December 20th, 1999

No Breather!

1. A whiff of January 2000

It has always been a wish of mankind to be able to travel through time, to gather it together by hours and minutes or to stretch it in order to again relive the past – or even more fascinating! – to be able to walk in the future. Unfortunately, and perhaps luckily, this remains only a dream. We cannot start to imagine to what additional complications mankind would be exposed if it would be possible to actually surf through the dimension of time. Whole professions themselves would find their proud self-righteousness under question. What value is the historian's perspective of events in relation to being able to relive through the era of what things were *really* like? Instead one is dependent on the powers of imagination, and this seems not at all to be linear, but over time to be expressed in three dimensions.

However, we analysts and forecasters would get into terrible difficulties if a voyage into the future actually could be possible. Because, honestly speaking, even without special abilities, it is not a bad life at all to be able to extrapolate the present to the future and to include the least "unthinkable" in one's projections. The public owes it to us. Too wild an imagination can also cause unease.

On a very small scale, however, there is the possibility to sniff out a little bit of this air of the future. The financial markets provide us the opportunity. One of the most charming, and at the same time least understood phenomenon which the economy provides us lies in the *anticipation* of events generally expected to occur in the future. Due to barrages of the hard and software specialists, the whole world has steeled itself for a rough transition to the third millennium. Apocalyptic scenarios have been playing for us. The failure of ATMs on New Year's Day 2000 belongs to the less harmless, the breakdown of electric power supplies belongs to the more threatening variants. What does your average citizen do with an eye to such eventualities? He makes provisions and looks that he has enough "readily available cash reserves" to be able to "survive" in an emergency. And how do the corporate and banking worlds react with regard to an event that may possibly result in a temporary drying up of payment flows? One is liquid up to one's ears. And how do the Central Banks react with respect to the new millennium? They provide additional liquidity to the financial system.

The whole globe knows that our world is to the greatest extent liquid, due to the Y2K-problem, and one can easily conclude that in the first few months of the new millennium higher yields rather than short-term investments are being sought. And while this conclusion is deemed reasonable, it also seems obvious that this "flight from liquidity" quickly could end up in an inflationary spending spree. Why shouldn't one stock up a little today – but admittedly to the debit of carefully built up liquidity – particularly since the latest forecasts foresee that the millennium problem may not be so bad?

The anticipation of a January rally has dominated financial market events in the past few weeks. The rate arbitrage could not be portrayed more clearly, because a change to a new millennium is not always available to show the significance of the growth in expectation and its forces. And so the effects of the mechanics of anticipation are completely balancing. Because what has climbed today, will no longer do so in January. It could well possibly be that most of the good things in the Year 2000 have already been anticipated. If you wait until January, you may already be too late, – which again substantiates the old truth that standing on the sidelines has never been worthwhile, "les absents ont toujours tort". One knows neither the time nor the hour ... even as the new millennium is being rung in.

2. 1999: A Lost Year?

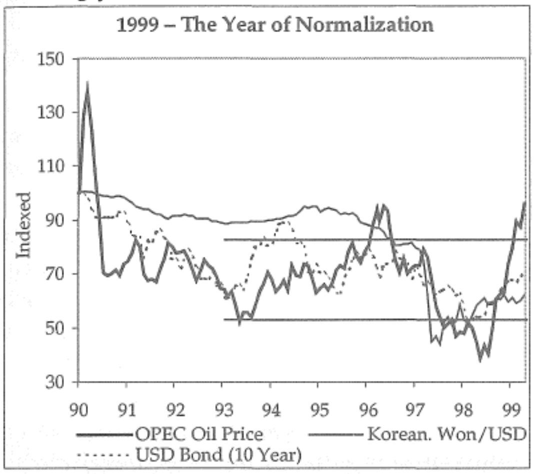
Despite the described and currently alleged anticipation of the forthcoming January 2000 rally, the investor has not been spoiled by this past year which is now quickly coming to a close. Whoever held bonds as so-called safe investments in his portfolio has had to clearly accept losses in most of the major currencies, and only eventual foreign exchange profits (for example US Dollar bonds, in the case that one calculates in Swiss Francs or Euros) have managed to brighten the picture more or less. Whoever, in the long-tried manner, has invested in Swiss Blue Chips, has had his kind efforts rewarded by reaching the price levels prevailing at the beginning of the year. A constant and quite aimless up and down movement is making life difficult for the investor as well as his advisor. Whoever had the courage to bet on a few good shares took especially big risks in 1999. However magnificent the gains of some "over-performers" appear to be (like ABB, Cisco, Nokia), so crass are the losses of shares out of which one could have blindly built investments in the past. Who can claim never to have heard of Daimler Chrysler (-20%), Philip Morris (-50%) or Zurich Allied (-8%), let alone not to admit that the one or other company is in one's portfolio with a view to better times?

