PRIVATBANKIERS
REICHMUTH & CO
INTEGRAL INVESTMENT MANAGEMENT

CHECK-UP

CLIENT INFORMATION OF PRIVATBANKIERS REICHMUTH & CO, INTEGRAL INVESTMENT MANAGEMENT

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EDITORIAL

«History doesn't repeat itself – at best it sometimes rhymes». With Mark Twain's words in mind, we took a look at economic crises from the past with a view to finding examples that rhyme with the problems of the current «global financial crisis», and sought to establish the consequences and lessons to be learned. You can find the results of our analysis on the final two pages of this issue.

Europe has to finally develop solutions rather than rescue packages. The upcoming elections in France, and next year in Germany, will offer guidance, also for investment managers like ourselves.

«Voluntarily» is taking on a whole new definition. Greece's creditors are «voluntarily» relinquishing their assets, and we Swiss are «voluntarily» working on abolishing bank-client confidentiality. When will our focus return to the liberal principles that form the basis of western prosperity? Functioning markets and competition are better for the allocation of resources than state interventionism. The latter has never led to prosperity – instead, the exact opposite is the case.

Karl Reichmuth
General Partner

FROM RESCUE TO SOLUTION

WINDOW OF OPPORTUNITY FOR EXPERIMENTS

The «global financial crisis» is already in its fifth year, and still we have newer and bigger rescue packages being bundled together. Southern Europe is reminiscent of a smoldering fire that the European Central Bank is trying to put out, using unconventional methods in some instances. The politicians promise solutions, but achieve little more than ever greater rescue plans. It is becoming time to seek solutions. The first attempt with the «voluntary» haircut for Greece has had no major contagion effects following two years of acclimatization. This offers grounds for optimism.

Fixed exchange rates are the main factor behind «boom and bust»

A perfect example is Hong Kong, where US monetary policy has a quite direct impact. In the wake of the 1997 Asian crisis, most Asian currencies dropped sharply, with the exception of the HKD. Due to its currency being excessively strong comparatively speaking, Hong Kong fell into extreme deflation. Today, we have a similar situation developing in Southern Europe. Owing to the fixed exchange rate – i.e. the EUR – the inflows of money were high and the boom correspondingly strong. However, the capital flows have dried up quickly and the tables have now been turned. The democracies of Southern Europe will scarcely be able to withstand a similarly dramatic downward price adjustment such as we saw in Hong Kong.

Southern Europe faces a twin crisis

Twin crises typically occur in emerging markets, as excessively high debts are combined with a banking crisis. They mostly end in a currency devaluation, structural reforms and debt restructuring. There are many examples of these, and in virtually all of them equity markets of the countries concerned remained under pressure until the devaluation. The reasons for this were the lack of competitiveness and the exodus of savings abroad, as we are currently witnessing in the Southern European countries. The equity markets hardly fell any further in nominal currency terms following the devaluation. That said, foreigners also suffered a loss due to the devaluation. Thereafter, however, significant opportunities opened up due to the economic upswing unleashed by the devaluation.

Avoid Southern Europe

We are therefore continuing to avoid Southern European investments, al-

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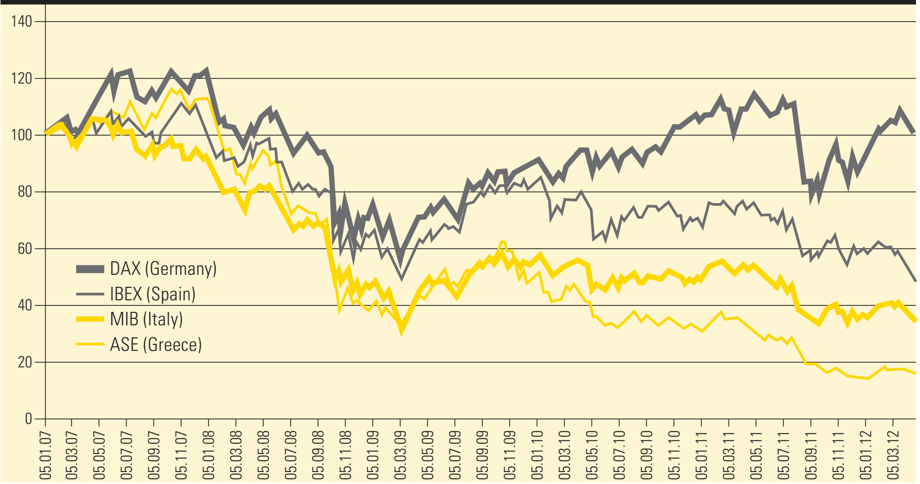
CONTENT

