and its zero interest rate policy. These wondrous gifts from the largest companies in the US to their investors now exceed total free cash flow. We really don't need to make any further comment about how mind-bendingly stupid this practice is.

Of course, certain companies such as Apple can easily afford to pay out USD 35 billion dollars each year, but they tend to be the exception to the rule. Be that as it may, we feel it is idiotic for a company to spend half of its annual profit on buying back its own shares. The money would be better invested in increasing capacity, but short-term thinking among managers seduces them into boosting the share price rather than concentrating on their employer's long-term success. To hell with the consequences, think the managers, but let's bump up the value of my share options first! The US economy has been booming for the last seven years, and yet balance sheets are in the worst state they have been for a decade. At some point – possibly in the not-too-distant future – interest rates will return to more traditional levels and the reckless managers who have squandered vast amounts of capital for personal gain will then be called to account. Or so we hope.

LET'S TALK ABOUT CYCLICAL RECESSION

What do the stock markets tell us?

Let's hope that we avoid the aforementioned cyclical recession in the new year. But a quick look at a few leading stock market indicators will cause the reader to frown a little – unless you choose to turn a blind eye and instead peruse the weather forecasts, which have recently been promising wall-to-wall sunshine.
Nevertheless, the reality is that some leading indicators suggest dark clouds could gather over certain stock markets in 2016. Specifically, a suspiciously large number of leading share prices are currently hovering below the 200-day average. And not just in the US, but also in Europe and in our beloved, almost autonomous Switzerland. Bullish developments are driven by ever-fewer shares, while in the US the incredible price gains among technology stocks are masking the overall trend. The breadth of the stock market trend is far from reassuring, however, and we think it will be advisable to monitor the general health of the markets closely over the coming months. Even Google has yet to invent an alarm bell that can warn

us about impending downturns. Stock market trend reversals inevitably arrive unannounced and begin tamely, quietly and gradually. It is extremely rare for a downturn to begin with a crash – there is nearly always time to take precautions. The only problem is that in the current environment there are almost no real alternatives for us investors outside of the equities segment, unless we are prepared to make do with the microscopic yields on very long-term bonds, which unfortunately carry a very high risk in the event of a turnaround in interest rates. Never in the history of humankind has it been so difficult to decide when to run for cover. In the past there have always been ways to park money temporarily and wait for the better times to return. But in the future, global negative interest rates could threaten short-term cash deposits, making it unutterably difficult to decide to pull one's money out of shares in Nestlé and their ilk.

We are on the lookout for discreet warning signals, however, as provided by the 200-day moving averages for various stock markets. And we are praying that these will evaporate, as the central banks would have no ammunition left in the event of an emergency. It is akin to planning a transatlantic crossing without a lifeboat.

SO WHAT NOW?

The short-term outlook

We are fairly optimistic about the immediate future. Firstly because the predictable initial and minimal US rate hike has already been factored into market prices. And secondly because Mario Draghi has made it clear that he intends to further beef up the monetary stimulus measures and buy up vast quantities of additional debt – all with a view to bringing average EU inflation closer to the 2% target, which we feel is wishful thinking. Unfortunately, Brussels never asks for our opinion. The intentions of the central bankers are what count. And even though the flood of money has thus far produced meagre pickings, with incredibly disappointing results in the case of Japan, the bankers are simply increasing stimulus measures, while Germany, which is bearing the brunt of the load, requires very different treatment. Be that as it may, the markets still seem to view the low interest rates as good news, which is the crucial factor. Whether this

confidence will survive beyond the first quarter of 2016 remains to be seen. As outlined above, our optimism is limited to the start of the new year and does not extend to the whole of 2016, which will need to be reviewed soon. Let's not forget that the stock market uptrend stabilised some time ago, and a cyclical correction is on the cards in the short or long term. Another trend that suggests caution should be the order of the day is the mania for acquisitions, which reached alarming proportions last year. Around USD 2 trillion was spent on acquisitions – money generously provided by the bountiful bankers, who cashed in on the record-low interest rates. Frenzied acquisitions of rival companies using borrowed money always set alarm bells ringing in the background and should encourage caution. Particularly when those acquisitions are being made solely in order to optimise tax, as is currently the case.

It is becoming apparent that interest rates in the US and Europe will soon diverge, and yet nowhere will offer anything even approaching normal interest rate levels. In the short term, this is a good reason for maintaining equity investments. However, the risk remains that at some point the credibility of the European Central Bank's actions will collapse and the market will no longer appreciate the risk/return profile provided by the interest rate environment. There is a clear and inherent system risk at present, with an unknown half-life. This assessment may seem hugely opaque, but the truth is that the roller coaster ride of the European Central Bank is like a breakneck flight into the darkness. There will be a very narrow window of opportunity for market participants to exit the stock markets if Mario Draghi's high-wire act goes wrong, and that is not something you want to be involved in.

Your motto for the new year should be to stay sober and wide awake at all times. And above all, be sure to dance close to the exit door of the stock market party.