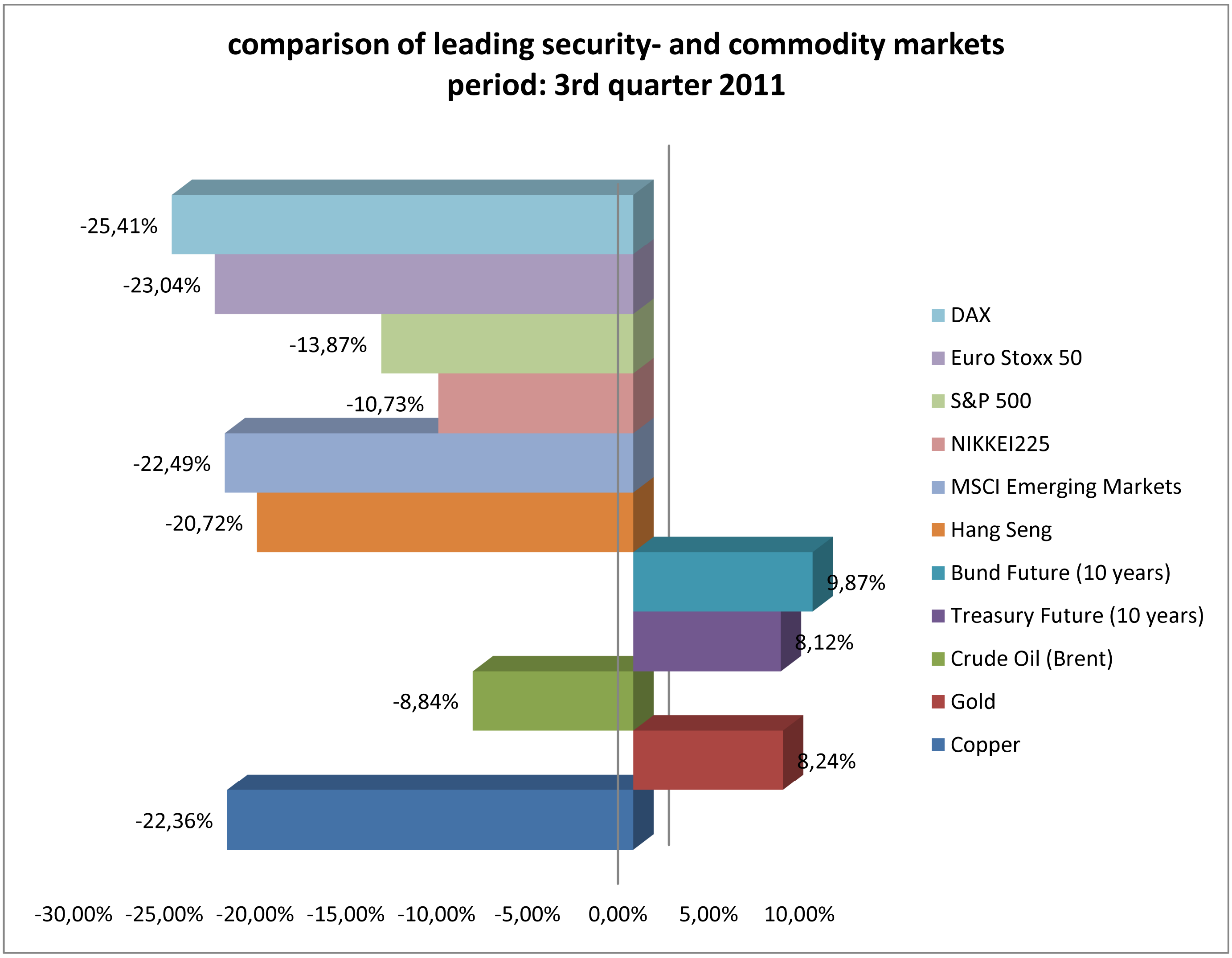
Market Comment October 2011

The third quarter of 2011 could not have been more nerve racking. Thus in the first week of July the DAX, the German share barometer, was well above 7400 points and then within less than 70 days shed more than 30% of its value. And copper, probably the most important industrial metal, plummeted in the same period by just over 28%.

Between 1st and 4th August a handful of American investors issued selling orders for European and especially German blue chips and although the number of these orders was small, the sums involved ran into the billions, setting off a destructive momentum, and since then the wave of adverse reports and speculation has never abated. At a certain point, panic took hold of individual investors became apparent and the intensity of gyrations of share values took on dramatic proportions. Worldwide the values of many securities are already pointing to a deep recession! All this, it should be noted, without manufacturing companies generally having published worse results or negative reports. On the contrary: Full order books and stable or increasing dividend payments are the rule rather than the exception worldwide.



Why have market players marked down numerous asset classes with discounts of historic proportions over such a short period? This dramatic collapse in values is all the more astounding as German manufacturing industry in particular was and is still well situated. It is certainly nothing to do with the problems of the comparatively small Greek economy. The problem there is essentially one of preventing a spread of the contagion.

Reliable answers can certainly only be obtained if this extremely abnormal trend is viewed in the international economic and political context. Such events are not normally the result of individual reports or new insights, but the consequence of a chain of adverse circumstances and a correspondingly unsettled market environment.

