

Dear Investor

A Publication by Solidinvest of Switzerland.

Economic trends, equity markets, and investment scenarios.

January 2012

POLITICS AND BUSINESS

Politically, 2011 was a dismal year, both in Europe and in the USA. It would have been necessary on both sides of the North Atlantic to develop solutions that would have brought runaway government debt under control. In the face of the 2012 presidential elections in America, Republicans and Democrats failed to agree on measures for curbing the further escalation of the US budget deficit. And in Europe, the debt crisis turned into a wildfire despite the endless succession of summit meetings in Brussels.

In America, which urgently needs to balance its budget, it is hardly likely that a solution will be found in the course of 2012. This delicate issue will not be approached until 2013, either by Obama,

should he be reelected, or by a Republican successor. Unless US government debt **spins out of control** before then, the world will have to tolerate this paralyzingly slow political agenda.

The Europeans have less time at their disposal to master the debt crisis. Recently, EU politicians were legitimately referred to as "**masters of deception**". Thus, at its globally publicized summit on December 8/9, 2011, the European Union passed a resolution that it had already passed and subsequently disregarded when the euro was introduced. **In the future, it was decided, the systematically ignored debt limits pursuant to the Maastricht Treaty would henceforth be observed.** The last, lavishly celebrated EU summit meeting did not,

however, deliberate over how this should be achieved in concrete terms. The attendees merely announced that in 2012, there would be a consensus regarding the introduction of stricter rules with respect to budget discipline.

But when it comes to solving Europe's true problems, the politicians – masters of deception – continue to beat around the bush. Europe has established overblown social constructs that can no longer be financed. As aptly described by Roger Köppel in a recent issue of "Die Weltwoche", both productivity and competitiveness have fallen victim to top-heavy welfare states. **Creative forces wither in situations where governments act as general-purpose supply machines.** The outcome is rising taxes, because the highly indebted governments want to offset their deficits at the expense of their citizens and businesses. **The right approach would be to cut taxes and a reduction of the scope of social services.** But Europe's politicians do not want to handle hot potatoes like these because doing so would curtail their own spheres of influence. In fact, money would have to be taken away from governments to force them to focus on their principal responsibilities. Europe is moving in the other direction: higher taxes, less competition, no growth. **The bailout of the euro will**

not rescue the single currency in its current form, but it will generate massive losses of affluence.

ECONOMIC BASELINE CONDITIONS

ECONOMIC TREND / INFLATION / DEFLATION
INTEREST RATES / CURRENCIES

In 2011, the economic environment in the USA trended contrary to that in Europe. Until mid-year, a relapse into a recession was the dominant theme in the USA, while Europe – headed up by Germany – fared remarkably well and even posted respectable growth rates. The situation changed starting in July 2011 in conjunction with a **growing awareness of the EU's debt problems.** It is fair to assume that growth already came to a standstill in the fourth quarter of last year or perhaps had even begun to cede to recessive trends. This discrepancy between America and Europe is likely to accentuate in the course of 2012.

Based on the latest metrics on the US economy, 2012 growth rates are expected to be in the 2 percent range. That's better than zero growth or a recession. But it is not enough to significantly trim unemploy-

ment, which has permanently been hovering around 9 percent since the 2008/2009 crisis. **Two percent growth is insufficient for America**, and certainly nowhere near what it would take to get the ailing housing sector back on track.

Given the fact that US consumers regard the labor market and the private real estate market as seismographs for the condition of the US economy, growth stimulus based on consumer demand will be meager. In 2012, inflation will hardly be a topic in America, so the Fed can keep interest rates at "zero" without risking much exposure to pressure because of rising consumer prices. **The more the euro gets cornered due to the unresolved debt crisis, the better chances the dollar has to stand out as a safe-haven currency and to appreciate in value.**

The situation in Europe is much less comfortable because at the transition to 2012, many regions of the Eurozone were already approaching or stuck in a recession as manifested by the leading indicators. Against the backdrop of dismal economic metrics, the highly indebted nations must cut spending

and raise taxes. This will accelerate the recessive momentum instead of creating growth stimulus.

