INVESTMENT COMMENTARY NO. 185
January 28, 1998

"Beaut'-ugly"

1. Black or White or...?

Around the end of the year strangely masked creatures, the "Sylvesterchläuse", pass through our neighborhood. They are the expression of archaic rituals that have survived until today. Even more, with "retro" and "nostalgia" becoming ever more popular, they are experiencing an actual revival. In groups of six to nine the "Chläuse" visit primarily the far of farms where they go through ritual dances and original "jodels" and end by wishing a happy New Year to all.

There are three types of such "Sylvesterchläuse". First and foremost are the "beauties": Men dressed up as women, rosy-cheeked with enormous hips and elaborate hats on which wooden figurines represent idyllic rural scenes and elaborate farm houses. Such dollhouse hats often represents years of effort and are masterpieces of naive art. The dress is colorfully patterned after the historic Sunday costumes of the area and numerous large bells provide not only for acoustic background noise, but by their placement on the upper body of the costumes reinforce the impression of archetypal fertility goddesses. The "beauties" thus represent the lowest levels of the Maslowian needs pyramid: safe, comfortable housing, food and drink in abundance, and fertility paired with (male) sexual fantasies. In short: The land of milk and honey.

There is a second classic type of "Chlaus", the "uglies". The are completely covered with pine branches, their needles sticking in all directions like a porcupine's. They stare at people from behind wooden masks, mysterious and frightening. They represent all that

people fear. Fortunately tradition does not require that the "uglies" behave in accordance with the appearance so that the mixed groups of "Sylvesterchläuse" unite into happy parties of "beauties" and "uglies" passing through the wintry Appenzellerland.

But there is more. With the cleverness typical of people living close to nature's primitive forces, the Appenzeller's have created a third category of "Chläuse", the "beaut'-uglies". They are a mixture of colorful opulence and bristly meanness, a true picture of the real world pleasures and sufferings as they have been experienced by our rural ancestors and as we experience them still today, albeit within a slightly changed environment. The desire for "heaven on earth" is as strong today as it was then and reality is still a cryptic mixture of beauty and ugliness.

There is no adjective more befitting of the current state of the economy and the markets than "beaut'-ugly". Consider for example the performance of asset management in 1997, where the opulence of the "beauties" is still too modest a metaphor for those who were fortunate (or smart) enough to constrain themselves to the booming markets of Europe and North America. Inclusion of Asian equities, e.g. through one of the many heavily promoted Asian funds, quickly muddied the picture and lead to a performance more akin to "beaut'-ugly". The performance of those heavily invested in the Far East can only be represented by the pine boughs and wooden grimaces of the "uglies".

The behavior of most stock exchanges is equally "beaut'-ugly". On the one hand, large sums of funds in search of investment returns are flowing into the stock markets of Europe and North America. On the other hand, each sell-off in Asia's troubled markets is sufficient to let the devilish mug of the "uglies" take over the Western markets as well.

There are two sides to the low interest rate scenario as well. Debtors face lower refinancing costs but creditors, including pension funds and life insurance companies, face increasing difficulties in meeting an acceptable rate of return target. Taking additional risks is often the only escape for them.

Finally, the real economy presents itself in a "beaut'-ugly" condition as well. On the one hand there is an abundance of good news: low inflation, low nominal interest rates, sustained positive growth (at least in the US), rapid improvements in productivity for entire industries and countries, and significant and apparently persistent profit growth for firms. No wonder the stock markets are booming. On the other hand Europe faces record unemployment, a lack of confidence deflationary circumstances and ever higher mountains of private and public debt. Loss of jobs due to restructuring and reorganization raise the question whether in the end only very few will work while most will have to resign themselves to permanent unemployment. Who would consume what under these circumstances?

2. *Light and Dark in Rapid Succession*

Reviewing the "Investment Commentaries" of the past few years with a critical eye we are struck by the frequency with which we declared the times to be "more difficult than ever". And even though we certainly are not the only prognosticators who seem to have a subscription to this one observation, we should seek to resist the urge to repeat the banal at every occasion. Having to decide is always difficult. If there were not "light" and "dark" we never would have to decide. The "one hand" and the "other hand", "beauty" and "ugliness" are integral parts of any decision.

There is a small but not insignificant difference to earlier times, however. Today "Beauty" and "ugliness" are infinitely closer to each other. Geographically closer in that the world has indeed become a village; and temporally closer in that positive and negative events are presenting themselves almost contemporaneously. One moment the situation is bright in Technicolor and seconds later it is in deepest black. It is as if we were in a techno disco equipped with strobe lights. We see the world around us almost simultaneously in different artificial colors, just never the way it really is.