The enormous selectivity applies even to markets which were "interesting" from the viewpoint of the development of certain indexes observed during 1999. If one subtracts the largest and the most influential price winners from the Nasdaq or from the Dow Jones Index, then very little profit remains (which, with respect to future developments, can be interpreted in two completely different ways: Either a few companies are definitely overvalued, or all of the rest contain a substantial "catch up" potential... Please see the yellow supplement "Investment Policy", #1). Being true to its name, real stock market gains were only achieved in the Far East and in most of the emerging markets; but who was foolhardy enough to place bets on such markets, especially after the catastrophic year 1998? One cannot simply dismiss 1999: it was a difficult year for both investor and advisor. Stagnation can be even more troublesome than a bitter loss situation, because lack of purpose is not desired where profit is the rule and the appearance of risk should then form the expected exception.

We nevertheless consider it completely inappropriate to speak of 1999 as a "lost year." As you know, at the beginning of the year we strongly recommended to our clients to take advantage of the prevailing market conditions and to use the general excitment involving option trading by means of utilizing a structured product. This has paid off. Only a minority of the over one hundred structured products of our Bank have shown a loss; the most were able to generate yields of 10% and more, and this by taking little or only average risk.

Yet from an economic standpoint, 1999 was also no "lost year." If one still likes to remember what a predicament 1998 delivered, then one will be aware of what enormous world economic changes had to be conquered in this year that is drawing to a close. In essence the financial market crisis was a loud and dangerous bursting of a mighty credit bubble, which over the course of the years swelled to immense proportions under the umbrella of the International Monetary Fund's support of emerging markets. With Russia's inability to meet its payments, it became clear that it was impossible that anyone in the world could cover the entire cluster risk of all emerging nations. And it also became suddenly clear that such a guarantee scheme was not at all desirable. Such a scheme sends the wrong signals because all the creditors are obliged to take excessive risks at too low a price, while debtors would obtain funds at a ridiculously low price unjustified by the level of risk. The concept "moral hazard" made the rounds and paraphrases precisely this orderly political problem, which can arise through rash granting of guarantees. (We will return to this subject again in our discussion of the Holzmann case below. Unfortunately these mistakes occur again and again, and often more frequently than believed possible.)

1999 was the year of normalization. Interest rates began to vacillate from their absurd lows at the beginning of the year to reach an appropriate level for growth. The price of oil rose following the forced sales of 1998, to a level which allowed the OPEC to remain together, but which did not yet allow the build up of new transportation and refinery capacities. Direct investments in emerging nations gained strongly and have, in the meantime, reached higher volumes than before the crisis of 1998. Since late summer 1998, the now free-floating currencies of countries such as Korea, Thailand, Russia and Brasil have stabilized even though at strikingly lower levels.



Source: Bloomberg;

We spoke at the end of 1998 of the opportunities which could result out of the crisis of the preceding Fall. For us, standing in the foreground was the view that, from now on and for a time to come, international capital would flow to a price level which would be justified by yield prospects and not be falsified by any (in its ultimate effect illusionary) agencies. Or expressed differently, we predicted an efficiency gain for the international capital markets at that time. It has arrived; by and large the significance of this normalization should not be overrated.

If you are surprised today by why the recovery of the emerging nations has progressed so rapidly, then the reason is certainly not to be found in any such successful interational stabilizing and stimulating programs, but rather in the higher efficiency with which capital now is able to find the desired risk/yield profile. Further development can absolutely be faced with confidence, providing that the international community and its institutions can succeed anew in not introducing any further schemes which would ultimately draw too much money to highly insecure places and into too risky projects.