In 2012, the Eurozone is set to trim budget deficits back to 3 percent. It will take growth, not a recession, to achieve this goal. Accordingly, it was justifiable for Christine Lagarde, Managing Director of the International Monetary Fund (IMF) and French Minister of Finance until mid-2011, to warn of an imminent recession. **But it is questionable whether Berlin or Paris realizes just how much is at stake.** The wariness with which Europe is seen "from the outside" comes to the fore in the statistics of the Fitch Group, which show that US money market funds have drained 110 billion US dollars from the European banking system since May 2011.

It is doubtful in this context whether the introduction of eurobonds endorsed by politicians and "certain economists" can turn out to be the act of liberation that might end the crisis of confidence. Pooling debt in stability bonds, of course, does not in any way mean getting rid of debt. The same applies to the situation in which politicians force the European Central Bank (ECB) to act as a lender of

last resort by guaranteeing and if necessary buying European sovereign debt.

In 2012, Europe also need not anticipate any tangible degree of inflation. Thus, the ECB has enough latitude to further reduce the already very low interest rates. The euro will remain under pressure and is not likely to gain any ground versus the world's key currencies.

It is unrealistic to assume that the emerging markets (China, India, Brazil) will not be affected by a recession in Europe. Additionally, these countries do not have the economic wherewithal – strong domestic growth – to offset the global growth deficit that would originate from a European recession. A sizeable turndown in growth will continue to affect the so-called BRIC countries in 2012. Nonetheless, the growth rates of most emerging economies are impressive in comparison with Europe and America.

If Europe wants to return to a regime of growth, it must bootstrap itself. It would be wrong to wait for help from the outside. A more centralistic ap-

proach with more harmonization is not the way to go. A loss of flexibility and maneuverability in an overdimensioned Europe is a one-way street. **If Europe wants to safeguard its relevance in the global economic context, it will need to reappraise its virtues,** which means working harder, and citizens must liberate themselves from their enormous dependency on centralistic government. Insisting on 35-hour workweeks and retirement at 60 is the wrong way. How deep must Europe plummet into a recession before such insights take hold? The party is over!

EQUITY MARKETS / INVESTMENT OUTLOOK

Financial 2011 yielded few reassuring results. The following table shows the performance of several equity markets up to the editorial deadline on December 21, 2011.

Performance in %

MSCI	World	- 9.1
SMI	Switzerland	- 9.8
SPI	Switzerland	- 9.7
SLI	Switzerland	- 15.6
Euro Stoxx 50	Europe	- 19.0
DAX	Germany	- 15.4
FTSE 100	UK	- 8.1
S & P 500	USA	- 1.3
Dow Jones Ind.	USA	+ 4.5
Nasdaq Comp.	USA	- 1.9
Topix	Japan	- 20.1
Sensex (BSE)	India	- 26.0
Hang Seng	China	- 21.5
Bovespa	Brazil	- 18.0

In 2011, the Asian equity markets and Brazil suffered most. In comparison with the other countries in continental Europe, Switzerland fared best. In a largely red market environment, the UK performed better than the Eurozone countries. The best results were achieved in the US markets where the Dow Jones, the world's most watched index, managed to advance by 4.5 percent.

The impact of the euro turbulence on the Old

World equity markets is obvious. In comparison with America, the 2011 economic scenario in Europe wasn't so bad that this could have been the cause of the performance difference.

The euro crisis and the powerlessness of European politicians in crisis management – which was drastically aggravated by the runaway government debt situation in 2011 – imposed such a heavy burden on the equity markets that it simply wasn't realistic to expect better annual results.

This is best illustrated with an annual review of the European markets. Despite Fukushima and the political turmoil in conjunction with the so-called "Arab Spring", losses until mid-year were tolerable. But when the debt crisis in the Eurozone began to unfold, stock prices did a nosedive in early August. Equities did not sustainably recover from this slump even though short-lived rebounds repeatedly occurred amid the rapid succession of crisis-control summit meetings.

In view of the low-interest-rate policy in Europe and the USA, the market for fixed-income paper (bonds) also performed poorly, even in A-rated investments. Under consideration of the (modest) inflation rates, investors even had to contend with

negative bottom lines. It was no longer possible to buy bonds issued by Mediterranean countries when private lenders, contrary to earlier assurances, were forced to agree to haircuts by EU politicians in conjunction with the refinancing of Greece's sovereign debt.

