Market Commentary December 2012

„You must spread your view steadily in order to understand the world; you must descend into the depths if the essence of reality is to show itself in you."

Friedrich Schiller (* 1759 , † 1805)

"The shepherd always tries to persuade the sheep that their interests and his own are the same."

Stendahl, writer (* 1783, † 1842)

We would ideally end 2012 the way every year should be ended, with all tasks, problems and uncertainties brought to a close and a "clear desk" ready for the new year. We are further away from this goal than ever before as regards the international policy and capital markets. As reliable forecasts are in short supply, asset management must continue to adapt.

A dramatically long list of economic oddities and astounding facts has been sufficiently documented in the media, and in varying levels of detail. The media coverage of this tangle of economic connections and interdependencies is being further compounded by the political interests of individual groups and states.

We will spare you, and ourselves, yet another rehashing of the individual details. Instead, this commentary will take a very conscious step back and shed light on the impact the current situation is having on the actual options available to investors in a number of situations. Psychologically, the present situation is an extremely challenging one for many investors. The flood of banknotes issued by the central banks is driving up the prices of real property, equities and bonds, in many cases to absurd extremes. The correct signals are being given off – the prices are rising, after all – but these increases are largely down to unbacked promises made on the basis of newly printed paper money, a fact that is often left out. But one thing is for certain. It is not "all different" this time either, and the laws of economics cannot be switched off forever...

Bond markets

Against a backdrop of exploded government debt, largely negative real interest rates and a massive increase in default risk, the "bond bubble" continues to swell, even in the "safe-haven countries". In real terms, this means that investors are taking on considerable inflation and credit risk interest-free, and paying for the privilege! Thanks to the well-known measures taken by the central banks, this situation may remain the same for a while, but it cannot be sustained in the long term. We entirely agree with the opinion expressed by an increasing number of leading economists, that ***"it is no longer a question of whether the bubble will burst, but when".***

But what does this really mean for investors? Primarily that prices on the politically distorted bond markets may approach fair value within a very short period of time, and will probably fluctuate dynamically in the process. The danger comes from two directions; both more realistic market interest rates and more realistic credit ratings could trigger significant price drops in bonds. If existence (see Schiller quotation) is unambiguous, i.e. the facts speak for themselves, it is not essential to make predictions about the specific causes of this kind of dynamic.

What can I do? We like to keep things simple, so...:

- Steer clear of fixed-income investments that guarantee a real loss at the time of investment.
- Realise capital gains in cases where a real loss on final maturity is guaranteed.
- Find out about ways to hedge so-called interest-rate risk and credit risk.
- Learn about alternatives and special situations, e.g. involving subordinated bonds and currency bonds. Send us or your bank advisor on a bargain hunt...
- Spread your investments as globally as possible.

Equity markets

Equities are a traditional asset that belong in every portfolio. However, there is cause for concern when, for example, only 10 of the 500 equities contained in the S&P share index are responsible for 90% of performance in the USA in 2012, 7 of which are banks! The situation is similar in many other countries, with liquidity being hoarded rather than invested. Many companies are going to red alert. In many places, trading margins are still far above their historical averages and therefore leave no room for positive surprises; quite the opposite, in fact. However, it should be the future expectations that drive equity markets, not the current situation. With unemployment rates of over 25% in Southern Europe, real wages stagnating or falling worldwide and 40 million on food stamps in the USA with its debts of over 17 trillion. This list could go on forever. Where is the consumer boost needed to get the economy back on track going to come from?

What does this mean for investors? In the long term, equities are a must, but they require a fundamental and realistic analysis of future trends. There is no way around an increase equity allocations, even for insurance and pension funds. Particular caution is required in times where certain countries (e.g. Germany) are attracting cautious investors and positive market trends are largely driven by liquidity. Overindulgence in liquidity can all too quickly lead to a "hangover" situation; the central banks cannot keep printing forever.

So, what can I do?

- Give preference to international companies with low <u>uncovered</u> pension liabilities and healthy balance sheets.
- International companies with strong market positions are better able to increase their prices in times of rising inflation. Be sure to take note of this!
- The ability to pay dividends from current profits on a sustainable basis is key.
- You must always ask yourself where in the world real economic growth is occurring, as that is where you should be, too.
- Be critical of your own intuition; if a company's *<u>name</u>* is well known, this does not necessarily mean that you have to purchase shares in it.
- It is much harder to purchase assets today than it has been over the last 50 years! Delegate your asset selection to sub-market specialists. As an asset manager, we do this on a constant basis wherever necessary.

A final word must be reserved for **liquidity**, which is more important now than it has ever been. We would keep this portion of your assets at a significantly increased level, whether via account balances, via short-term bonds in hard or reserve currencies or via physically backed precious metals.

Conclusions

We would like to conclude this market commentary in the form of a letter echoing what many of our clients have stated in numerous meetings over the last few months:

BPM BERLIN PORTFOLIO MANAGEMENT

Dear central banks and governments,

Yes, we get it. You are firmly committed to inflating away problems at the expense of citizens in a way that benefits your over-indebted budgets while keeping interest rates persistently low. This constitutes state-sponsored dispossession of broad sections of the population. Against all economic sense, you have chosen to continue to ignore market mechanisms in order to avoid having to revisit political decisions that have already been made. In your attempt to make asset owners feel subjectively richer, and perhaps to stimulate the ailing economy with increased consumption, you are allowing bubbles to form. This is a dangerous game! Of course, infrastructural measures, training schemes and labour market reforms all cost time and money, so they don't look good in an election campaign. However, you can also rest assured that we will not sacrifice our own interests on the altar of your political ones!

From the whole BPM team, we wish you a happy festive period! We hope that you stay healthy and optimistic despite the challenges you face, or perhaps even as a direct result of them.

We look forward to continuing our partnership and contacts with you in 2013!

Uwe Günther Sven Marzahn