STOCK MARKETS FROM COUNTRIES IN TWIN CRISIS UNDER PRESSURE



Source: Bloomberg

though they already appear very cheap. However, it is possible that the twin crisis could end up as a triple crisis in this region. This would be the result of an exit from the EUR followed by a hefty devaluation. After a phase of turbulence, competitiveness would then be rapidly restored. The current depressionary pressure would be at an end – the losses would be borne by the creditors!

Is Greece important?

In terms of its size, Greece is not significant. However, we believe that Greece will be a touchstone that will allow us to identify whether the political will is in place for keeping the Eurozone together, for better or worse, or whether economic reality is not after all more potent than the wishful thinking of politicians.

EUR – for better or worse?

If the answer is yes, in other words if no country can or has to leave the EUR, then the impact of Southern Europe's problems are not localized there and instead affect all of Europe. High transfer payments and a weaker EUR would be inevitable. Given the floor set by the SNB, the CHF would also be correspondingly weak. Against what, you might ask? Good question. We would assume against the USD, Asian currencies, and gold.

EUR exit as a perfect example

One conceivable scenario would be for Greece to drop out of the EUR. The best timing for this would be after the elections in France, and with sufficient time before the German elections in 2013. Hence, this summer would offer a window of opportunity. This scenario would play out as follows: the EU would affirm that Greece is an important country in the EU and has already done a great deal. However, to allow it to get back on its feet and to give the youth of Greece a future, it is best for Greece to leave the EUR. The fixing of the exchange rate of the drachma vis-à-vis the EUR would be left to the markets to decide resulting in a fall of approximately 50-70%. The banks would be nationalized, sovereign debt restructured, and the EU would have to convert the rescue packages into reconstruction aid. Given Greece's size, this would be feasible. It could – if successful – serve as a model for further exits from the EUR at a later stage.

Temporary contagion effects

In such a case, contagion effects would be on the cards across Europe. There would immediately be a question mark above Portugal, Ireland, and also Italy and Spain. The uncertainty would see many stock markets slump temporarily by perhaps 15-25%. Yet this would be a move toward solving the problems rather than merely treating the symptoms. Although there is little likelihood of this coming to pass, the thesis is possible enough for us to temporarily hedge equity market risks in some cases. I'm not doing this with my children's investments, since there a temporary slump is of little concern. For longer-term investors, we are and remain very positive with regard to equities.

Stagflation in the west

Looking beyond Southern Europe, we still regard the stagflation scenario as being the most likely. The 2008 banking crisis had all the ingredients for a repeat of the Depression years of the 1930s. However, this time the central banks reacted, and did so forcefully. They were not bound to any gold standard, and it was therefore possible to prevent the deflationary spirals. The other side of the coin is that no structural cleanup took place, and there is now scarcely any growth impetus to be found. Thus, we expect a few years with below-average growth rates and higher inflation.

What do we advise?

We remain convinced that shares in large cap companies are still the best choice in this environment. They have always withstood similar crisis periods the best. They may be volatile, but you can take this in your stride as long as there is no change in the fundamental assumptions. Avoid Southern Europe until it becomes more competitive. Long-term bonds are also still to be avoided. The risk of suffering price losses due to higher bond yields or of expropriation due to inflation has seldom been as high as it is today. We will hold precious metals until either the central banks abandon their extreme monetary policies or real yields start to rise.

