

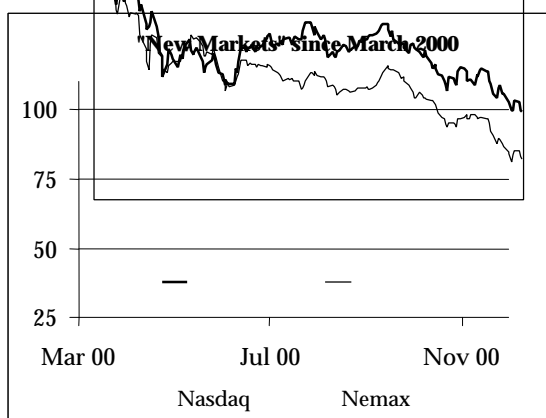
December 14, 2000

Lack of Leadership, Poor Orientation

1. The Year 2000: Two to One

It is now time to look back. And for a cautious attempt to look forward into the coming year. And, perhaps, to ascertain what might be in the distant future.

We have (almost) left a strange, sobering year behind us. Does anyone still remember the inspiring swing with which the avoided millenium catastrophe catapulted us into the first months of 2000? We needed this victory over that "oh-so-superior" technology which we had brought upon ourselves with the double-0's, in order to bring to overflowing the jubilation over the "New Economy". Up to the month of March, everything which was in anyway and anyhow connected to a dot.com, was inundated with money without any regard to economic substance. One initial offering followed another, surcharges of almost horrific dimensions were added to issue prices, and everyone who skeptically stayed out of the fray was regarded with derision and scorn.



Source: Bloomberg;

Since then essential and substantial corrections have taken place. The American technology index Nasdaq was down 42% at the time this Commentary went to print, and the German New Market has suffered even

more – down 61%. The bottom line: A half of a fortune! Or even more! This is dramatic, and the concept "correction" should actually be replaced by one of a sectorial "bear market". Holdings melted like November snow in the sun.

However, corrections have not only taken place in specific sectors of the financial markets. Disillusionment is also a keyword in the world of politics. Wherever one looks, mountains of insoluble problems seem to pile up, and frustration reigns where once an optimistic mood dominated in the beginning of the 90's. In Palestine and Israel the Camp David spirit has completely vanished, in Romania an epigone of Ceausescus has come to power, the Middle East is again playing with fire in raising oil prices, Saddam Hussein is according to rumor again filling his arsenals of B- and C-weapons, the proliferation of highly accurate and dangerous war instruments in every receiving nation is running at top speed as never before, Milosevic again has a say in Serbia, and in Latin America from Argentina to Peru to Columbia to Venezuela, there are crises. And the leadership powers? America, Europe?

The present assessment breaks down to 2:1. A minus sign on the side of politics and a second minus sign on the side of technological share indexes, respectively, with a view to the workings of the financial markets with the leaps in development in technology.

One positive sign remains. And an important one, at that! Namely the almost perfectly functioning capital market. The interest rate situation in the major currencies, Dollar, Euro, Pounds, and Swiss Francs is encouraging. None of the Central Banks wants to contaminate the system with inflation. The value of such a stability cannot be overestimated.

This Commentary attempts to address three elements of international policy displaying

very diverse characteristics, the situation on the stock exchanges, and especially in the sector of the "New Economy", as well as the element of the monetary situation in the sense of a current analysis at the end of an interesting and provocative year. Our objective is an attempt to give some guidance for the true transition to the Third Millennium and beyond, a transition whose exact course is undefined more than ever before.

2. The Unavoidable Topic

One hardly wanted to read the newspapers any more, when one saw that in the USA legal actions were still pending in the courts concerning the consideration or neglect of still uncounted ballots in Florida. A sad state of affairs without end which was being met in Europe with disbelief, especially because of the belief that in this "Nation of Litigation" it is obvious that everything, and really everything ends up in court.

Firstly, we must realize that the whole matter should be a *warning* to all who have believed in the domination of the world through total data transparency. Especially in the USA the contention is that such accumulated data gained by surrendering the protection of privacy will serve as a suitable basis for "social engineering" of the modern kind. The Calvinistic tradition of social control is thus combined with the powers of modern data processing and receives, through the crude protection of the combined media-powers, a potency of incredible size. Only the passive observer fails to see the element of fascism in such a social opinion, which does not mean that it would find global acceptance without the approval of the media. Because wherever data transparency means everything, and where individual freedom and responsibility are subordinate to any social interest, it is there that we can find so many persons miraculously affected and so many offenders wonderfully involved. We can hatch and embellish numerous stories which are currently well suited for illustrative purposes.

