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Wealth Management News Q4 2011

Quarterly Information for US clients

Overview

Fixed Income
Due to increased recession fears interest rates have declined significantly in recent weeks. Since inflation expectations remain high particularly in the United States and the UK, this has led to severe mispricing of US and UK government bonds. Real interest rates for 10-year government bonds in the UK are now below zero, which implies that the UK would not grow over the next ten years while at the same time investors expect no risk of default for the UK over the next ten years. This is clearly contradictory and can only be resolved with higher interest rates in the coming months. In the United States the situation is similarly extreme with ten-year interest rates now well below the troughs during the crisis of 2008 and real interest rates below 0.3%, which indicates similarly contradictory market expectations as in the United Kingdom. In Europe meanwhile interest rates for highly indebted countries like Italy and Spain have increased dramatically. Since the latest rescue package of the EU for Greece does not help these countries and central bank interventions so far remain limited, we don’t expect this stress to calm down anytime soon.

Equities
Due to the increased concerns about an economic slowdown and the huge government debt in the United States and Europe, equity markets sold off heavily in late July and early August. At the time of writing the demand for central bank intervention is getting bigger and another round of quantitative easing by the US central bank Fed seems more and more likely. We think that renewed central bank intervention could cause a short-term rally in equity markets which could last several weeks since markets at the moment are heavily oversold. However, since corporate earnings will likely continue to slow and economic growth is likely going to be subdued into 2012 we are still convinced, that we have just entered the first stage of an equity bear market that is going to last well into 2012. Thus, for the next six to twelve months we expect equity markets to remain volatile and trend more or less sideways. Investors are advised to keep lower than normal equity allocations in their portfolios.

Alternative Investments
The announcements of the US Federal Reserve system to keep interest rates at exceptionally low levels at least until mid 2013 is long-term positive for gold, since this means that real interest rates are going to remain low or even negative in the coming two years. In the short run, gold is rather overbought though which does make it vulnerable to a significant setback. We recommend selling some gold positions when gold prices drop below 1’650 USD/oz. and sell all gold if it drops below 1’500 USD/oz. (stop loss). However, at the moment we think it is unlikely that gold will decline to such low levels. For other commodities, our subdued economic outlook makes us more skeptical of the asset class and we do not recommend buying into this asset class at the moment.

Tactical Asset Allocation	USA	Switzerland	Eurozone	UK	Japan	Overall
Money Market						3M: ↗ 12M: ↗
Bonds	3M: → 12M: →	3M: → 12M: →	3M: → 12M: ↘	3M: → 12M: ↘	3M: → 12M: ↘	3M: → 12M: ↘
Equities	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘
AI:						3M: → 12M: →
- Precious metals						3M: ↗ 12M: →
- Commodities						3M: ↘ 12M: →
- Real Estate	3M: ↘ 12M: ↘	3M: → 12M: →	3M: → 12M: ↘	3M: → 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘

Source: Wellershoff & Partners

The Dynamic Asset Allocation of Kaiser Partner

The strategic asset allocation decision, i.e. the decision which part of your wealth to invest in stocks, bonds or other assets, is generally considered to be the most important investment decision. It surprises us again and again, how little thought is given to this decision by investors and banks alike. Typically, a balanced investor will be invested in 50% bonds and 50% stocks, no matter whether interest rates are low as they are today or high as they were twenty years ago. But high and low interest rates have a significant influence on the returns that can be achieved not only by bond investments but also by other asset classes like stocks or real estate.

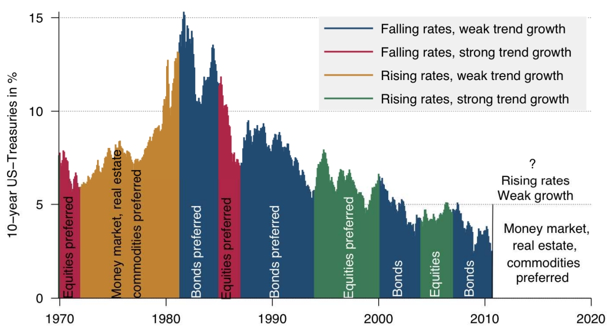
In fact, we are convinced that interest rates and the long-term average growth of economies are the most important drivers of investments. After thirty years of declining interest rates around the world, we are facing again a watershed moment. Interest rates are very low or practically zero in most developed markets like the United States, the UK, Germany or Switzerland. This means that interest rates will not continue to fall for another five or ten years. Instead it is highly likely that interest rates in a few years time will be significantly higher than today.

