PRIVATBANKIERS
REICHMUTH & CO
INTEGRAL INVESTMENT MANAGEMENT

CHECK-UP

CLIENT INFORMATION OF PRIVATBANKIERS REICHMUTH & CO, INTEGRAL INVESTMENT MANAGEMENT

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EDITORIAL

The financial system is stable for the time being, and the global economy has overcome the recession. For this, we have to thank the aid packages implemented by states and central banks. These reached their objective, namely to save the financial system.

One year on from the financial crisis, we see this less as a storm and much more as a precursor of a change in climate in the financial world. What consequences will the rescue measures have in the new decade? We cover this subject in this issue of Check-Up, yet we know that threats always come from unknown developments. Therefore, it is crucial to constantly review assumptions, keep the principle of diversification paramount, and make the necessary changes.

Exciting years lie ahead of us. We are looking forward to them, and would like to take this opportunity to wish you and your families all the very best for the New Year!



Jürg Staub
General Partner

CLIMATE CHANGE ON FINANCIAL MARKETS

LONG-TERM CONSEQUENCES WILL BE NOTICED

The sharp rise on financial markets from the low in March is one of the pleasing side-effects of the measures doled out in heavy doses to rescue the financial system. Practically all asset classes have been able to profit from this. The high price of gold is also a direct consequence of the massive money printing on the part of all central banks, reflecting the increasing skepticism with regard to the sustainable intrinsic value of paper money.

Wide range of long-term consequences

20 years after the Iron Curtain fell, the pendulum of free capitalism and globalization has reached the turning point. We have no doubt that the developments of recent years will lead to fundamental changes not only in the financial world, but also in the real economy and society as a whole. Below we focus on the possible long-term consequences for you as an investor.

1. Higher state debt and higher taxes

The worldwide increase in government debt is not just a consequenc of the massive rescue measures. It would have risen further in any case given that many countries were already showing deficits beforehand. Added to that, there are enormous social security commitments that states have promised their citizens, but which are not financed in most countries (with the exception of Switzerland and the Netherlands). As the baby boom generation reaches retirement age over the coming decade, these promises will increasingly have to be honored. Added to that, healthcare costs are rising inexorably. The costs of government debt arising from consumption spending are borne by future generations. The big question is: how can state budgets be brought back onto an even keel in such an environment? In our view, higher taxes seem unavoidable in the countries affected.

2. Poorer underlying conditions

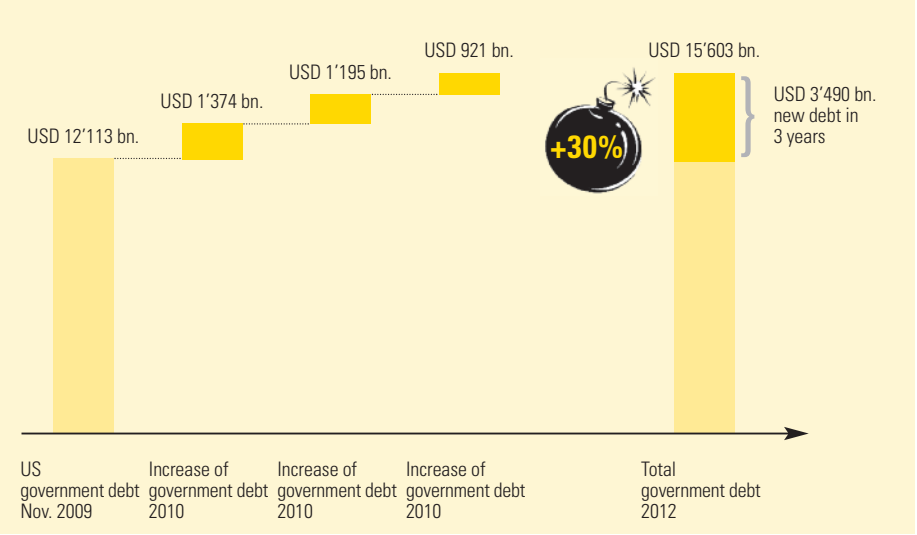
He who pays the piper calls the tune. The state rushed to provide aid, now the citizens expect that it has a say in matters and that something changes. Therefore, increased state interventions in the economy are on the cards - not just in the financial sector. However, regulation cannot prevent crises, as clearly illustrated by the financial crisis that broke out in the highly regulated banking sector.

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WHO SHOULD BUY ALL THAT NEW US DEBT?