Except: One must be able to count. The privacy invasion of the homes of the citizens has produced data in vast amounts. American banks are required today to report any client transaction over \$10,000 to a supervisory authority, which we assume will filter suspicious transactions out of the daily data disorder. What an delusion that we believe

we can gain control over the problems of criminality and money laundering by way of this penetrating, pea-picking procedure! Today we all know that in spite (or because?) of such measures, the USA has become a paradise for money laundering. It seems, according to the investigations of the American General Accounting Office (GAO), that the distinguished scion of the banking industry Citibank, stands right in the middle.

What does this have to do with the entangled presidential elections? Nothing and at the same time a lot. America bursts with numerous statistical investigations out of which all kinds of conceivable conclusions can be drawn. By way of its inherent exaggeration, this "total transparency" can evidently lead to a condition in which the control changes into its opposite. And we have observed exactly this in the election debacle. There is no nation with more extensive and precise opinion polls. There is no nation with earlier and seemingly more accurate election projections. And, there is no nation which, in the end, has its President-Elect with big delay, due to wrong, inaccurate or even uncounted ballots.

Palm Beach County has dealt a blow to the ideology of control. Whether it already is Waterloo, remains to be soon.

3. Vacuum of Several Years?

As the situation presents itself today, we should assume that uncertainty will be prevalent in the American scene for some time to come. If Gore would have won his lawsuit and the ballot recount would have been awarded to him resulting in a majority of votes in the State of Florida, then it would have been conceivable that he would had a bad start as President and it would have been safe to say that the unified Republican majority in the Congress would have been against him. "Cohabitation à l'américaine" has seemed to function in the past, but only because the conflicts in factual issues between the main parties intermingled, and because a vote against a bill of the President or his administration did not automatically lead to a vote of non-confidence as it does in parliamentary systems.

Gore would have had the Congress against him and also a large section of the population and certain states as well; the stigma of a forced election would have stuck for a

long time. Nor does it look any better for Bush. He, too, have to live with the blemish of the, although more correct, but however somewhat more questionable, election results. What is even worse, and at the same time anything but improbable, is the view that after Bush's election to the Oval Office, the true circumstances in Florida will gradually come to light. What did Florida Secretary of State Harris say to Jeb Bush, Governor of Florida and brother of George W., over the phone? And what did George W. and Jeb discuss? And who can believe that these conversations were neither monitored nor recorded?

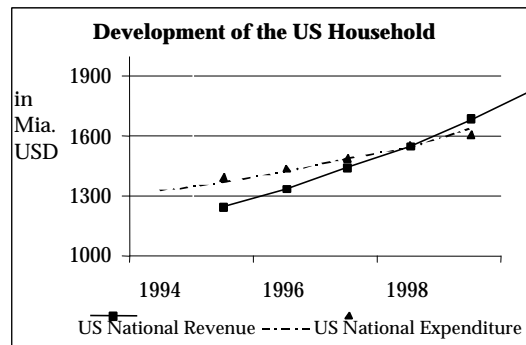
The confusion in Florida calls for subsequent investigations and will probably make for some unappetizing revelations, possibly during the first year of a Bush administration. Bush wanted to clean up the power cartels in Washington as a fresh force from Texas. But it will be just precisely these circles which will rise up against him, well armed with the concentrated strength of the New York legal industry and the majority of the media. Even the smallest irregularity would make an impeachment trial a likely scenario. Who would profit most at hand from this? Clinton. Not Bill, but Hillary. The probability that she could become the next and at the same time first female President of the USA, increases enormously with a Bush Presidency.

We can twist and turn it as much as we want: It does not look as if American domestic policy will be able to contribute to favorable general conditions in the next few months, and possibly in the next few years, neither for world policy nor for the global markets.

4. A Zero Decision Between Worlds?

The American People can obviously not make up their minds. The differences between the two candidates Bush and Gore are so minimal that such a result was to be expected. We are, however, not so sure regarding such triviality of differences. Rather we could not help feeling that the so rosy economic situation has shifted the view to the missed and dismissed.

As Vice President in Clinton's team, Gore belongs to a circle of power that could profit to a great extent from an economic upswing (not caused by this). Namely the budget deficit could be eliminated in this time span.