Christof Reichmuth
General Partner

THE BIG PICTURE

OUR SCENARIO ANALYSIS IN A NUTSHELL

UNCERTAINTY	STAGFLATION	AGGRAVATION OF CRISIS	NEW BEGINNINGS
Uncertainty persists over the development of the financial crisis going forward. Opinions differ on the action required: persistently expansionary monetary policies in the US/UK, cost-cutting policies in the Eurozone. The problems are not resolved by these actions, only postponed. Economic growth remains good in the emerging markets, modest in the US & Northern Europe, and negative in Southern Europe. Interest rates remain close to zero. Inflation is not an issue yet, on the contrary: temporary deflation in Southern Europe (due to the cost-cutting policy) and in Switzerland (due to the strong CHF).	The central banks remain expansionary and are thus more or less openly financing the national deficits. Governments increasingly intervene in the economy, e.g. via regulation, tax increases. The financial system is relatively stable. Economic growth remains low, even entering negative territory in certain countries. Inflation begins to rise. Meanwhile the central banks are keeping interest rates artificially low, including longterm rates. The negative real yields lead to a flight into real assets. Higher inflation defuses the debt problem over time; state bankruptcies can be avoided.	National deficits can only be insufficiently reduced. Confidence evaporates completely, risk premiums rise, and several countries become insolvent. The tension in the Eurozone leads to some countries leaving the EUR. The banking crisis flares up afresh. The SNB relinquishes the EUR/CHF 1.20 floor. There is a further massive rise in the price of gold. Economic growth turns negative worldwide: depression. Increasing state interventions in the economy: nationalizations (particularly of banks and insurers), controls on the movement of capital, imposed «bank holidays», protectionism.	National deficits are massively reduced. Cuts in social spending are accepted by the population. Prevailing optimism over the future leads to a new economic upswing: capital spending by companies rises, the wealthy make more risk capital available, unemployment falls. The massive amounts of money in circulation begin to move, but are quickly absorbed by the central banks so that there is scarcely any inflation as a result. Thanks to the fresh growth, the high sovereign debt is rapidly reduced.
INVESTMENT IDEAS: Shares in globally active firms offering good dividends (no Southern European equities) Emerging markets Gold, silver Selectively hedge funds	INVESTMENT IDEAS: Inflation-linked bonds Shares in globally active firms offering good dividends Real estate Gold, silver Selectively hedge funds	INVESTMENT IDEAS: CHF cash Only best-quality equities Gold, silver	INVESTMENT IDEAS: Cyclical stocks Emerging markets Real estate Commodities Selectively hedge funds
Probability 12 months: 40%	Probability 12 months: 40%	Probability 12 months: 20%	Probability 12 months: 0%
Probability 24 months: 25%	Probability 24 months: 50%	Probability 24 months: 20%	Probability 24 months: 5%
Probability 36 months: 10%	Probability 36 months: 60%	Probability 36 months: 20%	Probability 36 months: 10%

«PORTFOLIO OF THE FUTURE»

DIVERSIFIED AND FUTURE-ORIENTED – ADAPTED TO THE CURRENT MARKET ENVIRONMENT

%	WHAT	POT 1**: COMMITMENTS	POT 2**: PRESERVING VALUE	POT 3**: SEIZING OPPORTUNITIES	YIELD*	VOLATILITY*
35%	Cash & Fixed Income	Money Market or Cash in local currency			0-1%	0%
		Short-term bonds in CHF and NOK	Inflation-linked government bonds in EUR, CAD and SEK	Hedging strategies against rising interest rate	0-2%	5%
5%	Structured Products			Asia FX / CHF	4-8%	8%
30%	Equities		Stocks with high dividend yields and low valuations from sectors like food, energy, pharmaceuticals and telecom	Cyclical equities Emerging Markets Gold mining equities Small caps (Pilatus)	4-8%	15%
5%	Real Estate		Switzerland	Asia REITs	4-8%	15%
15%	Alternative Investments			Matterhorn 3 and 24 or third party instruments	6-8%	< 10%
				Reichmuth Himalaja	10-15%	< 15%
				Reichmuth Macro	10-15%	< 15%
10%	Precious Metals		Gold (physically)	Silver ETF	8-10%	15%
				Total	**3-6%**	**approx. 6%**

*Expected average values over a 5-year time horizon – no guarantee

**Read about the «Three Pot Plan» in our Check-Up of September 2011, p. 8 or at www.reichmuthco.ch. At request, we will gladly also send you a copy of this article.

INVESTMENT POLICY

MAY 2012

BASIS	CH	EU	USA	J	CHINA
Purchasing Power Parities		1.39	0.99	1.12	
GDP Growth		**N** **S**			
actual	1.3%	0.7%	1.6%	-0.6%	8.1%
1 year	↘	→ ↘	→	↗	↘
3 years	→	→ ↗	→	↗	↘
Inflation		**N** **S**			
actual	-1.0%	2.7%	2.9%	0.3%	3.6%
1 year	↗	↗ ↘	→	→	→
3 years	2.0%	4.0% 8.0%	5.0%	2.0%	6.0%
Stock Markets	**SPI**	**DAX**	**S&P 500**	**TOPIX**	**HSCEI**
Price/Sales	1.45	0.61	1.34	0.48	0.9
Dividend Yield	2.3	4.1	2.0	2.2	3.1
Price/Book	1.8	1.3	2.2	1.0	1.5
Price/Earnings actual	17	14	14	30	9
Price/Earnings estimate	13	11	13	14	8