Source: own graph, data of the Treasury, US budget

The threat of increasingly protectionist tendencies and more difficult access to capital will lead to less rapid improvements in productivity and thus to lower growth. This will not mean an end to globalization, but the long-standing increase in labor distribution and the resultant drop in goods prices are likely to be put to the test afresh. We expect lower real growth in the industrialized nations and rising prices for goods and services in the new decade.

3. Heightened depreciation race

Across the globe, at present there is no country that wants to have a strong currency – Switzerland included. In periods of crisis in particular, countries yearn for a weakening in their own currency to improve their competitive position. Tension is seething on the currency front. A correction in the imbalances between the US and Asia is overdue. In Europe, too, the calls from the export industry are getting louder as it suffers at the hands of the expensive EUR. The currency depreciation race is entering its next stage.

4. Shift in power to Asia

The Asia crisis was more than ten years ago. Today, Asia – with the exception of Japan – has no debt problems anymore. It also does not have the burden of non-financed pension schemes. This backdrop, coupled with motivated and well educated people, drives home the fact that a shift in power in the global economy from West to East is inevitable for many years.

5. Higher inflation

Inflation is measured ex post. As long as unemployment is high and there are large overcapacities, the inflation figures will still remain low. However, the mountain of debt is growing – the Western world has a debt problem. This could be solved by halving all debts and raising interest rates. This would be cash flow neutral, and the excessive debt burden would be gone. Unfortunately, the entire banking, insurance and pensions industry would then be bankrupt. Therefore, this is inconceivable. The same goal can also be achieved with inflation. For the high-debt countries, the US and the UK, inflation therefore strikes us as the only system-compliant way out. Cancelling debts, rescheduling or a radical reduction in pension commitments are less likely. As soon as the overcapacities have been reduced and unemployment falls somewhat, there will be inflationary trends in the US first of all.

6. Higher interest rates

Long-term interest rates are what worry us most. Given the large new debt taken on by governments, we expect long-term yields to rise, with short-term interest rates being kept low for the time being. Our expectation here is based above all on supply and demand considerations. When a lot of vegetables come on the market in summer, prices fall. Hence, if the Fed does not again finance the high debt taken on by the US government by printing money, the prices for the vegetables (i.e. long-term US Treasuries) will fall, and yields will rise. This will be noticed across the globe. A keen eye will have to be kept on these developments. A rise in yields at the long end means lower asset values, given that if yields rise, so does the capitalization rate, and, as a result, the earnings multiples, e.g. the price/earnings ratio.

Expectations for the new decade

In the new decade we must therefore be prepared for a fundamentally new environment. Large states' overconfidence in their own power and less stable basic conditions will pose a challenge for people in general and investors in particular. The focus is on protecting assets from confiscation or expropriation, and on being ready in good time for an environment with rising interest rates and inflation rates. Only toward the middle of the next decade do we expect to see an end to the highly volatile 20-year-long sideways trend on the Western stock markets. Interest rates are then likely to be higher, the stock markets cheaper, and the outlooks better once again.



Christof Reichmuth
General Partner

THE BIG PICTURE
OUR SCENARIO ANALYSIS IN A NUTSHELL

CONSENSUS	STAGFLATION	FISCAL CRISIS	GROWTH
The financial crisis is over, the economy begins to recover slightly and the central banks remain expansionary until 2010. This leads to new asset value bubbles. State deficits remain extremely high. Inflation remains low due to overcapacities and unemployment.	The extremely expansionary monetary policy of central banks undermines confidence in the sustainable value of money. The economy stages a nominal recovery, yet real growth remains close to zero. Given the high supply of government bonds, long-term interest rates rise while short-term rates remain low. Unions demand higher wages, and this gradually leads into an inflationary spiral.	No recovery for the economy, and new aid packages are put together. Government debt grows quickly. Fears emerge of state bankruptcies of individual countries and a USD currency crisis. Current account imbalances remain high, and the currency reserves of surplus countries rise to an unsustainable level. Capital controls, rescheduling, and protectionism re-emerge.	The financial crisis is definitely over, and the economy stages a better-than-expected recovery thanks to the aid packages of the states and central banks. The central banks absorb the excess money supply in good time. There is only modest inflation for the time being.
INVESTMENT IDEAS Blue chips Emerging markets Commodities Gold, silver	INVESTMENT IDEAS Inflation-linked bonds Stocks with high dividend yields and low P/Es Stocks with favorable long-term debt financing and high intrinsic values (e.g. real estate stocks) Gold, silver	INVESTMENT IDEAS Cash in home currency Government bonds only in a first phase, thereafter no more exposure to Treasuries Stocks that pay stable dividend stocks Real estate in stable countries Real physical assets Gold, silver	INVESTMENT IDEAS All types of equities, above all capital goods producers Emerging markets Inflation-linked bonds
High Yield Spreads: 600 bps	High Yield Spreads: 500 bps	High Yield Spreads: 1500 bps	High Yield Spreads: 300 bps
Probability 6 months: 50%	Probability 6 months: 40%	Probability 6 months: 5%	Probability 6 months: 5%
Probability 18 months: 20%	Probability 18 months: 50%	Probability 18 months: 20%	Probability 18 months: 10%

