BPM BERLIN PORTFOLIO MANAGEMENT

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What is the one thing that actors in the capital market hate even more than bad reports? That`s right: uncertainty. And the last few weeks have seen more than enough of it. The principal cause of sleepless nights for investors across the globe of course continues to be the confidence and sovereign debt crisis besetting Europe. And even the latest 14th EU debt summit in December has given rise to very little in the way of expectation that a comprehensive solution will be found to rescue the continent from its precarious position.

Let's look a little closer.

Europe's leading nations have plenty of good reasons for reticence. Firstly, there is currently little enthusiasm amongst the "patients" for the wholesale adoption of the American cure which involves the unchecked printing of money. The medium-term risks to monetary stability and, by association, social order within the European Union still appear too great for such a solution to be tenable. Secondly, proposals to shoulder the debt burden of individual member states (those bordering the Mediterranean) have now become almost impossible to sell to domestic electorates. Thirdly, any launch of the intercontinental ballistic missiles from the arsenal of monetary policy (for example, in the form of the unlimited buying up by the ECB of government bonds issued by states mired in crisis, or unlimited safety nets) would do nothing to solve the underlying problem of unsustainably high levels of debt. The sole aim of such action would be to create opportunistic confidence in the ECB and its readiness to assume responsibility for the debts of weak Eurozone countries.

Whatever you may think of the Germans, the Dutch and the Finns, there's no denying that their bifurcated approach of embedding efforts to find a solution to the current problems in a long-term sustainable strategic concept in the interest of safeguarding the collective wealth of European nations is both important and right.

Let's look closer still.

With just a little effort - and without any need to subscribe to conspiracy theories – it is possible to tease out some of the decisive interests involved:

1. The last ten years have seen decisive changes in favour of the Euro within the leading global currencies of the US dollar, Euro and yen. Regrouping on the part of Arab and Asian central banks in particular to the benefit of the Euro is having the effect of placing the American model of using foreign debt to finance the US budget in long-term jeopardy. A freely convertible Yuan would accelerate this process yet further and place America's ability to refinance the debt mountain, which is currently in excess of 15,000,000,000,000 US dollars, under severe strain.

2. 2012 is a crucial election year for the USA and President Obama. Economic problems have combined with thorny domestic and foreign issues to whip up a storm around the Obama administration. With this in mind, any successes, demonstrations of strength or – in the absence of anything better – problems that are at least manageable are of crucial importance. The USA is quite clearly not interested in destroying the Euro and the Euro bloc; it does however see an advantage in weakening its global strategic position.

3. The attack being mounted on the Euro is focusing on its Achilles heel - and it is the absence of political and fiscal union that is meant here rather than little Greece. What was once an entirely manageable and containable Greek problem has become a wildfire which is threatening to engulf the whole continent, putting at risk the prospects of successful reform within the Eurozone and now having a destabilising effect across the globe. If the current crisis were to be used to resolutely get to grips with long-overdue structural reforms in Europe, this might well lead to enormous losses at the hands of speculators placing bets on the destruction of the Euro.

4. When you compare critical economic framework conditions for future growth, such as indebtedness, infrastructure, education, tax systems, the power of innovation and the ability to create jobs, the USA can be seen year on year to be lagging further behind the other leading global economies. All this makes statements made by the leading ratings agencies and even Barack Obama, who - and here you can only marvel at his sheer presumptuousness - is offering Europe the help of the US in the resolution of its debt crisis, seem especially dubious.

5. Economically speaking, it is hard to imagine that the serious problems currently besetting the finances of individual states could signal the end of almost six decades of ever closer European integration. It will take more than the objections of a few hedge-fund managers and their Anglo-Saxon friends from the worlds of politics and rating agencies to derail this process.

6. The exchange rate of a currency is one – but not the only – reflection of the economic power of the area in which it is used. Today's Euro is a good 14% stronger than it was when the exchange rates were set on 01.01.1999; to put this another way, it has increased in value by almost 50% since the introduction of the Euro as cash. Remarkably healthy for a currency on its deathbed.

Who is paying the bills?

It is our view that, with the exception of a few banks and hedge funds, all the actors involved share a vital international interest in solving as quickly as possible the problems of confidence at the European periphery. To cut a long story short, no-one knows who is going to pick up how much of the tab. In any case, we have come up with a close-knit network of several candidates, all of whom have a considerable economic self-interest (listed in the most probable order of ability or readiness to pay): The European Central Bank (ECB), the European Financial Stability Facility or EFSF (Euro crisis fund), the International Monetary Fund (IMF), the group of emerging nations, the US Federal Reserve, and the Chinese national bank, the PBC.