FORECAST	CH	EU	USA	J	CHINA
Money Markets (3 months)		**N** **S**			
actual	0.1%	0.8%	0.5%	0.2%	3.1%
6 months	→	→ ↑	→	→	→
Swap Rates (10 years)		**N** **S**			
actual	1.1%	2.2%	2.1%	1.0%	n.a.
1 year	→	→ ↑	→	→	
3 years	↗	↗ ↗	↗	↗	
Currencies		**N** **S**			
actual		1.2	0.92	1.12	0.15
1 year		↗ ↓	↗	→	↗
3 years		↗ ↓	→	→	↗
Stock Markets	**SPI**	**DAX**	**S&P 500**	**TOPIX**	**HSCEI**
actual	5’700	6’787	1’388	803	10’795
1 year	→	→	→	→	→
3 years	↗	→	↗	↗	↗
Real Estate Market	→	↘	↗	→	→

Legend: ↗ = increasing → = neutral ↘ = decreasing **N** = Northern Europe **S** = Southern Europe as of: April 17, 2011

MARKET OUTLOOK

2nd TRIMESTER 2012

CURRENCIES

The exchange rates of the major currencies are likely to stay roughly at the current levels in the coming months, as they have in the year to date. Although the CHF is overvalued in terms of purchasing power, it will probably remain so due to the balanced state finances and Switzerland's high current account surplus.

The movements in the exchange rates may be small, but the relations are in an unstable equilibrium. EUR/USD is very volatile, given that the doggedly high deficits and still rising sovereign debt in the Southern European countries repeatedly place question marks over the future of the EUR, ensuring correspondingly high exchange rate fluctuations. If all the weak countries remain in the Eurozone and the debts are increasingly monetized, the EUR will tend to weaken. EUR/CHF is rather stable thanks to the CHF 1.20 floor guaranteed by the Swiss National Bank. The exchange rate will continue to hold just above this limit over the near term. However, it would be presumptuous to rely on this guarantee looking to the long term. The JPY is the only currency to weaken markedly in the year to date, this coming on the back of massive interventions from the Bank of Japan. However, it has recovered somewhat of late, and is likely to remain roughly at its current level relative to the USD over the near term. The other Asian currencies, especially the Chinese CNY, have long since been undervalued. However, it is becoming increasingly likely that these undervaluations will not be corrected via corresponding appreciation, but instead at least in part via higher inflation rates.

INTEREST RATES

Interest rates are still very low. Central banks are sticking to their extremely expansionary monetary policies given that confidence in the financial markets has been destroyed, economic growth remains very modest, and there is still no threat of inflation. However, in the long-run, gradually rising interest rates can be expected.

The high risk premiums for many states and banks are forcing the central banks to maintain their expansionary monetary policies, as otherwise the lingering financial crisis would flare up again, with serious consequences for the economic situation. As long as the economy is only ticking over modestly – and above all as long as unemployment rates remain very high – the loose monetary policy will not yet lead to higher inflation, given that the weak unions are unable to push through any considerable pay rises. Wage costs – the most important cost factor in the production of goods – can therefore be kept low. The impact of the strong rise in money supply has therefore been visible less in the traditional inflation yardsticks (such as consumer prices) and much more in the prices of gold and other precious metals, commodities, real estate, luxury goods, etc. That said, consumer prices are also likely to rise more rapidly over the long term. This will also gradually push interest rates higher, albeit probably with a certain delay due to the financial repression.

Many states and banks, above all in Southern Europe, are having to pay high risk premiums on the low basic interest rates, that is if they are receiving any new money at all. The situation of the critical borrowers is untenable over the long term, but it is difficult to say at this stage how it will normalize.

STOCK MARKETS

The stock markets got off to a bright start in 2012, and have moved into a consolidation trend of late. The still smoldering financial crisis remains a negative influencing factor, but prices are well backed by the low valuations of equities in fundamental terms. Share prices are likely to continue their consolidation for the time being, but an upward-pointing trend should take hold over the longer term.