RECOMMENDATIONS FOR 2010
ADJUSTED IN LINE WITH INDIVIDUAL NEEDS

Money market and bonds – to smooth out fluctuations

Bonds and money market products have little appeal, but they reduce volatility in a portfolio. We advise holding the liquidity required for the next 2 years in cash, and investing the remaining fixed-income exposure in bonds with maturities of 2-4 years. Although these offer low yields currently, at maturity yields for the new investments are likely to be higher. Over and above this, we recommend selected inflation-linked bonds, although it is important here to keep an eye on the currency – i.e. to hedge the USD, for example.

Equities– to generate income and performance

Over the long term, equities should yield around 7-8% per year. At present, there are large cap and liquid stocks to be found that offer dividend yields of around 3-7%. This strikes us as being still attractive for generating income and performance. The dividend alone already brings in half of the hoped-for return. Furthermore, Asia is in a structural uptrend and is therefore more attractive over the long term than the US and Western Europe.

Special ideas – to profit from opportunities

Depending on the specific risk appetite, we recommend using special ideas to profit from market opportunities. Among these, in our opinion, are currencies in Asia as well as currencies in surplus countries. Hedge funds can profit from these opportunities on offer and will most likely achieve attractive risk/return profiles. Real estate stocks with inflation-linked returns and long-term debt financing will profit more in the scenario of stagflation. On page 6 you can find our assessment of gold. Although precious metals are en vogue, one must bare in mind that they can only be sold by central banks, not printed.



Patrick Erne CFA

INVESTMENT POLICY
JANUARY 2010

BASIS	CH	EU	USA	J	CHINA
Purchasing Power Parities					
Ned Davis Research		1.55	1.14	1.12	
GDP Growth					
actual	-1.3%	-4.1%	-2.5%	-4.5%	8.9%
6 months	↗	↗	↗	↗	→
3 years	↗	↗	↗	↗	→
Inflation					
actual	0.0%	-0.1%	-0.2%	-2.5%	-0.4%
6 months	↗	↗	↗	↗	↗
3 years	2.0%	4.0%	8.0%	1.0%	10.0%
Stock Markets	**SPI**	**DAX**	**S&P 500**	**TOPIX**	**HSCEI**
Price/Sales	1.5	0.7	1.2	0.5	2.1
Dividend Yield	2.2	3.5	2.2	1.8	2.0
Price/Book	2.1	1.5	2.2	1.1	2.4
Price/Earnings actual	37	64	22	n.a.	20
Price/Earnings estimate	17	17	18	38	16

FORECAST	CH	EU	USA	J	CHINA
Money Markets (3 months)					
actual	0.25%	0.7%	0.25%	0.28%	1.8%
6 months	→	→	→	→	↗
Swap Rates (10 years)					
actual	2.4%	3.4%	3.7%	1.4%	4.1%
6 months	→	→	→	→	n.a.
3 years	↗	↗	↗	↗	n.a.
Currencies					
actual		1.5	1.05	1.16	6.5
6 months		→	→	↘	↗
3 years		↘	↘	→	↗
Stock Markets	**SPI**	**DAX**	**S&P 500**	**TOPIX**	**HSCEI**
actual	5'570	5'850	1'100	900	12'500
6 months	→	→	→	→	→
3 years	↗	↗	↗	↗	↗
Real Estate Market	→	→	→	→	→

Legend: ↗ = increasing → = neutral ↘ = decreasing as of: December 17, 2009

MARKET OUTLOOK
1st TRIMESTER 2010

CURRENCIES
Exchange rates have been shaped by the ongoing weakness of the USD.