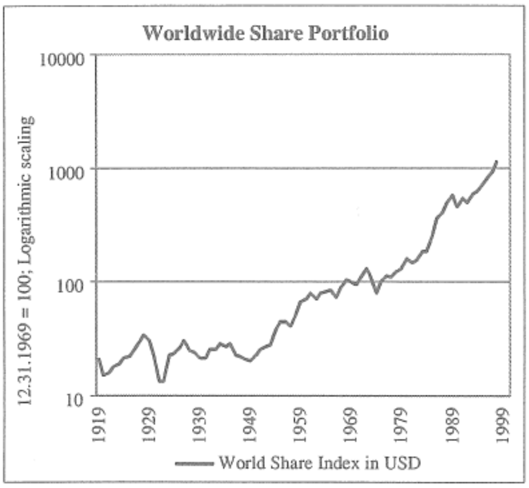
3. The 20th Century: A Lost Centennial?

At the end of a millennium and with it a century, one cannot help looking back to see if we can learn from the past year and, yes, previous years, to ascertain what the future may hold.

The view of the 20th century is basically *incredibly bleak*. Never before have so many terrible wars been fought. Never before have entire populations been so systematically irradicated. Never before have so much life, land, property and welfare been sacrificed for abstruse ideas and ideologies. Never before have such great masses of people been so deceived. This past century has inflicted pain on many men, women and children. For millions and millions the expression "lost century" is narrowly euphemistic.

Whether this shady side can be offset on the other hand by an absolutely fascinating technical and economic boom, which the century also brought with it, remains to be left to the discretion of the reader. However, one can conclude relatively unbiased, that both the warlike and destructive shadow side as well as the side showing creative components of an ever rapidly increasing upswing, have existed next to each other on the one and the same planet. And what is quite remarkable is that in view of the massive total destruction potential of modern day nuclear weapons is that *we still exist at all*. This observation is in no way trivial, because it allows hope and confidence to be the guidelines for the future. Notwithstanding the potential for destruction mankind has continued to survive; furthermore no one has yet succeeded in pushing the buttons to exterminate life on earth as we know it. Up to now freedom has had the upper hand. Freedom also means – among other things – economic growth and activity.

And so, it is remarkable that despite all wars and uprisings, free ownership has been only regionally, but never completely lost. A globally diversified portfolio shows a positive return, despite World War II, Stalinism, the Korean War, the Cold War, and Vietnam. Of course there were bumps and blows. But all in all the free investment position has survived better than a greater portion of humanity. We must take note of that.



Source: www.globalfindata.com;

arises from this century's relationship between the national and the governmental. Europe in 1900 was defined by empires, kingdoms and principalities, by proud republics and nearly once by brutal power forces of various colours. Viewed from a distance the two great wars and the subsequent cold war embodied a culmination, a rebellion against national ideals, which seemed to have steadily and increasingly lost meaning thereafter. Modern technology makes territorial boundaries more and more questionable. If the telephone, international television and, especially, the fax machine have brought a giant such as the Soviet Union to its knees, then currently the Internet is gnawing on all territorial structures. The end is not in sight – there is no breather.

In a future Investment Commentary we will come back to the tax consequences of these megatrends. As for today, taxes are concepts tied to a territorial principle. The development away from territory and towards a virtual internationality will raise some difficult problems requiring resolution. It is anything but sure whether a fiscal rebellion will arise in the first decade of the 21st century or not, because inability to pay threatens territrorial structures. Expeditions on what are now considered legally hidden assets will become the focus of attention.

Towards the end of the 20th century, the loss of meaning of national and territorial has left definite marks on the *monetary* side. Warfare and the politically motivated manipulation of money supply are twins. There has hardly been a phase of a well-known currency depreciation which has not been tied - shortly before, parallel with, or following - warlike action. Inflation can be arranged, if the national economy in question is isolated and if its capital is not allowed to pass freely across borders. Inflation allows itself to be exquisitely justified, if the generating policies of "higher interests" can assert themselves. And the highest of the "higher interests" has always in history been a war in the name of the Fatherland.