Such binary perception is dangerous for investors. If one concentrates on "black" or "white" one misses most of reality which is neither. And if one continuously changes from one view to the other one risks to start rolling like a ship on high seas. Sooner or later such a ship not staying its course will lose its cargo overboard.

In this "Investment Commentary" we seek to review some of the extreme perceptions. First and foremost we will need to review the crisis in Asia, especially its effect on the rest of the world. The buzzword today is global "Deflation". Furthermore we would like to take another look at the fundamental changes taking place in the global business of financial intermediaries, i.e. banks and insurance companies.

Not surprisingly we will find that neither bright flashes of certain partial encouraging aspects nor glimpses into the bottomless abyss of discouraging developments will cause us to abandon a few fundamental axioms of economic theory and policy. We are trying to pick our way through today's markets under the handicap of strange lighting conditions. Nevertheless we see no reason to make fundamental changes to our long-term investment strategy. Quite to the contrary! We seek to avoid following erroneous concepts and wishful utopias.

3. *A Flu Developing into Chronic Pneumonia*

In our last "Investment Commentary" (No. 184 of Dec. 8, 1997) we considered various aspects of the crisis in Japan and in the "tiger" countries. We concluded that first and foremost a gigantic misallocation of resources, which had been going on for decades, had lead to one-sided growth in huge, intransparent and corrupt business colossuses. The obviously existing industriousness and entrepreneurial spirit of the population was thus stymied. As is their wont, this like other such misallocation ended in unrealistic financial constructs and speculative bubbles. They've burst.

According to our (rough) estimates the past few months led to losses on the local stock exchanges approaching USD 1'300 Billion. The crash of '87 with USD 700 Billion looks almost modest by comparison. In addition real estate values in Asia dropped another 20 to 25%, much more in some areas. Including the currency exchange losses the Asian economies must have lost between half to two third of their value.

Such crises always have a short term effect which immediately threatens the stability of the regional, or in large cases like this one, global financial system. "Everyone for himself" results in huge reallocations, which serve to worsen the imbalances. The efforts of the IMF and of the World Bank have to be seen in this light. The Billions channeled into

these countries now serves first and foremost the international financial community rather than the Asian economy.

A quick check of the sums some European financial institutions have outstanding in Asia serves to confirm that to these circles the funds injected by the IMF must be highly welcome.

Asia-Exposure[1] of selected European Banks [2]

	Loans outstanding in US-$ Bil.
Deutsche Bank	16,0
Bayerische Landesbank	13,6
West LB	13,1
Commerzbank	10,1
Société Générale	17,2
BNP	15,0
Crédit Lyonnais	10,7
UBS+SBC	13,7
Credit Suisse Group	7,7
ABN Amro	12,1

[1] Including: Thailand, Indonesia, Korea, Philippines, Hongkong, Singapur, Taiwan; without Japan (!)

[2] Source: Handelsblatt

The European banks furnished over 50% of all the international credits to developing Asia. One cannot help but wonder how this came about. How in heaven's name can the state banks of two German "Bundesländer" each accumulate over 13 Billion USD of loans to developing markets in Asia, an inherently risky region? The answer lies probably with export finance; particularly government sponsored export finance for German firms. Much of the German export success appears to have been financed with German funds, especially German taxpayer's funds. This obviously makes exporting a lot easier... It is well known that the Germans are world champions in this field.

The sheer volume of exposure to this troubled region makes clear why the international financial community is working so hard to find a solution to avoid insolvency for countries or even some large debtors. One can understand that. The problem of any form of assistance to avoid insolvency is not in the initial assistance but in how phase two is tackled. Since in an international context bankruptcy is not equivalent to drawing a line under what is past and starting afresh, this type of assistance has a strong tendency to be reduced to a simple "bailing out", to become a mechanism, for redistributing the costs of the necessary write-downs among the anonymous mass of taxpayers who ultimately support the IMF. And this would not even be catastrophic or insupportable as earlier financial crises have clearly shown. The danger of a "bailing out" is a moral hazard problem: it provides the wrong incentives and signals to lenders and borrowers. They are implicitly invited to continue lending in a reckless manner. The ability to externalize the cost of faulty credit decisions tends to foster imprudent and excessive credit practices.

This is why we place much more importance on phase two of the plans for dealing with the Asian crisis. If once again lenders and borrowers manage to wiggle out and pass the buck to the world community we might have to revise our opinion as to the stability of the world's financial system. It would only be a question of time until the next crisis arose. And the cumulative effect of the destruction of wealth caused by such crises would ultimately be large enough to seriously hamper world growth.