The US current account deficit is still high and only coming down slowly, bringing persistent pressure on the USD. The EUR in particular has continued to rise against the USD. Unlike most Asian central banks, the ECB did nothing to counter this. China fended off an appreciation, while Japan at least limited it. This has led to a further increase in their already enormous currency reserves.

The US Federal Reserve has been keeping USD money market rates extremely low, which favored the use of the USD as a financing currency for carry trades. This led to additional pressure on the USD. The USD is now clearly below purchasing power parity against almost all currencies, especially against the EUR. Therefore, it is not improbable that it will recover somewhat going forward. Over the long term, however, the USD will continue to tend toward weakness given that the accumulation of deficits in the US and of reserves in the surplus countries will reach their limits at some point.

The EUR has remained unchanged against the CHF at just over the CHF 1.50 mark. This was thanks above all to the explicit exchange rate policy of the Swiss National Bank, which achieved this objective with sweeping interventions on the currency market. As the threat of deflation subsides these are likely to desist, and as a result the latent upward pressure is likely to push the EUR below CHF 1.50.

INTEREST RATES
Interest rates in the key currencies remain doggedly low and will only start to rise in the second half of next year.

The key central banks have signaled that they want to keep their headline interest rates unchanged at low levels in the coming months, given that there is still practically no inflation and the slight economic upswing should under no circumstances be strangulated. Long-term interest rates are therefore also likely to rise slowly at most. The enormous budget deficits in most countries have resulted in massive demand for capital from the respective states. Against the backdrop of the higher savings rate, it will be interesting to see at what yields private households are prepared to take up the offer.

The risk premiums for non-first-class borrowers have fallen further, but are still significantly higher than before the financial crisis broke out. Banks continue to hold very high balances at the central banks, which also shows that trust between banks has still not been fully restored. The government bonds of certain countries are now also showing high risk premiums in some cases. Particular examples in Europe are Greece (2.2%), Ireland (1.6%), and Spain and Italy (each just under 1%). The reduction of high national deficits will take time, as will sufficient capital adequacy for companies hit hard by the economic crisis. We expect that the reduction in risk premiums and the threat of defaults back to «normal values» will extend over a longer period.

STOCK MARKETS
The uptrend on the stock markets has continued. We do not see any dramatic threat of a correction for the time being, unless there is a rapid increase in long-term interest rates.

Measured in terms of the key fundamental valuation criteria and expected earnings, the current share price levels on most markets can be said to be fair. In some emerging markets – for example, China – the market trend has already taken on speculative traits in some instances, yet we cannot talk of excesses. The development going forward is likely to be mixed with no clear trend. The gradual economic recovery in the industrialized nations will have a positive impact on earnings. However, the supply of new shares from capital increases is high and will remain so, given that most companies are endeavoring to improve their balance sheets, and those in the banking sector are even being forced to do so as more stringent requirements have been introduced. Stocks with good, well-protected dividend yields – in some cases well above bond yields – are attractive in our opinion. These are to be found above all in the energy utility and telecommunications sectors, as well as in the real estate sector now that the price decline on the real estate markets seems largely over. However, we also remain invested in Asia with ETFs for the time being. They are profiting not just from growth, but above all from the low interest rate environment.



Dr. Max Rössler

QUADRUPLING OF THE GOLD PRICE

YET IT'S STILL NOT TIME TO GET OUT

In the issue of Check-Up of September 2003, we recommended buying gold. The reason back then was the impending currency depreciation race, and this argument still holds true today. In 2003, gold was trading around USD 300 per ounce – today it costs four times as much. This alone would be an indication to describe gold as a 'bubble'. After all, if a market price has increased four or five-fold in the space of a few years, the air starts to become rather thin.

Less jewelry demand – rising investor interest

A sharp correction is possible at any time. For example, in the wake of the price increase and the economic crisis, demand from the jewelry industry has slumped by some 30%. Hence, the price of gold is increasingly being driven by supply and demand from investors.

Potentially explosive price trend

Central banks cannot print gold. Therefore, it is sought after by investors when confidence in paper money falls. The supply cannot be increased infinitely. Even a modest shift in the enormous volume of financial assets held in gold would be expected to unleash an explosive development in the price of gold. By the same token, a ban on holding gold or a gold tax would give little succor to the price of gold.

How to invest in gold?