If there has been some progress gained in this otherwise dismal century, then it is increasingly difficult for the civilized world to find reasons for isolation. We interpret the European Union less as a result of a political feat than as a result of a development which appears as anything other than absurd. However countless other unions and conventions, for example the World Trade Organization (WTO), operate extensively on an understanding which due to technical developments is anyway unavoidable. Free trade does not exist because any such "bad" authority explicitly wants it to, but rather because it cannot be held back in the sense of the power of the factual.

4. Europe in Transformation

Territory and power have seldom been surrendered peacefully. One must be aware of this if one applies the development described above to the individual world economic regions. So Europe is evidently a long way away from the creation, in which the political and the national would hold the proper position and lessened importance. The almost reflexive reaction of the German government to both of the cases Mannesmann and Holzmann has shown with textbook clarity, how difficult and lengthy the path to a domestic market can be, in which it truely justifies its name.

For the last few weeks, the quite unique Mannesmann concern (pipes and telephone, etc.) has been confronted with a so-called hostile takeover bid by the British telephone conglomerate Vodaphone, whereby "hostile" is a problematic description in such cases, because a takeover is actually only hostile to the existing management, and usually not at all for the shareholders and owners of the target object! Certainly there can be no objections if this mega-merger is critically examined. And there may be no objections if one comes to the other conclusion that the transaction makes no sense in this form. It could well be that pipes and telephones in one and the same company enjoy an especially meaningful symbiosis. Both with pipes as well as with telephones, one can speak into one side and the sound comes out on the other side.

However, such economic considerations have not been thrown into the discussion, but rather indignation over the possibility of *transnational* hostile take-overs. And immediately the call for an EU-wide takeover code of conduct resounded, which ultimately can not aim at anything other that laying bureaucratic stumblingblocks in the path of such transactions. Does one really have to make an effort to create a domestic market, and to assume that the first time this domestic market could take effect, that the nationalistic and protectionistic reflexes would gain the upper hand? A sign on the part of the EU-Commission that at least it understands something different when speaking about domestic markets is urgently needed.

The Holzmann case also does little for proress. It is a classic example of the "moral hazard" (see above, page 3). A proud and solid construction company is destroyed by an incompetent and/or slightly corrupt management over the years. By offering the lowest prices (usually stemming from the small and medium enterprise sector), competition was systematically eliminated, admittedly with the consequence that not only the competition, but also Holzmann could no longer survive pushing at the limits of profitability. Since Holzmann got on very well with the banks, notably with their topmost committees, they played this game for such an incredibly long time until the numbers appeared so hopeless that not even the allied banks wanted to or could help.

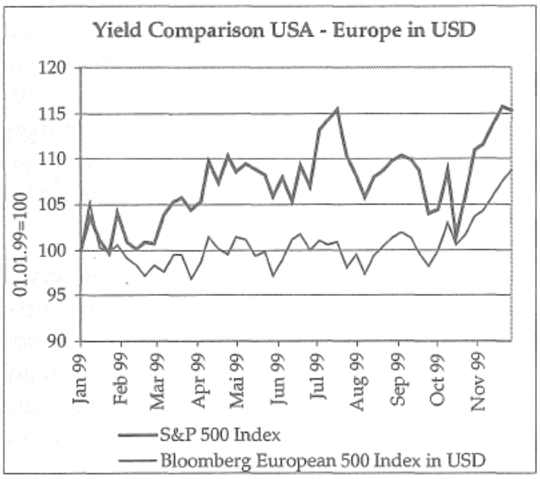
The active economic policy of the treasury happily played alone. Under the pretext that he must not only save workplaces in the tens of thousands, but also a majority of the suppliers, the German Chancellor himself personally (he wants political applause) produced the "well-tried" means of the state guarantee. As a consequence, one returns to normality and acts as if nothing much really happened. The game goes on, with big business realizing that the goverment will be the lender of last resort.

When one deliberately supports a scheme that has previously destroyed jobs in small and middle-sized companies, and has used tax money probably extracted from the pockets of just exactly those small and middle-sized businesses, in order to keep the hungry "black hole" alive, this amounts to fiscal corruption and protectionism of the worst kind. This is a real "moral hazard."