Source: Bloomberg, www.irs.ustreas.gov, Bureau of Economic Analysis;

This appearance, however, is deceiving. The chart above shows that it is not actually the savings performance which has produced the reduction in the budget, but rather a quite steep rise in the revenue of the US household.

The outward economic success of the Clinton Era stands face to face with the serious foreign, as well as domestic, political omissions and deficits. In principle the unparalleled chance of the absence of another serious world power was widely missed. In fact there is hardly a country on earth that does not feel in any form the long arm of Washington's *interference* in some way; *order* has not *in any way* resulted from this activity – on the contrary. Seldom before have such a great number of dubious characters such as Fujimori in Peru or Mugabe in Zimbabwe or Chavez in Venezuela been able to remain so uncontrolled in power. The potentates in the emerging and developing nations could hardly ever before enrich themselves so easily, even allowing, if necessary, complete sections of those populations to be exterminated. Not that we wish more activism on the part of the USA – on the contrary. Effort and yield do not stand in a sensible relationship in the present politics of interference.

Arrogance and inability have led in the Arabian World on the one hand to the Moslems being more and more openly anti-American, and that the governments supported by the USA are able to remain in power only with great effort and repression. On the other hand the Palestine problem has also not been solved; on the contrary we stand before a pile of broken pieces. The chance to break away from the strategic dependency on petroleum was missed in an unpardonable way. The room for manoeuvre of any American Administration in the settling of the Middle East conflict as well as also for repeat performance of a broadly

supported policy in the Arabian nations will therefore be fearfully small.

Nor do we regard US interference in Latin America more positively. Under the guise "Drug War" (admittedly set into motion by Clinton's predecessor Bush), the USA leads a kind of colonial policy there with negative portent. Not that these countries will be dred economically through monopolized cheap exports. Rather the attempt to stop the export of expensive raw materials for drugs by preventive measures of all kinds, should result in principle in raising prices and strengthening the incentives for cultivation. Guerilla-like operating drug cartels are the result of this hopeless policy; democracy and rule of law will never be able to survive such conditions.

The Latin America policy of the USA would possibly be halfway acceptable under the title of "Misdirected Gullibility and Naiveté" if it were not accompanied by a double standard equal to none. Yes, demand contrasts also with the supply side fought solidly internally. Is it a coincidence that one quite often hears of the successes of US drug searches abroad, but those carried out internally are extensively avoided? And how do the financial centres in New York and the offshore locations in the Caribbean behave? Are the assumptions that the tentacles of the Drug Mafia reach all the way into the US Congress completely erroneous? If anyone was interested in the "Drug War" and the high prices connected to it, then it is the Drug Mafia and its associated financed circles. Many a declaration of hardliners concerning the subject "drugs" is relevant with this insight. Perhaps we find a continuation under other signs which has made families like the Kennedys and others rich in the retinue of the Prohibition?

Also domestically there are deficits. Notwithstanding the admiration for the enormous flexibility which has made the economic upswing of the last nine years possible, there are still old and unfinished problems which, as shadows, cannot be ignored. American education has not improved nor has the infrastructure of the country been upgraded. There are still gaping social differences, especially between the blacks and the whites. The important question of subsidiarity remains; what is the role of the Federal Government, and what role should the individual states and the mu-

nicipalities themselves play? The USA is much more centralistic than is generally assumed.

We do not wish to evoke apprehensiveness. The North American regenerative power has always been amazing. However, a nation which ought to be a world power, a country which has to solve its own domestic problems, a country which will be without leadership for some time, can neither leave the politically-interested citizen nor the concerned investor apathetic.

5. Europe's Opportunity?

The conceptual vacuum produced by the USA since the conclusion of the bipolar global system, for the time being will hardly (respectively, rather in a diminishing way), be filled by Europe. The impetus of Maastricht has long subsided. At the top of most European governments sit more or less pragmatic socialists who have neither corporate- or foreign-political visions. The Austrian debacle clearly caused by the individual governments and not by the EU, instantaneously pointed out the order of priorities, mainly, that one stays in power.

In the meantime an inner-European bilateralism is being maintained, which stands in crass contrast to the declared beliefs of the Union. The EU Commission must make do with the technocratic level, even though the most essential and the most difficult questions are of a multilateral nature and must be solved multilaterally. So time is wasted on questions concerning taxation of interest, the BSE-problem and traffic policy, instead of devoting time to the necessary depth of complex questions which should be of the most urgent nature. What kind of constitution should Europe have?

