



INVESTMENT COMMENT

Global Set-up

The world economy continues to expand in its current cycle. However, the whole expansion is very uneven and major structural imbalances have built up due to ill guided policies in the past few years. Policymakers hope that these imbalances will disappear as the expansion continues. However, we believe these imbalances will get worse and eventually force a painful adjustment that will lead to major shifts in global financial markets.

The emerging world grows at a strong pace and capacity utilization is extremely high. Production, GDP, employment, real income and consumption stand already clearly above previous cycle highs. Hence, inflation pressures are around everywhere and the authorities have started to fight it. One group of these economies has freely floating currencies and has let them appreciate as interest rates were hiked to clearly positive real rates. This has in turn attracted new capital inflows that are strengthening those currencies beyond desired levels and parts of the economy are already getting negatively impacted. That inflow of capital in turn reinforces the boom as the new liquidity drives asset prices higher, which in turn attracts even more money. A clear example of that group is Brazil, a country I visited recently and was surprised about the elevated general price level.

Another example is China. Unlike Brazil she has not a freely floating currency and fully controls capital flows and the level of its currency. The prevention of a sharp adjustment to the upside of the Renminbi forced the Chinese central bank to intervene that created vast amounts of liquidity domestically. This in turn has led to a gigantic asset inflation and a great real estate boom, as domestic investors (who are not allowed to move big amounts of their capital

out of the country) see that interest rates (2.5% for deposits; 6.5% for loans) remain way below the true inflation rate, which is probably near 10% and not 5% as reported. While the central bank is trying to offset part of this highly inflationary policy by raising the bank reserve requirement ratio, it is not as effective as it only takes part of the newly created liquidity away. Hence, the boom continues, although at a moderating pace.

The developed economy is also recovering but in general at a rate decisively below normal for this stage of the business cycle with still plenty of slack capacity. In this part of the world, the structural problem of sharply rising and extremely high government debt has taken center stage. Governments that have given up their currency sovereignty and are structurally running deficits in their current account are at a disadvantage, as they have to cut expenditures and put their economies through a severe austerity process that is highly deflationary in nature. That is true for the European peripheral countries Greece, Ireland, Portugal, Spain and also Italy. While European policymakers address the debt problem in general by simply trying to kick the can down the road, hoping that things will get better over time, we believe that just the opposite will be the case. In our view, most of these economies will fall back into negative growth later this year or stay in negative growth territory. This also means that tax revenues will fall short of plans and the expenditures for so called automatic stabilizers, entitlement programs and so on, will grow bigger. Hence, these countries will far undershoot their goals of fiscal improvement. Markets are not asleep and noticed this early and began to factor debt rescheduling into the pricing of government paper. Hence, interest rates for that paper will rise BECAUSE of a weakening economy and not despite of. Simply speaking, credit



worthiness for these countries will continue to deteriorate sharply. Once rescheduling begins with one country, others will follow and the banks holding that paper will have to make the write-offs they don't have the money for. Hence, governments of the center will eventually pay the bill, which will become a highly political issue once the taxpayers understand the large dimension of it.

Germany is the big exception in the Eurozone and continues to run large external surpluses due to its thriving export industry. Domestic demand, however, remains quite sluggish. The risk of rising inflation in Germany is highest in Europe as the currency is undervalued and interest rates are set too low. It is therefore only a question of time until labor will demand higher wages and inflation risks increase.

The US has a freely floating currency and therefore has more flexibility. However, she cannot escape the adjustment as Bernanke, Congress and the Obama Administration may believe. The US remains the only developed nation that believes she can continue to run 10% deficits of GDP and print money of previously unseen amounts without any painful consequences. Policymakers are living in a fairy land and do not assess the situation realistically. There is no free lunch and the US will also get disciplined by the markets but, unfortunately, can pursue her course longer than those governments that are locked into a currency over which they have no sovereignty. It is most likely that we are still in the early stages of a major US-Dollar crisis that is and will continue to distort the asset markets as well as the global economy and eventually lead to a painful adjustment.

This is the setup for the great world drama we will witness over coming years. Obviously, policymakers try to procrastinate as long as possible. But will markets cooperate and let them off the hook easily? We doubt. Markets are dynamic processes of people in action and they force fundamental shifts. The only question is when.