What would then be evidence of a passably positive way of managing the "work-out" phase of the crisis in Asia?

- The large, intransparent, inefficient, unprofitable and often in corruption entangled conglomerates are abolished. We either observe a true change in proprietorship or, where no buyers can be found, the conglomerates are liquidated, at least in part.
- The political reforms demanded by the IMF result in better conditions for the rule of law and more respect for the individual.
- The IMF assistance is not misused to refinance loans to private creditors. These debts should be worked out at least in part through debt-equity swaps.

Whether things will evolve in that way is doubtful. But here too there is no clear black or white.

4. *Effects on the World Economy*

Worrisome questions arise not only with respect to the further development of the financing of this region, but also with respect to the extent of the already appearing recession in Asia and in the rest of the world. Simple "seats of the pants" estimates are, however, misplaced. It is most unlikely that all of a sudden all projects in Asia will be terminated and that this region will use neither cement nor electric power in the future or that no more soup can be sold. Certainly, Holderbank, ABB and Nestlé will face more hurdles in the future and it is very likely, that business will not be as profitable as in the past. The contribution of Asia to corporate profits will be reduced and may even go negative for some time. But to view this in too bleak a light is inappropriate.

It is not possible that all the many positive points this region had to offer in the past have all of a sudden turned negative. Asians are still industrious, "hungry" for a better life, and present in very large numbers. Throughout history they have proven time and again that their peculiar mixture of forbearance and tenacity makes impressive periods of recovery and growth possible.

This raises the question whether the West will now be inundated with cheap goods. The exchange rates of the local currencies have declined dramatically, which has not been without effect on the terms of trade. The Korean car producer Kia is said to have increased its sales in the US by 74% during November. The "Sephia" model was offered for USD 8'000.-. But it would be wrong to see this wave of cheap imports from Asia in only one, negative way. For the following reasons:

- Exchange rate losses also have serious drawbacks for the country devaluing its currency. Crucial inputs needed for production have to be paid for in hard currency. Interests rates, and with them refinancing costs are high. Price increases of imports associated with a straw fire in exports can lead to inflation.
- Cut price sales as those for Kia cars are of limited benefit to the seller. Throughout the world there are individuals who specialize in shopping at fire sales. But such sales are no long-term sustainable marketing concept. If the goods are more than mere undifferentiated commodities, then the question as to whether the seller will still be around at the end of the guarantee period is much more important than a few Dollars off the sticker price. Put differently: Despite all price advantages, the Asian suppliers will have to do much more confidence building before Europeans and Americans will dump their own products in droves to switch. This is true for Kia as well as Daewoo, Hyundai or Samsung.

5. *The "D" - Word*

The Asia crisis came just in time to give a boost to a concept that had begun worrying some people and that already found its way into some financial pamphlets. After inflation fears had dominated until the summer of 1997, it is now the fear of deflation that preoccupies financial punts on both sides of the Atlantic.

The argumentation is very neo-classical. One can follow its tracks all the way back to the early days of the history of economic thought. The large productivity gains of the past years, so the argument goes, will invariably lead to a loss of jobs and buying power. Production will take place ever faster and more productively with ever fewer workers. Due to the decline in buying power of the masses, consumption will decline and no one will be able to purchase the goods so efficiently produced. The result would be an economic implosion. This argument was heard at the introduction of the steam engine, the opening of the first railroad, when serial production started spreading and most recently when Asians began producing computer chips at ever-cheaper prices.

Appearances seem to support the argument. Unemployment in Europe is at levels never seen before in modern times. Without the government's support for certain inefficient companies the number would be even large. This should not be allowed to continue demand many. Little wonder then that some old fashioned Marxian ideas about the impoverishment of the proletariat enjoy a significant renaissance especially in the heads of some European intellectuals.

These people studiously avoid entertaining the idea that the effect (unemployment) my have little to do with the purported cause (economic progress). This despite obvious evidence supporting this view. For example, during this same technical revolution US industry has created more jobs than ever before in history. In fact, US unemployment is so low that until recently it gave rise to fears of inflation. And the "impoverishment" of the proletariat" should hollow to those who actually make the effort to analyze consumption and construction in the US. Both have stabilized at very respectable levels.

6. *The Problem of Relative Prices*

As is usual with difficult questions, there exists first and foremost a hopeless confusion in the definition of the relevant concepts. All speak of disinflation and deflation, often without knowing precisely what they mean.