Why is the constitution question so urgent? Because, firstly, we cannot continue to conduct our business oblivious to the fact that the EU does not assume state characteristics in many interests. If this is so, then we must admit it and consequently create a framework which the rule of law and the understanding of democracy demand. The EU malaise at the foundation of many European countries is closely connected with this constitutional deficit. In the nineteenth century, constitutions were viewed as limitations of the Central Power opposite the individual and opposite the member states. A European constitution had to do justice to exactly

these and only these requests. Or as was recently formulated in The “Economist”: “A Constitution for a (not ever growing) Europe“. As long as we do not know in Europe what should be regulated centrally and what should be delegated as a subsidiarity task, we should at the same time not place more confidence in the EU as an institution. An euphemism for “good governance” does not suffice. With time we do not want to believe in this anymore.

Secondly, the constitution question is vital with respect to the intention of enlarging the community to the East. No one can believe that an EU so expanded can still function under the principles of the Roman contracts. The question of the prerogatives of the founder states have to be asked, the question of the majorities and of the quorum, the problem of the power of execution by the head office, etc., etc. Long-term, this actually also means before any consideration of any new admissions take place, let alone should any be loudly announced, this structural question must be solved in an honest way. Anything else would seem implausible and lacking in leadership.

Thirdly, the constitution question is asked in conjunction with a view to the common currency, the Euro. It was placed in this world by a constitution-like contract. Because it is only a contract, it runs the risk of being steam-rolled over the course of time and of losing its credibility. If there are being plans to expand the number of participating countries, then the structure of their money must be set at a watertight level. Still a test of the European Central Bank has yet to appear. If however the speed at which the various national economies drift further apart (as seems the current case), then it will be difficult to prove leadership when ultimately the necessary legal basis is missing.

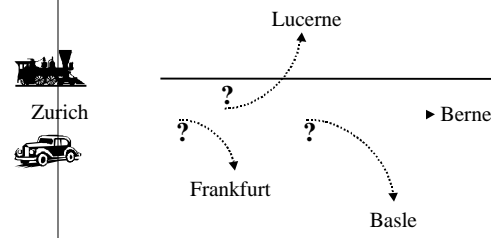
6. Switzerland or Variations on the Theme Real Options

We are approaching the end of this Investment Commentary and wish to quickly deal with Switzerland. The subject matter is, however, inasmuch for the investor not completely irrelevant because it is closely connected to the question of the future of the financial centre.

In our last Investment Commentary (No. 204, dated October 9, 2000), we attempted to explain the concept of the real option with a

view to the valuation questions in the “New Economy“. “New Economy“ enterprises as a means of preserving the freedom to operate in a daily ever-changing technological environment – this was the quintessence of those considerations. With them, starting points were also set for assessment of the alternatives.

„One Way Zurich - Berne“ – or Maybe Not?



Source:

However, the concept of the real option can also help in political questions. Therefore we will again briefly review it. Let us assume that a Zurich resident definitely wants to go to Berne, for example. Under normal circumstances, he will take an express train from Zurich to Berne, a journey which takes 1 hour and 11 minutes. If the destination, however, is not *a priori* clear and known (not every Resident of Zurich must absolutely go to Berne...), the express train then proves unsuitable, thus reducing one's own freedom to operate. We pointed out in the last Investment Commentary that technological development which distinguish themselves, so that the “destinations” are always becoming more undefined and that the strategic express trains can be dangerous, because they can in certain situations lead to destinations that no longer exist. The “New Economy“ in this comparison corresponds to private transportation, which practically leaves open at any time the freedom to operate. That temporarily one private vehicle runs out of gas does not change anything about its conceptual correctness.

The present Swiss government apparently has not understood much of the value of the freedom to operate. How can we otherwise explain the statement of the Foreign Minister, obviously with the consent of the entire committee, to set out the “strategic goal” of joining the EU? Is he aware of how attractive this Union will be in 2008? Does he already know the disadvantages of alternative integration structures for our country? –

We can quickly become entangled in contradictions. So on the one hand with the undertone of wild determination, it is announced that there is nothing to shake the bank secrecy laws (what sensible person could not agree to this principle?); on the other hand we know at the same time that entry into the EU would mean giving up our bank secrecy.

If *one* lesson can be drawn from Swiss history, it then would be the one of the value of the freedom to operate. Our sworn neutrality has not protected our country from attacks of littler or greater size, but rather, has over the centuries, confirmed the well-trying tactic that it is just such a small nation that has to keep its credible options open at all times. A government which at an inopportune time gives up its freedom under the alleged pressure of an ambitious diplomatic corps and a panicky Euro-Turbo in Parliament, proves itself weak in leadership and with poor orientation in the most important fundamental position for Switzerland.