Gold can be bought forward like currencies, or you can invest in physical bars or coins. There are also gold mining shares, which react more sensitive to the price of gold due to the reserves these companies hold in the ground. All these types of investments have certain advantages and disadvantages. You have to choose which is the most suitable for you in line with your own needs.

Despite all short-term ups and downs, we continue to recommend holding around 5-10% in gold or silver. We would only recommend selling gold completely once an end to the currency depreciation race and a return to healthy monetary policy are in sight.



Tobias Pfrunder

ETFS – A PANACEA FOR ALL ILLS?

WHAT THEY CAN DO AND WHAT THEY CAN'T

Exchange-traded funds – ETFs for short – are increasingly the focus of investor interest, as underscored by the strong inflows of capital into these investment products. ETFs are investment funds, but unlike traditional funds they are traded on an exchange and, as a rule, track the performance of an index.

Advantages of ETFs

Due to the purely mechanical tracking of an index, there is no need for a fund manager to take investment decisions. Therefore, ETFs have lower fees. Being listed on an exchange, they are also very liquid and can usually be traded at any time. Unlike certificates or structured products, they usually have no counterparty risk. By investing in an ETF, the investor gains access to an entire market, depending on the underlying index. For example, by choosing an ETF that has the SMI as its underlying, an investor can invest in the 20 largest Swiss stocks in one transaction.

Disadvantages of ETFs

The main disadvantage of ETFs lies in the decision-making mechanism. Given that they mostly passively track an index, the underlying investments are not assessed. The investment decisions are thus ceded to the index provider. Generally, most equity indexes are capitalization weighted. This means that the weighting of an index component does not reflect its future potential, but instead merely its current size in terms of its market capitalization. This can also lead to certain ETFs having large clusters of risk. For example, in an ETF on the world equity index, the US accounts for some 50%. Added to this, there are the currency risks. In addition to market risks, ETFs must in individual cases also be analyzed for regulatory and administrative risks.

Sensible use of ETFs

We still regard a well diversified portfolio of individual securities as being more advantageous and mostly more cost-effective than the intermediate solution with ETFs. For diversification reasons or in cases where security selection is difficult or of secondary importance, ETFs can represent sensible instruments for implementation. Ultimately, an ETF is nothing more than this, a form of implementation. They cannot take from the investor the key decision of which markets to invest in. We will gladly assist you in the decision-making process.



Sergio Hartweger CFA

FISCAL AND/OR CURRENCY CRISIS?
ENTIRELY POSSIBLE OVER THE MEDIUM TERM

It is seldom apparent where the next crisis will come from. Given the developments over the past 18 months, a fiscal or currency crisis is not improbable in the medium term. It may still be a few years off, yet it may be worthwhile to spend a few thoughts on this topic.

What is a fiscal crisis?
A fiscal crisis occurs when a state has difficulty in meeting its payment obligations. The reasons for this are mostly an extremely high national deficit and rising risk premiums on the state's debt. As a result, the state seeks to restructure its debt, for example by the enforcing conversion of short-term debt into long-term debt with an extremely low coupon.

What is a currency crisis?
In a currency crisis, the exchange rates for one or more currencies get out of control and experience dramatic shifts over a short period, e.g. a depreciation of 50%. This means that imported goods become extremely expensive for the countries affected. Yet exports become much cheaper, which ultimately helps to reduce unemployment. By the same token, a country whose currency appreciates dramatically would see its export industry come under pressure and be forced to reduce costs, for example by cutting jobs.

What form could a fiscal crisis take?
The gradual developments of late begin to gather pace. People increasingly lose confidence, and neither the governments nor central banks can restore it. To combat a financial crisis, the government could decide to lower government spending and increase taxes. Special taxes, such as one-off high wealth tax, would also be conceivable. The state could also impose investment restrictions, for example requiring pension funds and insurers to hold at least 50% of their investments in domestic government bonds, or banks to grant at least 50% of their loans to the government. If the national debt is in the country's own currency, the most convenient way to settle that debt is to open up the coffers of the central bank, i.e. to inflate the currency. However, even in this case the ongoing deficit must be eliminated, otherwise it will be impossible to restore confidence.

What form would a currency crisis take?
Restrictions would be placed on the free capital markets. Currency controls would be introduced, with separate markets for the settlement of trade transactions, for interest and dividend payments, and a market for capital transactions. As regards trade, the exchange rate would be managed in such a way that imports do not become excessively expensive but at the same time the export industry can survive. The exchange rate for interest and dividend payments would be worse than that for trade transactions, but still just enough as to be bearable. Other foreign exchange transactions would either be prohibited or could only be conducted at extreme conditions. Such controls and regulations would not be restricted to the capital market, and would instead generally lead to more protectionism and a decrease in the international division of labor.

