BPM Berlin Portfolio Management

Market Comment June 2011

On May 31, 1911, exactly one hundred years ago to the day, a memorable event took place: the celebrated launch of the RMS Titanic. On April 15, 1912, just 320 days later, the ship sank during its maiden voyage after colliding with an iceberg. What does this tragedy have to do with the current global economic policies and modern asset management practices? Let's start by dismissing the doomsday warnings: there is no impending downfall of the global financial system. But there are similarities: irresponsibility and a lack of foresight played decisive roles in the tragic fate of the Titanic. The people making the decisions on land and on board let greed get in the way of rationally analysing chance and risk despite knowing better. As asset managers today, it is our duty to weigh the known factors prudently, to protect the assets entrusted to our care.

The number of known pros and cons has, surprisingly, changed little in recent months. The expectations and prognoses found in our annual outlook are still up to date. The details in the strategic lines of development have, of course, been substantiated and supplemented by current facts and figures. We cannot, unfortunately, offer a more optimistic outlook, as most of the profits from the current stock market upswing are believed to have already been made.

A summary of main points:

In 2011 enormous amounts of money have flowed into the global stock markets, resource markets and real estate markets under the influence of the still more than sufficient supply of liquidity provided by the central banks. The net result is an increase in prices in these markets more or less across the board. The actual goal of the policy, developing a self-sufficient economic upswing and the sustained consolidation of the banking system, has not yet been achieved.

On the contrary: gigantic "misallocations" of vagabond capital streams led to additional pitfalls for which not even the approach to a solution can be seen.

1. The emerging countries, for example, which were still a stabilising factor during the crisis, are increasingly suffering from the billions of dollars that were speculatively invested in these countries and that are fanning the danger of inflation.

2. Countless gigantic modern ghost towns financed by the government have sprung up in China that cannot attract inhabitants or users.

3. Increased resource costs have led to a reduction in sales for countless companies and these increased costs cannot be compensated for with higher prices. Poverty is becoming more widespread in many parts of the world due to increased food prices.

4. The capital flowing into government bonds thought to be "absolutely safe" is artificially keeping the returns for these government bonds low and allowing numerous countries to continue increasing their dangerous debt levels under inexpensive conditions without having to pay a fair market price (= interest) up to now.

5. Bailout funds are financed with tax money and without sufficient securities and reciprocations within the framework of the EU umbrella, thereby creating lasting and permanent damage to the financial power and leeway of many countries.

6. The entire world is talking about Greece. To get straight to the point: The future of the euro will not be determined in Greece, but rather in Ireland. The European financial centre in Ireland is much more significant with regards to the stability of the financial markets than small, heavily indebted Greece. The euro is being rescued as a common currency in Ireland. With Greece there will be no way around debt forgiveness or debt relief. The timeframe for this will (unfortunately) be widely determined by politicians, so as to prevent the writing-off of billions at the major banks in the fragile economic situation. This can gladly be discussed in greater detail in person.

One could say: So what? It's worked so far!

We would gladly share this view if it weren't for these three major problems:

A. The financial leeway for governments and central banks is, unfortunately, finite. At the very latest there will be substantial market reactions once the citizens are no longer willing to tolerate the financing of spending programs or once the debt reaches a level that makes it impossible to obtain additional credit due to a lack of creditors (bond buyers). As history has often shown, smaller events, such as the downgrading of an important country's credit rating or the collapse of an important bank can be catalysts for such events. As a result investors flee and a chain reaction becomes probable.

B. A decisive factor in human economic activity, namely consumption, has not been kick-started despite the enormous economic stimulus programmes. On the contrary: It has continuously fallen in the major industrial nations for years. This is also quite true in modern "economic miracles" like Germany. Strong growth in company profits (which we are seeing all over the world!) should normally lead relatively quickly to higher employment and, in particular, to noticeable growth in wages. And this is exactly what is not happening!

C. We should always remind ourselves that stock markets anticipate actual developments by several months. Considering the fact that the economic stimulation (even if based on credit) is expected to continue, the stock markets are currently reflecting very positive developments in the near future. In our opinion the actual problems are not properly accounted for in terms of pricing. This is not abnormal during upswing phases. To put it bluntly: At the moment the potential for pleasant surprise in the future is much lower than the potential for disappointment.

We expect the economic figures in Europe to remain positive overall into the third quarter. After this point, however, the awareness of the results of the start of an unavoidable liquidity shortage is expected to increase. Since we are talking about a relatively short time period of just a few months, we are already advising that a defensive position be retained.

We consider the threefold strategic approach at BPM to be corroborated in full and continue to recommend:

- High, continuous yields from various bond classes, including bonds with floating interest rates, convertibles, high yield currency bonds and bonds with custom designed coupon
- Higher proportion of commodities and precious metals (the better money)
- The use of mixed forms of bonds and stocks (hybrids) in order to benefit from the advantages both forms of investment have to offer.

Substance stocks and top values from emerging countries are strategically necessary additions, even if intermediate fluctuations can be nerve-wracking. Government bonds and economically sensitive investments should be underweighted now, as there are hardly any attractive options available. Inflation will be an important subject in the medium term, as nations, unsaid, would like to "inflate away" some of their escalating debt by this means.

We are certain that, with a steady hand and strategic outlook, we will be able to achieve an attractive performance in the second half of the year, as well. And we will ever keep in mind that the biggest gains are to make if the majority of the investors gets into panic or fear. But Titanic's Captain Edward John Smith's fateful decision to ignore the risks and warning signs is exactly what we will not do.

We also wish to express our thanks for the trust that has been shown to us, as well as for your recommendations to others. We are available for personal discussions with you at any time.

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