The picture of political helplessness contrasts with the quite comfortable situation in the economic sector. The barrage at the beginning of the nineties has shown its effect. The majority of Swiss businesses are today robustly involved in competition. The swiss are of course totally global players and have learned that earnings growth is the only means to survive in the long run. The Swiss stock exchange stands out positively from most of the other markets of the world. The relatively small technology share sector may be the main reason for this phenomenon.

7. Valuation Turbulence without End?

At the beginning of November we had the impression for a short time that the stock markets, including the badly shaken technology shares would break loose from the very volatile valuation uncertainty. In many cases the ratio between share prices and profit ratios, respectively, to earnings growth improved. More simply stated: Since March of this year, a great many businesses can now to be bought more cheaply.

In the meantime we have also learned that the economy under negative signs, i.e. with losses, is a subject in itself. The "New Economy" has caused a proud number of flops within the past few months, and those bankruptcy cases are mostly also quite nutritious with reference to the sums wasted in the

sand. The euphoria on the German New Market which we mocked in April (Investment Commentary No. 200), has been replaced by the deathly silence after a nuclear explosion. Even in Switzerland there are at least four cases (Miracle, Complet-e, 4M Technologies, Biomarin) which can be noted as total or almost-total losses.

We said at the time, based on observations on the American Market for stock exchange newcomers, that only about 3% of the new issue businesses really succeed and we pointed to the lean average return of not even 4% p.a. for transactions with market newcomers. We are not repeating this for the purpose of stating "we told you so". Honors for accurate forecasts do not concern us rather we want to say, we are now far enough along that the laws of normal economy (this means without a "New Paradigm" and similar fantasies) are now again being followed.

In principle, we must be satisfied with the performance of stock markets in Year 2000. Darwinism has proved well-founded once again, and it functions. Particularly impressive is the brutality with which cheaters, whether deliberate or negligent, are being punished. Gretag-Imaging was the last example of such rough treatment by the markets. Having been convinced that the company would show a profit of 100 million francs or more, the company's management suddenly announced that they had been mistaken and that the amount in the best case would only make up half that amount. Of course that cannot be. Either financial management had horribly failed, and this would be very bad, or the company had just remained silent a little too long and against its better judgement, and this would even be much worse. The stock exchange rewarded the company with a discount of 50% in a few trading hours.

The warning minus sign for the stock markets at the beginning of this Investment Commentary must therefore be put in relation. It is a fact that at the moment there is more frustration than delight in the markets. And it is also true that the political targets convey no positive impulses. And furthermore the good-faith crisis in the "New Economy" subsequently runs its course. In future one will not make money so quickly, above all if one can only offer air.

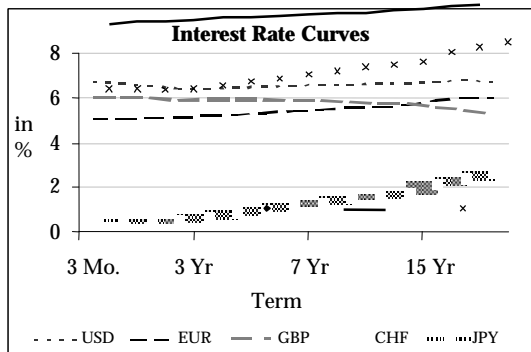
However, there is much to be said for this, that the zero point can be reached or even crossed. Because after all this turbulence, there cannot be very much speculative air left in the system. Speculative air presupposes lenders as generous compressors. We cannot imagine that the inclination of the banking system continues to favour high risk exposure after all the dives which occurred over the past few months.

The recipe for selecting shares, which was defined already last spring, which recommends a high level of diversification with a high requirement for corporate quality, continues more than ever to hold true. Yes, it could even be that this recipe will soon again bear fruit after a few anxious months.

8. A Reason for Optimism

Not that the writer from St. Gall, towards the end of this, by the way admittedly rather cheerless bulletin, still wants to spread Christmas cheer enthusiastically (if one is allowed to say that...). But we pointed out at the beginning that we believe the monetary situation is relaxed and favorable. We find it necessary to delve a little deeper into this (positive) assertion.