At the same time economic growth should slow down in developed economies like the United States but also in many emerging markets like China. This is mostly due to the effects of an aging society that are slowly but surely going to erode the potential for growth in the Western World. Because our world is changing we believe that a traditional approach to asset allocation is going to disappoint investors in coming years. In fact, if interest rates are going to increase and economic growth remains weak, this will lead to significantly lower returns for stocks and bonds but higher returns for real assets like real estate or commodities – a development that we have observed time and again during the last 40 years.

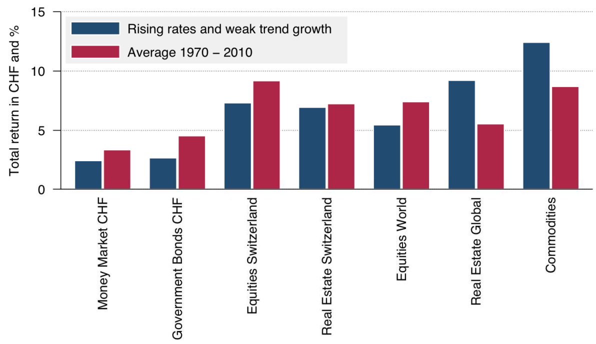
Thus, we at Kaiser Partner adapt our portfolios dynamically in such a way that they are geared towards the predominant economic regime over the coming years. At this point in time this implies fewer stocks and bonds in our portfolios for the coming years but more real assets that protect investors from inflation and provide solid cash flows even in difficult times. If in the future times may change and economic growth might accelerate or interest rates might start to fall for a long time, we would then adapt the overall asset allocation accordingly.

This way, the dynamic asset allocation approach of Kaiser Partner provides you the right portfolio at the right time so that your wealth is protected against excessive and unnecessary losses. Because if one can see that interest rates are not going to fall much further in the future, why invest in a portfolio that will inevitably disappoint investors when they start to rise again?

Market regimes in the past



Asset class returns in times of rising rates and weak growth



Source: Thomson Financial, Wellershoff & Partners

Our Long-term Outlook: Rising Interest Rates and Weak Trend Growth

Interest rates are not going to fall much further

Interest rates have declined for the last thirty years since the forces of inflation were tamed at the beginning of the 1980s. This has led to significant backwinds for most asset classes. Due to the latest financial crisis short-term interest rates in the United States, the UK, the Eurozone or Switzerland are close to zero and central banks are increasingly struggling to find effective means to stimulate a still fragile economy. Long-term interest rates are also at the lowest levels in more than 150 years globally so that it seems safe to say that interest rates are likely not going to decline much further.

Scenarios for the future developments of interest rates

But just because interest rates are low, there is no need for them to rise. So why do we believe that in the coming years interest rates are going to rise on average?

First, we see the reaction of the central banks on highly indebted nations like the United States or the UK where more and more money is printed to support the economy and relieve banks and households from their losses of the last financial crisis. Currently this newly printed money has little effect, but in the long run it will increase inflation if the money is not withdrawn from the economy in time – something that is very unlikely to happen, because it would likely lead to another severe recession in these countries. Thus, the anglo-saxon countries are facing increasing inflationary pressures, which will lead to higher interest rates since investors demand compensation for this future inflation.

In other countries, inflation is not the main problem, yet, but in order to pay back debt, they are currently forced to save and balance their government budgets. If these countries cannot save enough in time, investors start to fear that existing debt may not be paid back. The result are rising interest rates because investors want to be compensated for the risk of default inherent in even the safest investments like government bonds. This is exactly what is happening to southern European countries like Greece, Portugal or Italy today and is likely going to affect other highly indebted nations like Japan in the future as well. There are very few countries like Switzerland left that have little debt, little inflation and solid government finance. The problem is that these are small economies that depend largely on the developments in their neighboring countries and main trade partners. Thus, the increasing problems of the Eurozone will also increasingly affect Switzerland, just like Canada will increasingly be affected by the problems of the United States and so on. Overall then, it seems unlikely that there will be sufficient hiding spots form the global trend of rising interest rates.