It is obvious that Europe needs precisely a different kind of medicine. Most of the economic structures, with only a few exceptions in big industry, are still nationally oriented. Still some capital likes to flow sector-wise across EU member borders. Yet mobility within Europe is low (which does not surprise us, when one is allowed to directly counteract that mobility and the liberalization of the work force by enforced guidelines and supporting measures. Trade unions, especially in Germany, still predominate far up the hierarchical ladder of the big companies, which are not suitable enough to attract enough risk capital.

A chance for a real productivity-increasing and capacity-expanding recovery on our continent can only occur if, as in the cases of Mannesmann and Holzmann, the reported, unfortunate interaction between politics and big capital interests ceases and in its place comes very limited restraint. Europe has yet to move in this direction. There scarcely exists a national government which is not constantly tempted to sin. But with the EU commission one is not so sure that interventionist tendencies also prevail. The enthusiasm which drives forward a so-called tax harmonization gives rise to a certain degree of skepticism. Has one ever heard of a tax harmonization before which has not in the bitter end led to a tax increase, leading to an adjustment upwards of state quotas?

The differences in returns of the European and US stock markets as well as the currency differences are in our opinion not completely unfounded. Europe is not able to convince itself yet. Potential alone is not enough in the long run; proof of action must now follow. There is *no breather* for our continent. On the contrary!



Source: Bloomberg;

5. What a Free Capital Market Can Do

It is easily understood that open European envy could arise towards the Americans in view of the hard facts of their far healthier economic growth, more much lively domestic demand and higher returns on stock exchanges. What is over there anyway that is so much better?

Let us begin with things that are certainly *not* better. There are many. Let us start with the common everyday items (which ultimately are not so unimportant). The coarse way in which they build cars does not convince the European; the Italian is used to elegance; the detail-loving German relishes value, stability and perfect furnishings; the Swede is impressed by robustness and safety. The lack of sense of design applies not only to automobiles but also extends to the complete absence of names of deserving industrial design. Already many a machine manufacturer has tripped over the immense differences in mentalities. Not even speaking of suppliers of European designed household products: Neither fixtures and fittings nor more or less energy-saving stoves nor European coffee machines can be sold in America. And there is no shower gel either. One still uses soap just like in the days of the Mayflower.

The considerable indignation of service personnel, the frequently encountered unfriendliness and the astonishing incompetence at customs, a bank window or failing all, a visit to a public hospital, seems always to amaze the European. One does not really want to believe that in this country it is a fact that the service sector is now beginning to win the upper hand over the other sectors of the economy.

Finally we look with increasing concern to the developments in the American legal system, which "Rule of Law" has long set as an example for us, and which is threatening to slip more and more into an arbitrary reign of the "Rule of Lawyers." Slips in the absurd product liability laws are obvious; the misuse of the legal instrument collective suits paralyzes entire branches of the economy; the mix of politically correct "affirmative action" and the ubiquitous presence of the media has already begun to threaten the, up to now, highest American prerogative, the freedom of speech.

For the outsider it is obvious that *double morals* dominate to an enormous extent the American society and its institutions. Under the title of compensation for Holocaust victims, law firms jostle under the title of compensation for Holocaust victims and dubious politicians position themselves accordingly; under the banner of the fight against drugs, one of the worst colonial wars in South America is being waged; in the eagerness to obtain more so-called transparence, the Americans are tearing down all the protective walls of privacy. That these blessings of the American double morals under the reign of *pax americana* should be expanded to be embraced by the whole world, lends for the first time an expression which at the time of its most frequent use had little legitimacy: "Imperialism."

One wonders, in view of the numerous millstones, which are burdens for the development of a free economy, what now makes up America's comparative advantage over Europe and the rest of the world. The answer is simple. It is the freedom with which capital can move, no more and no less. The USA is very close to the ideal model of what we have learned from micro-economic textbooks. There is a suitable offer for each specific demand for capital; the balance of supply and demand takes place daily, hourly, and each second on extremely efficient stock exchanges as well as on other negotiable platforms. Unlike Europe, it prepares young American companies without effort to obtain venture capital. The arduous and often hopeless, Kafka-like visit to the banks to struggle to obtain foreign capital has been spared to the Americans. One can start up *after* previous provisioning through equity capital.