Generally speaking, equity markets are not expensive. Equities of first-class companies in defensive sectors that are attractively valued (for example, low P/E ratio, high dividend yield) are still among our favored investments. They bring in a good current income, are less dependent on economic developments, and as real assets they offer protection against a possible resurgence in inflation. There are also other equity market segments that offer interesting opportunities, albeit with higher risks. Shares in the financial sector, particularly in the crisis-hit countries, have fallen very sharply and could shoot up massively if the financial crisis were to be resolved. Shares in commodity and precious metal producers are very attractively valued compared to commodities prices and the price of gold. Real estate stocks are trading well below their intrinsic value in most countries (but not in Switzerland) and therefore have strong upside potential, especially if real estate prices were to rise again.

Dr. Max Rössler

CHALLENGING CURRENCY ALLOCATION

CURRENCIES ARE PART OF AN INVESTMENT STRATEGY

You should buy cheap investments in a cheap currency. This is certainly a successful premise, but not quite so easy to put into practice. Which currencies are cheap? From the CHF perspective, basically all of them given that the CHF is much too expensive. Therefore, we recommend high foreign-currency allocations for CHF investors.

Currency adjustments via inflation

Currency adjustments can take place via changes in the exchange rate, but also via inflation. For example, if the «fair» exchange rate between the CHF and the EUR were to be 1.40 and the difference in inflation between Switzerland and the Eurozone remained at around 2-3%, then this «fair» exchange rate would fall by 2-3% each year, and in about 5 years would reach 1.20, the floor currently set by the Swiss National Bank. However, we expect the inflation spread to narrow or turn around temporarily, as we saw in the 1980s following the SNB's intervention then. Therefore, we expect the EUR to be slightly stronger against the CHF.

Asian currencies are attractive

The inflation trend is important here, too. Many Asian countries currently have high inflation, not just in economic terms but also structurally. Part of the still significant undervaluation is thus being eaten up by inflation over time. Nevertheless, we expect to see nominal appreciations as well and still recommend holding part of the allocation in Asian currencies.

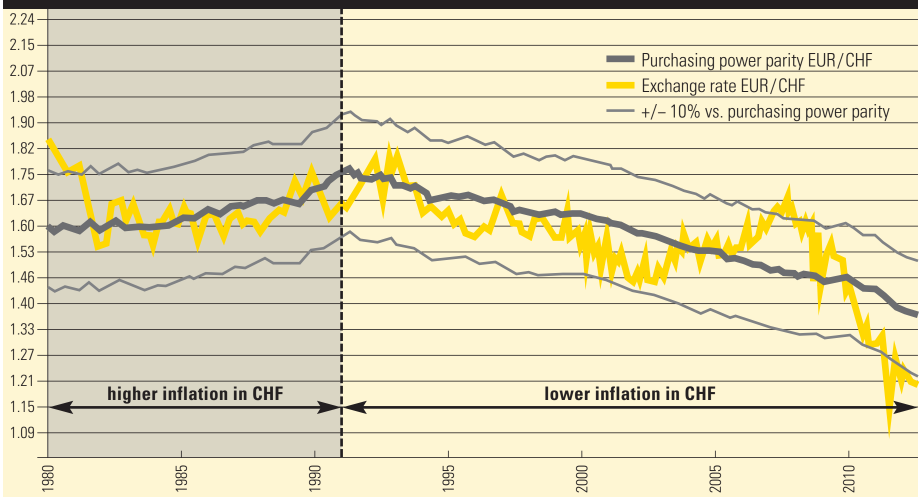
CURRENCY ALLOCATION RECOMMENDATIONS

Ref. Curr	CHF	EUR	USD
CHF	**50**	5	2
EUR	**10**	50	3
USD	**10**	15	70
SEK	**5**	5	5
NOK	**5**	5	5
CAD	**5**	5	5
Asia	**15**	15	10

Which currencies are attractive?

In the current environment, we regard the NOK, SEK, CAD, and SGD as being attractive. These economies have healthy government finances and comparatively low debt. However, these currency areas are relatively small. Correspondingly, an excessively quick appreciation of the respective currencies could trigger interventions by the local central banks like we have seen in Switzerland. We recommend holding part of the foreign currency allocation spread evenly across these currencies.

DIFFERENCE IN INFLATION RATES DICTATE PURCHASING POWER PARITY



Source: NDR

Patrick Amrhein

WHICH INFLATION FIGURES ARE CORRECT?