The last week has shown just what kind of punch even selective concerted action can pack: Firstly, the ECB and other central banks have made it absolutely clear that they are basically prepared to do more than ever before to stabilise the crisis; secondly, they have at the same time demonstrated this readiness in practical terms with moves to reinforce inter-bank liquidity. It undoubtedly goes down well with international capital markets that investors know, when push comes to shove, that the central bank is on hand to pull the chestnuts out of the fire. As has already been mentioned, this naturally implies problematic long-term consequences; at the moment we are in a phase of acute crisis management, and nothing more. The new central bank policy is leading in almost all global markets to massive rises in the value of shares and raw materials and, at the same time, to moderate falls in yields and the price of credit default swaps.

Interim conclusion

Yes, it's true that the USA is still the world's number one economic power. In America, the economy, the real estate market and consumer confidence are all showing signs of temporary recovery. However, we are still a very long way off the high growth required to create jobs and put the brakes on the runaway debt train. And yes, the public perception is that the USA just can't go bankrupt because the country can print the nominal (!) money required to service its debts at any time with no questions asked.

And some countries will of surely leave the Euro currency union because their lack of economic performance within the Euro is robbing them of the air they need to breathe. What is important now is to find sensible ways to dovetail the immediate measures which have been born of necessity and are saddled with unpleasant side-effects with a universally binding concept of long-term European integration and stability. *The current situation requires both speedy action and level-headedness!*

Even in the face of all the challenges set out above, the Euro itself and the European Union project are not in serious danger. We can well imagine that, once the imminent and painful adjustment processes – perhaps better described as slimming cures – have run their course, the international position of this currency may even be strengthened.

What does this mean for investments?

It is our belief that the trends remain clear. And we have seen no need to revise the basic prognosis given in our last market commentaries. From the perspective of investors, the risk profile is strongly asymmetrical, as the expected yield is significantly higher than the current statistical risk.

We do of course receive concerned enquiries from across the world reflecting the current levels of uncertainty. What is clearly new here is the fact that investors are again being plainly shown that the price of an investment almost never corresponds to its value. In optimistic bull market phases, too little is generally paid for "risk", whereas in times of high uncertainty investors often receive very attractive risk premiums. Such differences in valuation often endure for long periods of time, giving the investors and managers sufficient time to position himself appropriately. What are the key statements on the asset structure?

A. Substance and quality are the trump cards. Bonds and shares from companies with solid balance sheets and sufficient critical mass are available world-wide!

B. Numerous bonds from strong and solid banking institutions are tarred with the same brush as those from investment banks with a weaker capital base. Variable-rate securities from solid European national banks or institutes in which the state has a high direct stake are quoted at much less than their actual value and offer attractive current coupons plus inflation protection through rate adjustment clauses.

C. International central banks bought more gold between July and October than at any time in the last 40 years. Gold and silver are simply better money – not less and not more. It is a "Must have".

D. Due to medium-term inflation risks – for example, after a possible deflationary period in the coming quarters – the relative proportion of stock market net asset values should be increased. Current levels of market turbulence enhance the attractiveness of conservative

special forms in the form of discount or bonus structures, as these lead to yet better conditions.

E. The new equity capital directives for banks and insurance companies (Basel III and Solvency II) will in future make certain financing instruments unattractive to institutes. The right of cancellation of these securities is currently making it possible to identify outstanding yield opportunities for investors.

F. The US dollar and emerging economy currencies, such as the Brazilian real, Turkish lira, South African rand or Indonesian rupee, should make up a substantial proportion of an international bond portfolio. The Norwegian krone, Australian dollar and Canadian dollar should also form part of the mix and ought principally to feature in the form of shares held in these currencies.

G. An indiscriminate and fear-driven reduction in Euro positions is, in our opinion, both unnecessary and harmful.

H. German and American government bonds serve to destroy real purchasing power and are currently not worth considering as long-term investments; they should at most be viewed as interim deposit options.

We would like to conclude by pointing out a paradox in capital market psychology: There are few other markets in which the purchase of goods (financial investments) at lower prices (rates) gives rise to a palpably negative feeling whereas their purchase at relatively high or even increasing prices does the opposite! A cause of this – among others – is the concern to avoid a situation in which regret arises due to the fact that the good becomes cheaper after purchase. The verifiable quality of the planned investment is, by way of contrast, often overlooked in the process. We regularly make use of this observation in the analysis of our conduct as portfolio managers.

Please rest assured that we will continue to act in the coming weeks with an objective view and calm expertise. The performance of the managed assets in the various risk categories clearly underscores the appropriateness of the investment philosophy which we espouse. Please don't hesitate to contact us if you would like a fuller discussion or have questions or suggestions. We would like to thank you very sincerely for the confidence that you have shown in us.

Uwe Günther Sven Marzahn

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