Growth is not what it used to be…

We also believe that economic growth in the next decade is likely going to slow down compared to the last decade. This is due to four main long-term influences:

- The massive debt that has been accumulated in western countries needs to be reduced if these countries do not want to risk default and a massive economic disaster. This can be done either by reducing government expenditures (e.g. for retirees or defence), increasing taxes or higher inflation. All of these measures have shown to lead to slower economic growth for at least a decade if not longer.
- As emerging markets are developing, less and less growth can be achieved in these places and thus, they are less and less able to compensate for slower growth in developed markets. This is so because it is relatively easy to grow an economy if it is very underdeveloped. But once every household has a car and a color TV etc. it becomes more difficult to add something new to the household that effectively adds value and creates growth.
- Globalization also leads to the immediate spread of new technology. Today, any new invention, any gain in productivity can immediately be applied all around the world. Thus, it becomes increasingly difficult to get an advantage as a nation through innovation, since other nations can copy a new technology in short time and catch up with the innovator.

All in all, these are the main reasons why we are convinced that the next years will bring rising interest rates and lower economic growth. It is time today to prepare for such environment.

Focus: Economy

It becomes increasingly obvious that consumption is slowing down in all developed markets except Germany and Switzerland. Even in China consumption is showing signs of deterioration. While it is currently impossible to say whether these developments are going to lead to another recession, it at least confirms our view of a normalizing economy where growth in the United States and the Eurozone (with the notable exception of Germany) will be below average in the next twelve months. In the United States in particular, growth dynamics show signs of deterioration. This led the chairman of the Federal Reserve Ben Bernanke to announce that interest rates are likely going to remain exceptionally low for another two years. This announcement shows again that the central bank in the United States is adamant about keeping real rates low to stimulate economic growth and job creation even if this growth comes at higher inflation in the long run. In our view the Fed is misguided in the assumption that lower interest rates will be successful in creating jobs in the United States. We think that at interest rate levels close to zero traditional monetary policy measures become ineffective because the central bank neither can force banks to lend more money at even cheaper conditions to businesses nor can they force business to borrow more money at low rates if they fear inflation and higher interest rates in the future. Overall then, we continue to expect further inflationary pressures in the United States and the United Kingdom where the central banks are already far "behind the curve", i.e. the current interest rates are well below the interest rates necessary to stabilize the economy at its current state. Even though in the coming months we expect inflation to calm down again due to lower commodity prices, lower consumption growth and less investment growth we still calculate a "neutral" money market rate in the UK of 8 per cent and almost 4 per cent in the United States.

Currency markets on the other hand remain driven by psychological factors and the ongoing news flow about the crisis in the Eurozone and the political gridlock in the United States. Over the last three months the Euro has gained roughly 5 per cent vs. the US Dollar, while the Swiss Franc has gained significantly vs. both the Euro and the US Dollar. Overall, this development has increased the already significant overvaluation of the Swiss Franc and led the Swiss National Bank to actively engage in weakening the Swiss Franc. While these measures have led to some first successes we believe that further measures will be taken by the Swiss National Bank and a further weakening of the Swiss Franc is likely in coming months.

Currency Outlook	**vs. USD**	**vs. CHF**	**vs. EUR**	**vs. GBP**	**vs. RUB**	**vs. JPY**
USD		3M: ↗ 12M: →	3M: → 12M: ↘	3M: → 12M: ↘	3M: → 12M: ↘	3M: ↗ 12M: ↘
CHF	3M: ↘ 12M: →		3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: ↘ 12M: ↘	3M: → 12M: ↘
EUR	3M: → 12M: ↗	3M: ↗ 12M: ↗		3M: ↘ 12M: ↘	3M: → 12M: →	3M: → 12M: →
GBP	3M: → 12M: ↗	3M: ↗ 12M: ↗	3M: ↗ 12M: ↗		3M: → 12M: ↗	3M: ↗ 12M: ↗
RUB	3M: → 12M: ↗	3M: ↗ 12M: ↗	3M: → 12M: →	3M: → 12M: ↘		3M: → 12M: →
JPY	3M: ↘ 12M: ↗	3M: → 12M: ↗	3M: → 12M: →	3M: ↘ 12M: ↘	3M: → 12M: →	

Macro Forecasts	**USA**	**Switzerland**	**Eurozone**	**UK**	**Russia**	**Japan**
Real GDP Growth 2011 (2012)	1.7 (1.5)	1.5 (0.5)	2.1 (1.5)	1.2 (1.2)	4.0 (4.0)	-1.0 (0.5)
Inflation 2011 (2012)	2.8 (2.5)	0.6 (0.8)	2.4 (2.0)	4.4 (3.2)	8.5 (7.5)	-0.2 (0.5)

Source: Wellershoff & Partners

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