Where is the risk of a fiscal crisis relatively high?
The risk of a fiscal crisis is, of course, high in countries with big deficits that are to a large degree financed abroad. The risk is even higher if the debt is issued in a currency that the state in question cannot print itself. Greece – a Euro zone member without an independent currency – is an example for such a case. In the US, however, the government debt is almost exclusively denominated in USD. Therefore, the payment obligations can always be met by printing money, also given that the US Federal Reserve is less independent from the government than in other countries.

Currency crisis in the case of extreme imbalances
Countries with high current account imbalances that have not put corrective measures in place are more at risk than others. Small countries and small currency areas are also more likely to be affected as the market is much tighter. Given that the USD currency area is enormous, a strong undervaluation of the USD would be possible, yet further exacerbation of the situation seems unlikely for the time being.

What would this mean for other countries?
A crisis in one country can unfortunately spread rapidly and affect other countries. Let us assume that Greece were to reintroduce its own currency, devalued by 50% against the EUR for example. Government debt would be honored, but would be repaid in drachmas and at a poor exchange rate not corresponding to the market. In such a case, the sovereign debt of other threatened countries, e.g. Spain, Italy or Ireland, would immediately be sold and valuations would be slashed amid fears that they too could pursue a similar avenue.

What reaction would be required?
Essentially, countries and currencies

at threat should be avoided from the outset. In such crisis situations it is scarcely possible to know what will happen next, and it would therefore also be advisable to hold as many investments as possible in real assets and equities in democratically stable countries with secure property rights, such as, for example, Switzerland.

Dr. Max Rössler

COMPETITIVE ADVANTAGE FOR SWITZERLAND

«STABLE DEMOCRACY» VALUED GOING FORWARD

My father taught me that every decision is better if it can be taken at the lowest possible level. This principle applies in municipalities, cantons, or nationally – and, I would like to add, also internationally. There is no doubt that the climate problems cannot be resolved on a national level. However, most other problems would not have become so large if they had been left at the lowest possible decision-making level.

Currency freedom instead of dependency?

In 1991, Switzerland decided not to join the EEA. As a result, there was never the danger of us having to give up the CHF as our currency and join the EUR. Greece and other heavily indebted countries in the Euro zone illustrate what it means to give up your own currency.

State-endorsed breaches of the law

The illegitimate measures undertaken by certain states are unworthy of free democracies. Germany bought stolen Liechtenstein bank data and France appears to have even instigated the theft of data from Geneva banks. These states have thus made receiving stolen goods a perfectly acceptable practice. The US has also disregarded constitutional frameworks in connection with the betrayal by Bradley Birkenfeld of his former employer UBS. In the media, these examples of constitutional states running roughshod over each other's laws are being played down by opinion makers, although this is mostly the beginning of a bad trend. After all, bank-client secrecy was not introduced for tax exiles, but to protect, inter alia, against the threats of the political developments in neighboring Germany.

Threat of confiscation

Reminders of the Great Depression heighten the awareness that the state must be distrusted on occasion. Even in the – at least earlier – liberal US, owning gold was banned in 1933. The tendency toward sweeping state interventions is clearly discernible. In the UK and France there are plans to introduce special taxes for a certain group of citizens. Assets held abroad are to be clawed back by all possible means to cover the state's own debts. Are such moves the harbingers of the rising threat of confiscation, or in other words a new form of expropriation? One of the basic rights of citizens in a free society has always been guaranteed ownership of personal property. Is this still the case?

Enviable Switzerland

The direct system of democracy in Switzerland may be much slower than purely parliamentary democracies, but it is the best means of ensuring that no false promises are bandied about and that the next generation is not saddled with heavy debt. This system guarantees stability and predictability – virtues that are becoming rarer in the Western democracies. Singapore and Hong Kong are increasingly being touted as safe havens from Western tax regimes and avaricious states. However, these are not true democracies and therefore less predictable. For the challenges in protecting assets going forward, Switzerland's competitive advantage in this regard – with its democratic strengths and tangible stability – will be decisive. Therefore, Switzerland will remain a secure location for asset protection over the long term, even across generations. Confiscation or expropriation – in whatever guise – will not be an issue here for a long time.



Karl Reichmuth
General Partner