Already a brief look at the interest structure of the major currencies US Dollar, Pound, Euro, Swiss franc and Yen shows the enormously flat course of the curve over the various time periods. This can mean two things. Firstly, relatively low long-term interest rates point to little or no inflation expectations. Who would lend long-term money without at least being protected against a possible future devaluation? The fact that the aggregated opinion of the millions of market participants has not built in practically any inflation premiums in long-term fund offerings is very remarkable. ♦ ♦



Source: Bloomberg;

On the other hand, in comparison to long-term interest rates, the relatively high short-term interest rates point to the fact that none of the Central Banks keep generous money supplies on hand, and with it the building up of future inflation potential. On the contrary, it is just in Europe and also in Switzerland which show the development of the narrowly defined money supplies downward, and also the American Fed will soon have to again review its books, if the rather poor figures for the continued economic development are confirmed. The monetary room for manouvre of the Central Banks, as foreseen from the special case Japan, has proved to be quite comfortable. This is not a bad initial position for the broader prospects on the financial markets.

More important to us is the attempted explanation of the phenomenon of convergent interest rate curves across all currencies. Was it deliberately brought about by decent and talented Central Bankers? Perhaps! Or, partially. We must rephrase the question. Why in the world did the political sector omit the budget-expanding attacks on the Central Banks, which were customary in the late sixties and in the seventies? Has something changed in politics, or respectively in their intentions?

The answer lies at hand. Neither has the political sector learned much, nor have the responsible persons in the Central Banks completely changed their nature. Rather the elbowroom for monetary-political manoeuvres has narrowed dramatically, because in the meantime the bond markets have found a magnified measure of efficiency. Since 1994, we have gone through at least three phases of "fears of inflation". Each time, even though suffering from temporary bond price losses, we have not only rejoiced inwardly, but each time announced in these columns: The system works!

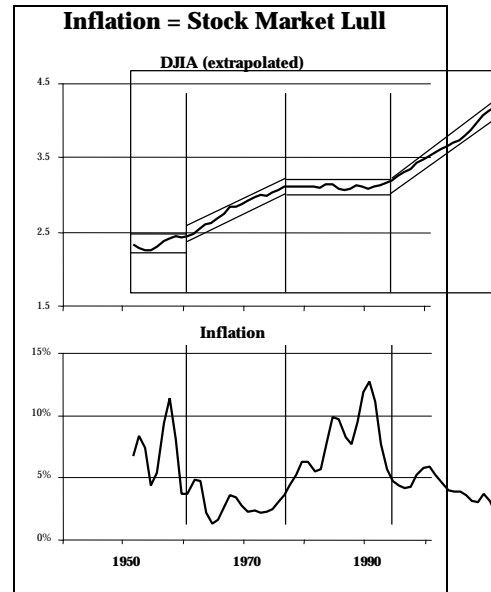
It actually does work. The flat interest rate structure in all the important currencies points to a very low monetary tension potential. The heating up of the American business cycle was perceived by the bond markets already in 1999. With a delay of approximately a half of a year, Greenspan increased short term interest rates. When he did this, the situation on the bond markets calmed itself again. Why? Because the investor saw that the Fed was doing the right thing and that it was not ready to spur on

any further boom in spite of the upcoming elections.

This may appear like a lack of leadership and poor orientation. No real bosses "make" monetary policy, but rather a market system which leads the monetary politicians by the hand. It is precisely in this that the superiority of the capital market lies: That no one has to or can act deliberately, but rather that "it" happens. At least once the beneficial, invisible hand, which Adam Smith has predicted, has revealed itself.

The value of these facts cannot be rated highly enough. Currency depreciation is and remains by far the worst economic problem. Currency depreciation shortens the planning and optimization horizons of market participants. Long-term lasting development is unthinkable under inflationary conditions. Currency depreciation robs the creditors (and with it above all the retirees, which in view of the present demographic situation would be especially serious!) and places false incentives on debtors, namely also for the State as a borrower.

Viewed from a distance, inflationary phases were always phases of stagnating or falling stock markets. The probability of further slight or very moderate inflation expectations over the coming months is a necessary but not quite sufficient argument for somewhat more positive conditions on the stock markets. Therefore, with an eye to the coming new millenium, which anyhow should lengthen the time span of the optics, we will close this Commentary for once with a chart. With a very long-term one. It should somewhat curb the anxious feelings with respect to world-political development and defuse the feelings of frustration over an annual yield that did not quite fulfil expectations.



Source: Dr. G. Landert;

KH, 4th December 2000