Markets will force policy action

We believe that emerging economies will not fight inflation decisively as they think they can get away by simply slowing their economies at the margin, which they think will solve the inflation problem. However, we believe we will see a slowing of the emerging economies and if one looks closely enough, the signs are already visible. But the inflationary process at work as described above is not coming to a halt but continues. Hence, we expect inflation to rise again next year after a possible temporary lull. As long as the policy remains inflationary, even if somewhat less than before, inflation will eventually rise to higher levels in the current cyclical expansion. Emerging markets' policy is highly correlated to the US policy, of course. As long as the US continues her demand stimulation by steering a highly expansive fiscal and monetary policy, the emerging markets had to stop pegging their currency to the US-Dollar and let the Greenback drop sharply. By doing so, they risk to lose their competitiveness and therefore risk social problems. China, as an example, needs to create about 10 million new jobs every year to keep the unemployment rate stable.

Hence, we fear a major and painfully adjustment will be procrastinated but will eventually arrive as a sudden surprise within a very short period of time and will come as a shock to the world economy when it happens, most likely within the next few years.

When we recently listened to Fed Chairman Bernanke at the FED's press conference after the FOMC meeting, it became clear that he will continue his policy, as he believes easy money will help to overcome the structural weakness of sluggish employment and weaker house prices. The change will only come when forced upon him. Hence, markets have to do the job of disciplining him by eventually going to an extreme.

We expect US CPI inflation to reach 4% during this year and clearly overshoot the target level of 2%. The US central bank is setting policy rates at such a



low level resulting in deeply negative interest rates at the short end. Such a policy is highly inflationary as it creates a tremendous incentive to sell the US-Dollar and buy foreign currencies and USD denominated real assets like commodities and US equities. Policy will in all likelihood change after markets have changed course, and not the other way around. Hence, we have to look for messages by the markets themselves in terms of negative momentum divergences, sentiment extremes and reversals from it as well as classic price reversal actions.

We like to add here that it is simply a myth that devaluing the US Dollar will make the US economy more competitive, as the FED chairman always says. We have heard that song ever again since the end of the gold standard in 1971, a few years after we started in this business. At that time, we had to pay CHF 4.32 to buy 1 USD. Today, it takes us only CHF - .86 to buy 1 USD. In other words, the US unit has declined by 80% in 40 years and Switzerland continues to run large surpluses on its trade and current account while just the opposite is true for the US. Actually, the US has in the last 30 years turned from the largest creditor to the largest debtor nation on this planet. Manipulating a currency does not put the US back to where it came from; only hard work, sound economic policies and excellence in education will do so.

We assume that we won't see an end of the current cycle, yet, this year, as economic expansions usually run for more than just two years. Emerging economies still have a lot of momentum going and the structural handicaps in the developed world prevent any decisive tightening in that part of the world. In fact, the US recovery remains structurally weak (home prices at new lows) and this will not only mean no interest rate hikes for some time but also continued negative real interest rates. And in Europe, the ECB is trying tightening, which has forced yields of government paper for the dubious debtors like Greece, Ireland and Portugal already to decisive new highs and the ECB either risks to become victim of its own policy or pushing some members out of the Euro by purpose. Moreover, it

is highly doubtful that the world economy with its current momentum is already ripe for a decline into recession, as it usually did so in the past only after about two years of rising interest rates. Hence, it is more likely the cycle will last another 1-3 years until the imbalances become much more extreme. But what we will most likely see this year is a decisive interruption of the trends that lasted and dominated for the last two years in the markets.

One cannot make the case that equities are too expensive and will therefore ready to correct. Actually, the valuation is not very different for the major markets from 2005-2007, before the last cyclical decline. Markets can decline even from "reasonable" valuation levels, if something else in the whole equation turns decisively. In general, valuation is not a good timing tool, it only tells us about potential risks and rewards but nothing about when. Looking at valuation in an isolated way, one could not make the case for a big correction. Moreover, we believe it is useless as a tool to forecast the next 10-20% market swing.

As the monetary side is the dominating factor here, the question is what will lead to the interruption we are expecting? As mentioned before, the emerging world is tightening already although it is in most cases not decisive, yet. The developed economies will see inflation rise clearly above the set upper tolerated limits by central banks. The dilemma will be whether they will act according to the unsatisfactory economic recovery and stay loose or to the rising inflation rate and tighten. If it is the latter, some change at the margin in monetary policy is pending. Europe has already started by hiking rates – and despite the weakness at the periphery. Japan cannot do so at present due to the economic distortion to the downside as a result of the recent tragedy and inflation is definitely not the problem there. But what about the US, which remains key as a market trendsetter? Will the FED quit QE2 and not do anything else?