At this point we do not wish to rehash the innumerable arguments, items of information or attempted explanations of the daily press as you are certainly sufficiently acquainted with these. The near insolvency of the USA as per 2 August, the international disunity about the future approach to supporting individual member states of Euroland and the lack of consensus of many national parliaments are indeed a noxious cocktail. On top of this came the apparent collapse of confidence in politicians and economic gurus, whose credibility in relation to finding a way out of the sovereign debt crisis is constantly decreasing.

Most market players will continue to harbour uncertainties about the capital markets as long as there is no sign of a clear and potentially successful solution to the problems. **Basically we are dealing not so much with an economic crisis as with a very abrupt escalation of a crisis of confidence. If confidence cannot be re-established, investments will be reduced and economic growth will thus be – at least temporarily – weakened.**

The interests of the big players

It is not only private capital investors who are overtaxed by the complexity of the present situation, also politicians and even whole governments are visibly struggling. For this reason we recommend that to rationally assess the situation it is a good idea to step back and examine the overarching, common interests of the key players. Neither the USA, Europe and Japan, on the one hand, nor the new "power players" China, India, Brazil and Russia have any interest in an escalation of the European debt crisis. On the contrary, the effects of such an escalation on their own economies would be drastic, as exports to consumption-orientated developed countries are a matter of survival. Accordingly emerging markets are piling on the pressure on the leading countries to find a solution and at the same time are holding out the prospect of considerable financial support.

Moreover, countries like USA and Germany continue to claim a leading role in the world or feel an obligation to lead, which they will not surrender willingly. The very clear expectation of the USA that the Europe should speedily adopt the "American medicine" of pumping massive liquidity into the markets in the form of cheap reserve bank money is to be understood in this context. The resistance of the European Central Bank (EZB), which unlike the Federal Reserve (FED) is solely mandated to maintain the value of money and not to maintain economic growth, against this pressure is crumbling. This additional relaxation of monetary policy could contribute, by means of more generous lending by commercial banks, to a firing up of the faltering economy, to ensuring the liquidity of the banking industry and to stabilizing the jobs market and hence consumption. Apart from this, there is not a whole lot more that the FED, ECB etc. can do. This approach is however associated in the medium term with a high inflation risk, which we are already taking into account in our management of the portfolios that we administer.

Astonishingly, the enormous negative impact of a possible recession in Europe, the USA and Japan on the "Middle Kingdom" - China - is little discussed. In China the internal social and political tensions of the country are entangled with and multiplied by the strong dependency on exports to developed industrialised countries. The worries about increased turmoil in China (as a result of the still unresolved debt crisis in Europe) are in our opinion a very plausible and fundamental factor in the considerable market volatility of recent weeks. If the economic motor in China falters, exporting nations will be directly affected. À propos China: In Chinese the character for "crisis" is a combination of the characters for "hazard" and "opportunity."

The pressure on politicians shows the first effects

The pressure on the heads of government to find a solution has shown results in recent days: After the parliaments in Germany, the Netherlands and Finland agreed to increase the size of the EFSF rescue package, hopes of an end to the euro debt crisis in the near future were renewed – and share values too in some cases clearly recovered from their lows. In addition, some leading European politicians expressed cautious optimism about a theoretical leveraging of the EFSF capital stock (note: if the rescue fund was given a bank or insurance license like a normal bank or insurer, it could extend loans or guarantees that were significantly in excess of its own equity capital). Such leveraging would mean that sufficient funds would be available for defending and if necessary bailouts in the Eurozone. However all these bailout mechanisms cannot obscure the necessity of the countries that have got into the firing line (especially large countries like Italy and Spain) of doing their homework and consolidating their budgets. Ireland is proceeding with astonishing success, thus showing that it can be done.

In plain words: We continue to believe that European political system will prevent the collapse of even one large systemically-significant commercial banks with all available means. In this context, we do not exclude the possibility of the nationalization of banks. We are expecting further decisive monetary policy measures in the coming days and weeks to re-establish confidence.

Conclusion

The world economy will continue to weaken in the ongoing quarter and at the start of 2012. However, in our opinion, in the course of 2012, growth will regain the upper hand. As usual, the stock exchanges will be slightly leading indicators. The absolute valuation of many asset classes has now reached a fairly affordable level. In spite of the cooling off of the economy and the resulting profit setbacks, the present values are often significantly below the long-term mean values. This analysis is apparently confirmed by the circumstance that the top managers of leading companies, especially in August, bought their own shares at a rate that was at a 2-year high.

After the major setbacks of recent months, political decision makers will be able to and indeed have to act more decisively. We admit that we were surprised by the extend and the speed of the tumble in equities and commodities. However our valuation of value stocks, corporate bonds, precious metals and commodities remains unchanged. In our view, these investments remain the key elements in asset allocation. Precious metals and gold mines continue to form a stabilizing element. In view of the doubtful stability in value of the dollar and euro, and the latent risk of inflation, we are not about to surrender "a single gram". Savings accounts, money market investments and high cash balances, and even government bonds are not long-term alternatives for the strategic investor nor are they "safe harbours", as these will be especially exposed to insidious inflation and the claimed security must be "paid for" by a permanent loss of purchasing power.

Rest assured that we will continue to manage your assets with a steady hand and a profound understanding of the workings of the economy even in phases of great uncertainty. We would like to thank you once more for the confidence you have placed in us and will be glad to provide more detailed information and to discuss any issues.

Uwe Günther Sven Marzahn

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