In principle, inflation represents the rate of price increases. Normally, consumer prices are used as a proxy for an inflation index. The consumer price index is composed of a basket of goods; yet its composition is different in every country. Many countries, for example the US, focus on core inflation, i.e. inflation is measured without considering food and energy prices. The reasoning behind this is that these prices tend to be too volatile and cyclical, and hence, misrepresent the actual trend.

Common sense over dogmatism

Once again, statistical figures should not be taken dogmatically but looked at with a healthy portion of common sense. In our view, the official inflation rate in the US of 2.7% is clearly an understatement. However, the «shadow statistics» inflation rate of 10%, which is calculated using the 1980 method, is clearly also too high (www.shadowstats.com). However, it is fair to assume that inflation figures worldwide – with a few exceptions – are above 10-year bond yields. Taking this into consideration, we have positioned our portfolios accordingly.

LEARNING FROM HISTORICAL ECONOMIC CRISES

LESSONS FOR OUR FORWARD-LOOKING INVESTMENT STRATEGY

On our behalf, Dr. Tobias Straumann, the renowned economic historian at the Universities of Zurich and Basel, categorized the types of historical crises, and analyzed how the various asset classes behaved in the different crisis periods. We then sought to establish the consequences and the lessons to be learned on the basis of his findings. Below we outline a simplified summary of the results:

Crisis types

1. *Hyperinflation*
   (e.g. Weimar Republic 1922-23): A typical crisis following wars. Back then, the massive war debts were paid via monetization (printing money). The massive expansion in money supply ultimately destroyed the local monetary system and led to hyperinflation. Such crises typically end in a currency reform.

2. *Depression*
   (e.g. USA 1929-33): Massive debts were accumulated in the boom years preceding the Depression. These could no longer be sustained in the subsequent economic slowdown and had to be reduced («deleveraging» or «balance-sheet recession»). Due to the gold standard prevailing at the time, the central bank was forced to remain passive as regards monetary policy. The results were a banking crisis, foreclosures, slumping stock markets, and a sharp decline in investment and consumer spending. Falling prices meant the debt burden continued to increase in percentage terms (negative spirals). Such crises with negative downward trends can only be stopped by a currency devaluation, restructuring of banks, and reflation (i.e. printing money).

3. *Twin/triplet crises*
   (e.g. Asia 1997, Russia 1998, Argentina 2001): A twin crisis is a combination of a banking and a debt crisis. In these instances, the economic upturn was mostly financed by foreign capital. The local currency was fixed or kept stable against the major currencies (mostly the USD). An economic downturn led to a sudden stop in the capital flows, the collapse of the local economy, and credit defaults at banks. The consequences were bank restructurings and a marked increase in private and state debt. Ultimately, both private individuals and the state became insolvent. Such crises mostly end with a combination of currency devaluation (i.e. a triplet crisis), structural reforms, debt restructuring, and a sharp rise in inflation.

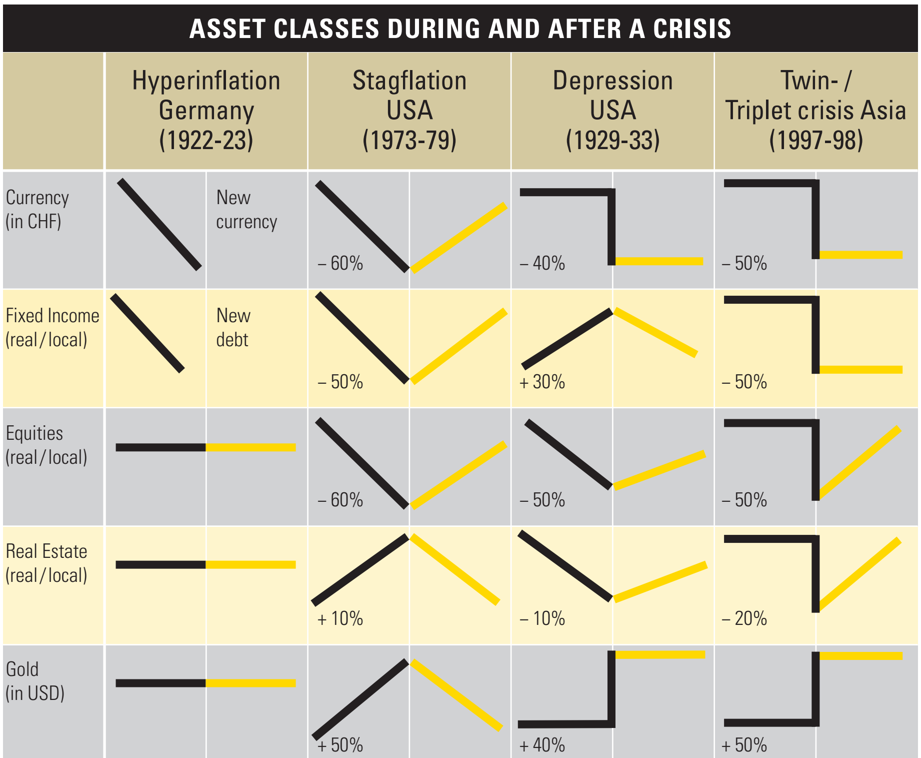
4. *Stagflation*
   (e.g. USA 1973-1979): Stagflation is a combination of a recession (weak, in part negative economic growth) with higher inflation rates. In this example, weak economic growth was tackled with an expansionary monetary policy. This ultimately led to a successive weakening in the USD and rising inflation. Such crises end with structural reforms and a normalization of monetary policy.