If the FED puts the unsatisfactory economy ahead of inflation fighting, foreign exchange markets will take over and push the US-Dollar down. In recent days,



we have already seen the dynamics move in that direction, and particularly so after Bernanke's press conference. The US-Dollar's performance is moving to the center of attention as it is an important benchmark for responsible monetary policy or the lack thereof. The Greenback has fallen to new lows against several currencies, at the forefront against the Asian emerging currencies (CNY, SGD, TWD, etc) but also against resource currencies (AUD, CAD, BRL). It broke to new historic lows against the Swiss Franc while it made new cycle lows against the Euro but not new historic lows. The chart of the trade weighted US-Dollar has broken to new historic lows. Very often after such a break, there is a snapback rebound before the decline resumes in earnest. The present sentiment is extreme and has been for a while with the fewest bulls on the Greenback in some years. We believe the Dollar is in the late stage of a medium-term decline and approaching a temporary rebound. Whether such a rebound can be sustained for longer than mid-year will depend on fundamentals, whether there will be important changes in monetary or fiscal policy in the US (less likely) or, whether a new crisis in the Euro breaks out again.

Time to take off some risks

As the US-Dollar is such an important variable in intermarket relationships, such a rebound would have important consequences. It would lead to a new "risk-off" situation and aggressive money would unwind some large positions in the prevailing dominating themes.

Commodities would certainly sell off with the Dollar rallying. Copper is already looking tired and at risk to correct in a bigger way. Some other base metals look similar. Even some softs have started to slip in recent days. Grains are still acting well, being supported by bad weather in the grain belt and delayed seeding. And precious metals have become more volatile in recent days. Silver's action in particular with extremely high volume after a more than 50% advance since the beginning of this year has all the earmarks of the beginning of a big shakeout before the advance can resume. And Gold

would go in the opposite direction.

Equity markets would come under pressure, in our view. We are already witnessing certain divergences. Emerging markets are not keeping track with the leading market, the S&P500 index, which is a change from last year. The number of new highs in global markets is thinning while markets keep climbing. Selected momentum indicators are not confirming the new highs of the US market. Moreover, sentiment remains also very optimistic. In the US, margin debt has now risen to levels last seen in spring of 2007! However, the early signs of a medium-term decline are also not present, yet. Breadth statistics confirm in the US and in European markets. New lows are not expanding, yet. Hence, we will probably first see a break, followed by renewed attempts before the stronger markets enter the big correction we are expecting for the second half of this year.

At present, we doubt a US-Dollar rally will lead far, as the fundamentals are not right. But we think it could act as a trigger for a bigger correction in asset markets. The fundamentals for the US currency remain rotten as long as short-term real interest rates remain deeply in negative territory. While at present, the weak dollar is seen as a positive for US equities, we believe that a regime change is potentially in store during the next phase of dollar weakness, probably from mid-year onwards. We consider this expected action being part of the endgame of the US-Dollar paper standard and creating rising uncertainties about the future. We therefore recommend using any upcoming rally attempt by the US unit to move money into current account surplus currencies in the developed and emerging world.

The decline we are expecting in global equity markets will most likely be more decisive than most investors expect. While there is no way of knowing the magnitude in advance, we believe a decline of 15-20% in the major indices is likely. It may seem impossible in view strong earnings, at present, but in our view the markets have now entered overshooting territory from where the rubber band



effect may all of sudden be felt during the second half.

It has been surprising that government bond yields in the developed world have not gone up more than they did (with the exception of the PIIGS). This may have to do with the current cycle that is more repo based than previously due to the banking crisis. This may have “artificially” increased the demand for government paper. As central banks have also been big buyers of government paper to create liquidity, it may have kept government bond yields at a distorted lower level than otherwise would have been the case. If markets decline as we expect in a “risk off” fashion, it is conceivable that the credit system may shrink its balance sheet again, thereby need less collateral and therefore sell government paper. While at first, bonds could perform better, they could later sell off again, particularly if the US refuses to make fundamental improvements. This would also be different from previous “risk off” periods and reflect concern regarding inflation in all forms, including threats of future defaults.

In a nutshell, we believe the rally in equities is getting extended and clouds are gathering. Hence, it is time to get more step by step more defensive in the next few weeks in asset allocation as well as

sector and stock selection. We would weed out the relative underperformers (e.g. financials, selected emerging markets) and focus on the leaders (e.g. US, Germany) and new relative strength improvers (e.g. health care, utilities) and also move stops up on long positions. Moreover, we stick to our view that Gold will remain in its structural bull market - even so we potentially do expect a big correction - and that gold will outperform equities for a few more years. Equities are at risk of entering a serious correction into autumn.

Long-term bonds remain unattractive for long-term investments and are good for trading only. After the rise in yields, they are moving sideways in an erratic fashion that should continue for a while longer. While cash is an unattractive strategic asset, it should become attractive for tactical reasons, as one can only buy at lower prices when cash has been raised before. Zero return is unattractive but at times “zero return with a high certainty” is better than hoped for positive returns that disappear quickly and become negative!

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