Inflation is a general increase in the price level of the economy. Deflation is analogously a reduction in the general price level. Both, Inflation and Deflation, are monetary phenomena. Inflation is the result of an overly generous supply of money and credit to the economy, which leads to excessive consumption and investment demand. Deflation is the result of a monetary contraction, which depresses consumption and Investment demand and makes existing production capacity redundant. Disinflation in contrast, is merely a deceleration in inflation. Its economic equivalent is the reflation of a possible deflationary trend. So much for the definitions.

Now, the argument goes, prices the world over are falling. Such statements are merely another expression of black and white perception: One sees only one side of the coin, and with respect to prices preferably the one one is familiar with. It is true that numerous goods and services have become cheaper. Some consumer goods (i.e. textiles, foods, gasoline, telephones, stereos) can be acquired more cheaply today than a few years ago. Real estate prices have also fallen in many parts of the worlds.

But not all prices have fallen. For some goods and services we just fail to notice when prices rise because they are a small portion of our budget or because they enter as intermediate products in the production process. Prices for computers and software are continuously rising. True, quality or capacity is increasing as well but the new (necessary) programs also require ever more computing capacity and new hardware. The same is true for software which is also continuously improving but also needs ever more support from ever more expensive specialists.

The same is true in other areas. Whenever more than the absolute (commodity-) minimum quality of goods and services is needed, the additional (individual-) quality has to be bought at relatively expensive prices. Accordingly the pay of those producing specialized goods and services far removed from the commodity characteristic are rising the fastest.

When structural change is taking place at the rate we observe today, some prices will be rising while others fall. One-sided perception of one or the other of these effects must not lead us to deduce from individual observations a general trend. The world of structural change is neither "beautiful" nor "ugly", it is "beaut'-ugly".

The concern that we might run out of work and that consumption might cease due to this is essentially the result of our outmoded perception of the term "work" especially here in Europe. We even believe that this misperception is one of the principal causes of the persistent unemployment. Europeans tend to believe that "work" is only that set of activities which also produces tangible output. Those who dig for coal in a mine are by this defini-

tion "worker". Those who sweat in foundries or build bridges with under dangerous conditions "work". But those who dress up as Mickey-Mouse for the enjoyment of other, they do not work. Equally unworklike is the activity of artists. And the term "work" can certainly not be applied to the activities of the millions of providers of financial services in London, Zurich or New York. Speculators, parasites, that's what these people are...

Structural change in Europe will only be successful once the old perceptions of what constitutes work are definitely buried and forgotten. The new definition of "work" should include all activities, which meet an economic or human need, regardless of whether it is coal, derivative financial instruments or virtual enjoyment.

The European view sees only those sectors disappear which have lost their importance as a result of the ongoing structural change: Heavy industry, traditional armaments, mining, agriculture according to European self-sufficiency ideology, some public services which lived of the cold war. This view also overlooks the importance of the new sectors gaining in importance because these sectors are not taken seriously. Apparently they deal with less important or less "valid" needs as the production of lignite, tank bodies, meat mountains and milk lakes. – Incidentally: Is the New World now "beautiful" or "ugly"? We view it as "beaut'-ugly".

7. *Concerning Restructuring*

Most of the comments concerning the largest restructuring transaction to-date, the merger of SBC-Warburg and UBS, are also tainted by a "black" vs. "white" view of things. For some, especially holders of shares in these companies, the merger is "beautiful." And because they have profited mightily from the merger they are now the target of others pleading for the introduction of a capital gains tax. Yet others deplore the loss of jobs and the end of two distinct enterprises where each had its own characteristics.

We also try to view this "earthquake" in the Swiss financial scene in a somewhat more differentiated light. We view it as "beaut'-ugly". Consider first the loss of jobs. We clearly recognize that jobs will be lost and in no way try to deny the negative consequences for those concerned. However, in no restructuring is it true that

- all redundant workers will remain unemployed after the merger. Instead new enterprises will spring up around the old structures and these new structures will need employees. It is also not true that
- all employees not laid off will indeed remain in the new environment. Many will have difficulty accepting their new roles, their new bosses or the goals of the new order. They will seek to improve their position through changing jobs or starting independently.

In other words, the job destroying effects of such a mega-merger may well provide new, positive impulses. This is true not only with respect to the old employees, but even more so with respect to the clients of the merging enterprises. Clients my well have their reservations about the new structure and the apparently more efficient service. And it may well be possible that they seek alternative channels to meet their need for banking services. can certainly see "beautiful" sides to the merger story. And this can again lead to the creation of new jobs, at least in St.Gallen if not in Zurich.

The "ugly" side of the merger we see rather in an aspect that has received little attention so far. One reason for the union, besides the understandable desire of UBS' senior management to save their hides from Martin Ebner, is the idea that the rather efficient Investment Banking of SBC-Warburg might go well with the well heeled Private Banking of UBS. The idea is one of vertical integration, of creating one colossus, which could provide all services, from issuing securities to placing them in the portfolios of private clients.