In summary, we can only point out that unsatisfactory results in every domain were the outcome of political meddling in the security markets. Cash and gold were the only trump cards for those investors who switched into these classes before anyone anticipated the severity of the turbulence that hit the markets in early August.

INVESTMENT OUTLOOK 2012

The transition from the old year to the new one fundamentally changes neither the political nor the economic environment. Europe and USA will continue to suffer under the burden of excessive government debt. For the same reason, the euro crisis will not be off the table anytime soon.

Given the fact that Italy alone has to refinance a total of EUR 540 billion in debt and budget defi-

cits on the capital market by 2014, the immensity of the task can be sensed at least vaguely. The grand total due to be refinanced by late 2014, including the capital requirements of the other countries at risk, is a whopping EUR 1200 billion. **The introduction of eurobonds has been proposed as a remedy to get a grip on this uncomfortable debt scenario** and thus appease the security markets. At least, that's what the proponents of eurobonds say. It remains to be seen what the rating agencies say if eurobonds are indeed placed. **Even eurobonds must be redeemed when they mature – in the worst case by Germany. And who, in the end, will rescue the rescuer?**

The conclusion is sobering: the situation as regards the European debt crisis is tense, and the risk of a further escalation remains acute. This means that the sovereign debt of several countries in Southern Europe can still be refinanced only at the expense of high premiums relative to Germany, making it even more difficult to rehabilitate debt as envisaged.

Could the economic environment brighten up unexpectedly in 2012 and help compensate the lack of confidence rooted in practically unserviceable government debt? The data available at the transi-

tion to 2012 is not such that one could expect the economy to suddenly blossom anytime soon.

So for the time being, 2012 is likely to extend the pattern that prevailed in 2011 and has been called the "roller coaster of the equity markets". However, there are several reasons, despite all these distressing factors, to stick with an **underweighted** exposure in stocks:

- The stocks of well-managed companies are real assets that do not lose value because of pressure on stock market prices.
- Many companies pay out attractive dividends, so returns are higher than the yields of many fixed-income securities.
- The stock markets will recover again as well. In many cases, upswings materialize as unexpectedly as "crashes". Accordingly, it is prudent to remain invested and properly diversified across industries.
- Historically, stock valuations are low. Boldly building up positions would probably pay off in the long term even though another slump in the interim cannot be ruled out.

No change in bond market strategy is indicated for the time being. Positions purchased in 2011 will be held, and what was not purchased last year will not be added this year.

The political and economic scenario at the beginning of the new year calls for the continuation of a conservative investment strategy with ample "cash" and adequate exposure in gold. Now that all market gurus tend to have a negative stance, 2012 could easily harbor positive surprises for investors.

Dr. Robert Lebrecht
Chairman of the Board of Directors

INVESTMENT STRATEGY

Comments

The decision to pursue a conservative investment strategy was already made in 2011. Exposure in equities was further reduced in the interest of continuity of a cautious investment philosophy. Structured (hybrid) products are still allocated to the equity quota. "Cash" remains overweighted in the long-term perspective.

The strategy pursued so far in fixed-income paper (bonds) has not changed.

A modification of the investment strategy would be considered if significant changes of the political and/or economic scenario were to occur.

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1. European investors

1.1. Asset allocation

- Bonds/real estate funds	up to 50%
- Stocks: Switzerland, Eurozone, USA	up to 40%
- Alternative investments	up to 10%
- Commodities incl. precious metals	up to 20%
- Emerging markets	up to 20%
- Cash	up to 40%

1.2. Currencies

- CHF, EUR	up to 80%
- Other, incl. local currencies	up to 40%

2. USD investors

2.1. Asset allocation

- Bonds	up to 50%
- Stocks: USA, Eurozone, Switzerland	up to 40%
- Alternative investments	up to 10%
- Commodities incl. precious metals	up to 20%
- Emerging markets	up to 20%
- Cash	up to 40%

2.2. Currencies

- USD	up to 80%
- Other, incl. local currencies	up to 40%

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