In America moreover, nothing is more natural than the disinvestment from a venture after making it successfully bloom. Not only is the investment guaranteed, but primarily also is the possibility to liquidate. From this results the opposite of the trade and industry structures of Europe. Businesses change owners in quick succession, are built up, are merged, are liquidated, and constantly they continue in ever changing new forms. In Europe, generations stay "in the business" even when they have forgotten trade skills and have lost the momentum of their grandfathers years ago.

The unequal distribution of new establishments and of newly established jobs between American and the Old World speaks volumes. Likewise the difference in economic growth, which less likely will end up as a rise in inflation in American than in Europe is due to the fact that productivity is constantly increasing. Sectors with threating bottlenecks are punctually rescued by the high capital market efficiency which, with a timely delivery, diverts new money for the next investment and because accompanying this new capacities are constantly be created. In the discussion surrounding the "New Paradigm" of the economy, thus around the argument that no inflation is to be expected for the time being, due to technological advances, both sides have overlooked not only that technology has experienced a violent growth, but that the capital market has reached an efficiency in which inflation has become quite a meaningless concept to economic control and stimulation.

6. Potential is not Everything

The recovery of the emerging nations during the course of this year has been quite surprising. We pointed out well ahead of time (in our Investment Commentary No. 195 dated July 5, 1999), that direct investments in emerging markets suffered amazingly little during the crisis of 1998. On the contrary, opportunities which arose during the currency crisis were utilised, in order that direct investments could continue to be built up and extended. Our conclusion postulated that out of these direct investments a domestic and import demand would soon be generated. This prediction has been fulfilled to a great extent in the meantime, and correspondingly the stock markets in most of those nations have tended to respond favourably.

So far, so good. The question concerning the future of this important region of the world does not only occupy Europeans because they are export-friendly, but also because they are investors who would like to touch a little less seriously upon the idea of diversification. The problem is this; there exists a very clear-cut difference between direct and portfolio investments. Portfolio investments, together with interbank loan transactions to resident businesses, land ultimately always in some form or another on local capital markets.

However, their liquidity is hardly given in any case. Particularly in tense times, the markets quickly dry out, and the investor can rid himself of his investments only at enormous discounts. Market liquidity is difficult to define and almost impossible to measure; it even cannot be easily generated. A variety of examinations of the topic lead to the redundant conclusion that wherever market conditions are liquid, liquidity rules. In other words, one cannot create liquidity, it just happens.

When not sufficient, but rather yet a necessary circumstance for liquid market conditions, the *Rule of Law* seems to us to be of significance. Where the environment is not conducive to fulfilling claims if necessary and where property claims cannot be assured quickly and simply, there exists little chance that a successful capital market can gain a foothold. One dare not even make considerations on a market for derivate instruments, which are, respective to self-assertive capabilites and certainty, especially sensitive. Without derivatives, however, the time dimension remains undeveloped with respect to investment decisions.

In conclusion, however promising phasewise the economic developments in emerging nations may be, and however fascinating its potential may seem, the position of the portfolio investor as a result of mostly insufficent rule of law and scanty market liquidity remains insecure. When we wish to invest in these regions, we still bet on companies from the industrial nations, who have demonstrated in the past that they can competently manage with direct investments. In this way we run less into the dangers of local markets or being cheated by one of many emerging market specialists. One is in any case involved with the potential of emerging nations.

7. Best Wishes

We cannot allow the last Investment Commentary in this millennium to conclude without our heartfelt best wishes to our readers and a warm thank you to our clients for their confidence in our Bank, which after all has taken part in the last quarter of the millennium which is now quickly coming to a end. We have tried to show with this Investment Commentary where the great courses of economy and politics are momentarily headed and with which rich provisions we are able to start in the new millennium. Completely without illusion we have also pointed out the millstones which actually put a burden on every region of the world. Utimately all of these burdens, whether they be European, American or also Asian, are concerned with the question of whether one finally grants humanity the freedom to be able to develop in dignity and decency. There is no breather for this question. The investor must decide where he can live with these risks and where he cannot. The concept of freedom must remain as a moral obligation in the thoughts of the citizen. There is no breather, not even after January 1, 2000.

KH, December 20th, 1999