This is the idea of a funnel, which collects and soaks up what exists in financing needs from private and public enterprises, collects them in a pipeline and forwards them by way of in-house investment funds and other aggregating mechanism to captive investment clients

who gratefully accept the blessings thus provided. The idea has its merits, even if it is not quite new. "Placing power" has always been a key word in the banking business.

From our modest perch we cannot help but wonder whether this vision or perspective – investment banking on top, private banking below – can be sustained in this manner. It is ultimately predicated on the assumption that investors are dumb and thus gratefully accept the orders and products their bank provides them with, accept whatever the funnel happens to produce right now. Some people may be fooled for some time, but sooner or later they will discover that there exists a free market offering other financial products and services. Is it feasible to deprive clients of this for long? Put differently and with a slight exaggeration: Can over time a structure flourish which is largely based on short circuiting the financial markets? And which, since funnel, pipeline and pot are all part of a costly whole, must be sustained through excessive fees and other performance reducing contributions! We have our doubts. In our view the investors should be the dog wagging its tail and not the other way around.

In addition many have begun to doubt the sustainability of investment banking as the goose that lays the golden eggs. Investment Banking is cyclical and is due to the ongoing structural change currently much in demand. But this boom cannot go on forever. It will be interesting to find out what happens to all the Investment Banking capacity that is being created today once the boom is over.

We are also not sure that in this merger the peculiarities of private banking by "Swiss rules" has been adequately considered, if "consideration" is the right word given the enormous time pressures under which the limited human resources of both banks must have stood. A significant portion of the Private Banking funds especially of the UBS are so-called "off-shore" funds, i.e. funds that may lack all the required fiscal registrations in the country of the ultimate beneficiary. We are certainly not wont to be moralistic about this in view of the confiscatory nature of many tax systems throughout the world. In some countries the avoidance of taxes can have clearly definable economic benefits, especially considering the use tax receipts are being put to. Nevertheless one must always consider that "off-shore" funds will always be viewed with suspicion, that they can be traced much easier today than before, and that therefore "off-shore" banking is subject to an increasing blackmail potential. "Off-shore" banking demands the highest degree of geographic independence and flexibility. Today in Vaduz, tomorrow in Curaçao and day after tomorrow on the Internet. We have grave doubts whether this requirement can be reconciled with the presence in London, Frankfurt, New York and other Lyon's Dens which is a requirement of Investment Banking. If we are right with our suspicions, then the new United Bank of Switzerland structure lacks a long-term strategic vision.

8. Against Unbalanced Thinking

Whether considering the continuous up and down of international financial markets, or contemplating with concern what is going on in Asia, or analyzing the economic situation in Europe or trying to understand the consequences of the merger of two banking giants we try never to lose sight of one thing: There is not only "black" and "white" or "beautiful" and "ugly". It is simply a fact of life that the world is different shades of grey, that it is "beaut'-ugly." Viewing only one side leads to caricatures, which are a poor guide for the development of future strategies. Neither euphoria nor deepest depression must guide our decisions.

Specifically this means that we will stick to our tried and true "big lines." These are still:

- a flattening of business cycles in all the important industrialized countries,
- a remarkable degree of discipline in monetary policy (which may be the cause for the first observation),
- low inflation and increasing convergence among different economies,
- a sustained downward trend of nominal interest rates,

- a high degree of restructuring pressure on enterprises combined with increasing competition for equity capital,
- accordingly more efforts towards increasing returns, and
- share price gains for those companies that succeed in this fight.

But we also know that many of these trends are obvious to other observers as well and are in fact priced into today's share prices. The time of large windfall profits from restructurings appears to be over. We will observe a convergence towards the mean. We know what this means for Swiss equities, the will over the long time horizon yield anywhere from 6% to 10% annually.

We also know that the risk of large moves on the upside, as well as (unfortunately) on the downside, is presently higher than usual. Currently implicit volatilities are between 25 and 30 percent. Normally they are around 25 to 20 percent. If the amount one is willing to lose has remained constant; one might want to reduce equity exposure somewhat. We come to this recommendation without giving up on our fundamental stance in favor of equity capital. But taking risks is a question of degree and depends strongly on each individual's personal circumstances and expectations.

We keep calm in the strobe lights of the markets exaggerations in all directions. Particularly we remain calm in choosing the investment- and risk policies. Come what may in "beaut'-ugly" surprises the future holds in store for us.

KH, 1-28-98