How did the asset classes fare?

The chart below shows the performance of the asset classes during and after the respective crises. From the perspective of the countries affected, real assets fared best, in particular precious metals and equities. Shares are only to be avoided in a depression. Nominal assets in the local currencies of the countries concerned were the biggest losers.

Learning the lessons from the past

The first step is to recognize the problems and to identify where there is the potential for contagion. Typical signs of problems include an increase in debt,



Source: Dr. Tobias Straumann

dwindling currency reserves, an exchange rate not justified by the economic data, etc. In the case of fixed exchange rates, economic imbalances can above all be identified in the development of the trade balance. We then have to determine whether a crisis could spread to affect another country or countries.

As we can see above, investors can only profit from a crisis when it is nearing its end. In the midst of a crisis, the focus must be on avoiding risks. In other words, during a crisis, you should not hold any assets – either nominal or real – in the country beset by the crisis, and certainly not in its banking system. It is only when the crisis is reaching a discernible end, i.e. when solutions address the causes, that opportunities can be exploited. As shown above, typical solutions to crises include currency devaluations, bank cleanups, and debt restructuring. Thereafter, often a devaluation-driven boom can be observed.

CONSEQUENCES FOR A FUTURE-ORIENTED INVESTMENT STRATEGY

	Overweight	Sit out	Avoid
Hyperinflation	Gold abroad Long-term debt	Equities Real Estate	Cash Bonds
Currency reform	Gold abroad Foreign equities	Equities, which survive difficult periods	Local nominal assets
Depression	Cash Short-term Bonds (Top debtors only)		Long-term debt
Twin/ Triplet crisis	Gold abroad	Foreign equities	Local nominal assets
Financial repression	Gold	Equities Real Estate	Securities which risk expropriation
Stagflation	Gold Dividend stocks	Cyclical stocks	Cash Bonds

Source: Reichmuth & Co, 2012

Consequences for the investment strategy

The following table provides a simplified overview of the recommended courses of action for the respective crises.

Where do we stand today?

At present, we see no signs of hyperinflation or of a currency reform. In the US, we are already out of the stage of a possible depression and are moving toward stagflation. We expect the same in Northern Europe. In Southern Europe, we already have a twin crisis, which is developing into a strong recession/depression due to being part of the EUR. In these countries, we expect to see a development more in the direction of a triplet crisis, for the reasons set out in our lead article. There is no absolute clarity at this stage on how this «global financial crisis» will play out. Our task is to observe and to identify the corresponding need for action at an early stage, which was also the motivation behind this historical analysis. If you have any questions or suggestions, we would be happy to hear from you.

Patrick Erne, CFA *Dr. Ricardo Cordero*

VIDEO RECORDING OF CLIENT EVENT

LEARNING FROM HISTORICAL ECONOMIC CRISES

The client events we staged in April met with a lot of interest. Dr. Tobias Straumann gave our guests a presentation on the different types of crises, outlining the impact on the asset classes with an example in each instance. Christof Reichmuth highlighted the lessons to be learned, and the consequences for a forward-looking investment strategy. There is a video recording on the website at www.reichmuthco.ch for those interested. If you would like to take part in one of the upcoming events please contact your relationship manager or register your interest on our website.