Review of 2010 and capital market outlook

The preeminent topic of 2010 was the unprecedented rescue effort by many governments and their central banks to save member states of the European Union from financial collapse. The banking crisis, financial crisis and fears of recession of 2009 appeared to have been forgotten until, at the beginning of last year, the periphery of Europe was plunged into a debt crisis resulting in renewed fear on the capital markets. The result was a dramatic devaluation of the euro; its exchange rate fell against nearly all important currencies. In the middle of the year, an initial EU **rescue package of 750,000,000,000.00 euros** then had to be put in place at short notice; as yet only Greece and Ireland have made use of it. Portugal, Spain and Italy are facing a similar fate. The USA (over 14 trillion dollars of debt) and Japan (debts of over 200% of GDP) have also built up huge deficits, which severely restrict the scope for further stimulus programs.

What solutions did the industrialized nations find to address these problems? Nothing particularly original. By providing liquidity to the commercial banks through the American Federal Reserve (FED) and the European Central Bank (ECB), at interest rates near zero, they attempted to boost lending and thereby stimulate the economy. At the same time, the central banks bought up billions of bonds every month in order to keep interests rates at an investment-friendly, artificially low level and to supply the markets with further liquidity. The success of this policy has been modest so far and it has succeeded neither in resolving the serious problems faced nor in eliminating the existing risks. Debt financed economic stimulus measures have only been partially successful and recovery has so far not been self-sustaining. The European Union probably still has the real test of its mettle to come in 2011.

By contrast, emerging countries such as China, India, Brazil, Indonesia and South Korea have been marked by significantly lower public debt and ever stronger domestic demand. Previous problems, such as corruption, weak infrastructure, anaemic domestic consumption and excessive budget deficits seem to have been consigned to the past. The shift in global economic power relations is continuing in striking fashion. This process is irreversible and must have direct consequences for strategic investment decision making.

In complete contrast to the desolate state in which many national budgets find themselves, international stock market valuations and raw materials prices have repeatedly reached new highs over the same period. This apparent contradiction can be explained very readily, however, if investor motivation is examined more closely. A further consequence of horrific levels of borrowing is the real risk of rising inflation. Thus it makes economic sense to switch to investments with true capital and material value. In addition, a very significant proportion of the liquidity that the commercial banks are currently receiving from the central banks (see above) is not being used for lending but is instead being directed into investments with higher potential returns and supposedly lower risks. Higher prices for industrial and precious metals, higher share prices and bullish investments in emerging economies are the visible signs of this.

Outlook for 2011

1. In 2011, the capital markets will have to navigate between the risks of the still smoldering debt crisis and the development of a property bubble in China on the one hand and high worldwide liquidity looking for attractive investment opportunities on the other.

2. Continuing increases in the price of raw materials and rising wages will ensure that inflation will also return as an issue in the medium term.

3. The mood in the economy and for the development of the stock market as a whole is "too positive". This represents a significant underlying risk.

4. As a result of specific European debt problems, the euro will remain under pressure. The future development of exchange rates will depend largely on the approach to the debt crisis and the success of the approach taken. In the short term, it is possible that the dollar will again be strong against the euro.

5. The money thrown at the market by "Quantitative Easing II" in the USA (a programme for buying back bonds) will be looking for investment opportunities and will continue to stimulate share and raw material prices as well as currencies and shares in growth regions. This conceals the direct risk of further "investment bubbles" in the target countries and investment currencies, which could have significant consequences should they burst.

6. The linked, parallel rise in interest rates in the US and Eurozone since the middle of 2010 will continue at a moderate pace. The previous interest rate lows of 2010 will not be seen again. But investors have reason for caution: this brings with it the risk of price losses on long-term bonds.

7. China will continue to attempt to control the risks of its already inflated property bubble. The question here is whether the Chinese central government will be able to put a gentle brake on growth through further interest rate rises. The outcome of these measures will be one of the prime factors influencing the development of the world economy.

8. With few exceptions, government bonds from industrial nations no longer represent an alternative form of investment and have an unattractive opportunity/risk profile.

9. The biggest profits from shares and bonds are behind us in the shape of the gains over 2009/2010. From an opportunistic point of view, the focus should now be on increased liquidity and a sufficient proportion of shorter-term investments, to provide the opportunity to buy "cheap" during any future market slumps.

In summary, for 2011 in particular we would like to remind our investors of advice given by the investment legend Warren Buffet:

"**Try to be greedy when others are fearful and fearful when others are greedy.**"

We would now like to present our market forecast of the winning and losing strategies for 2011.

Chances

- raw materials - in particular precious and industrial metals as well as agricultural raw materials
- shares - in particular in Germany and emerging economies, dividend orientation
- property - in particular international real estate investment trusts
- financing - if necessary securing building loan finance
- corporate bonds - in particular subordinated securities from good debtors and international High Yield Bonds

- foreign currencies - in particular the Brazilian real, Turkish lira, Indonesian rupiah, British pound
- accumulating inflation-indexed bonds, floaters and structured notes
- building up sufficient liquidity to be able to act in the next recession

Risks

- government bonds, in particular from European debtors
- corporate bonds from top debtors: hedging profits
- hedging or selling Japanese Yen and Swiss franc investments
- do not overestimate the importance of China in 2011
- undervaluing industries such as banking and automotive manufacturing

Conclusion

In many respects, 2011 will be a year when the truth hits home. Whether it's the future course of the Eurozone or overcoming the risks of a Chinese real estate bubble, addressing debt problems in the USA and Japan or preventing the use of exchange rates as an economic weapon - there really are plenty of risks and challenges.

Our primary goal, therefore, is to lead you, our valued investors, safely through the coming turbulence by acting responsibly and with foresight. The risk of significant setbacks is not inconsiderable. To achieve attractive yields, investors must be willing to accept the increased risk of fluctuations. Precisely for this reason, our top priority is rational and broad diversification, together with a focus on yields and capital assets. The good news is that a range of excellent investment opportunities, satisfying these criteria, still exist.

In 2010 we were able to achieve asset growth that was significantly above average, given the risk tolerance and targets involved, and we are proud of this fact. In 2011 it remains our aim to achieve outstanding results through careful analysis and far-sighted decision making. We would like to thank you for your trust in us and we look forward to continuing to work with you.

Uwe Guenther Sven Marzahn