

CONCEPT

VERMÖGENSMANAGEMENT

Money needs a price

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MONEY NEEDS A PRICE

"If you would know the value of money, go and try to borrow some." A thesis of Benjamin Franklin, Founding Father of the United States.

Conversely this recommendation, we note: to borrow money and get into debt is very easy today – except for the European periphery. Individuals are able to find consumer or real estate loans at historical low rates. States and governments borrow at capital markets or directly from the reserve bank money at most favorable conditions. The interest of some emission is less than zero and the creditors like to pay a price that they can deposit their money supposed safely. In this context, the question is of what value the many sheets of colorful printed paper are, in which we take great confidence regarding their store of value and exchange function. First of all we can see that in view of the flood of money flowing not only into the American economy, but to a much greater extent into the Japanese and also into the European economy, the price of money tends towards zero. This urges us to be careful.

The dangers of this crisis in its 5th year are the global linkages, the simultaneity of events and the same-directedness of their effects. Moreover, disagreement about the right way out of the crisis and preceded national interests made it worse finding solutions. Looking for culpability and trying to blame somebody else contributed to the aggravation. In certain belief that the challenges of our time require "unconventional measures" due to its magnitude those responsible penetrate further into uncharted territories still unknown to foot before. Following politicians and central bank are the economic agents: consumers, producers, employees, managers, job seekers, retirees and young people who are about to plan their future life. In this era new chapters of economic history will be written. From this era we will learn in future. At the moment, however, we move according to the method "trial and error" under the restrictive assumption that each error dramatically increases the problem and limits the bandwidth of further testing. Here is good advice obviously more expensive than the abounding money surrounding us.

INFLATION? DEFLATION?

There are some fundamental issues in the cascade of challenges on the way to solve the global debt problem. One is what to fight decisively: deflation or inflation. We are currently on the angular point between both possibilities. In which direction the pendulum swings is not foreseen. Both states are not desirable and from history we do not learn whether in past periods of inflation or

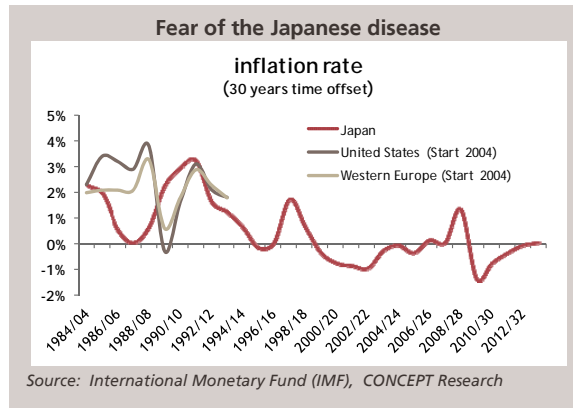
deflation the opposite would have been more bearable because it was not experienced. We have to analyze from today's perspective which development is desirable. There is an asymmetry in the discussion of solutions: Politicians and reserve banks fear depression obviously much more than inflationary tendencies.

The two lost decades of Japan are deeply embedded in the near-contemporary memory. At present, the country is trying once more to get out of the depressive lethargy after 25 years – with a tour de force that is historical in the choice of means without precedent. The given scenario of over-indebted countries and interest rates tending to zero for a long time anyway, tools to combat a spreading deflation seem to be limited to the creation of money.

Taking note of this, it appears more threatening to us that deflationary influences surround us in large quantities: states as well as private households need to consolidate their spending, which stalls the economy. The high unemployment rate in many industrialized countries, the low capacity utilization and the ageing of society in many countries predict deflation. Eroding energy prices in the United States due to new gas extraction processes are also price-dampening companions. Last but not least the cheapening of the Yen triggered by the Japanese monetary policy ensures that Japan exports its deflation to the world to import inflation.

Taking into account these environmental conditions it is understandable why politicians and central bankers have much greater concern regarding deflation than inflation. In the real economy only the wage settlements of a few states in the core of Europe which could spur

the consumer spending and trigger an inflationary effect. However, they are hardly able to compensate for the loss of disposable income in peripheral Europe in their effect. Consumer sentiments recover in America, but consumption still suffers from real loss of wages for more than ten years. The capacity utilization rates are low in many places as well as passing on price margins, because economy is held by a thread of the central bank policy. The unemployment rate reached its highest level in some places since records began. That's why there is a call for "unorthodox policies", that's why there is a ride on the edge, that's why solutions do neither take into account a way back nor promise the probability of target approach.

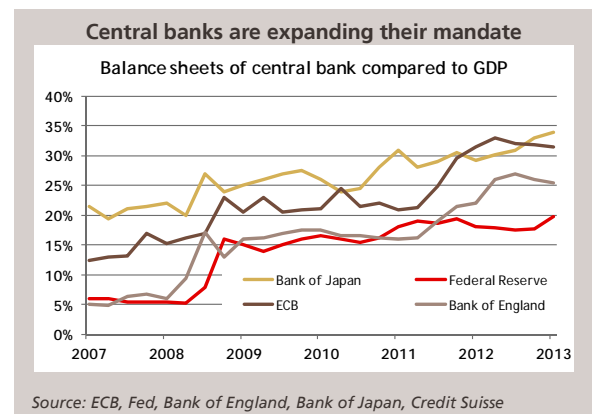


"the effectiveness of the measures with regard to the recovery of the economy and the labor markets" is "not clear" and that they unanimously see the possibility of an "outbreak of inflation" and "risk of bubbles in the stock and bond markets". In addition it is recognized that the current policy created "systemic risks and potential structural risks for banks". In the real world each of said evidence would be a reminder to think about a different way. But it is

probably the existing "uncertainty about how the markets will return to normal reviews when the Fed withdraws from them, which just keeps the Federal Bank from it. At present one can observe in China how difficult it is to put an economy oversupplied with money back on the right track. Prime Minister Li Keqiang made it clear when he took office in March that he will reduce the crisis-induced massive money supply which is now leading to overcapacity. This already resulted in a credit crunch and a dried up market among banks. Also the Fed realizes that the retreat from the markets "should probably be difficult ... and painful for consumers and businesses". Thus the path of least resistance is chosen and the perpetual motion machine federal bank is kept on running. In 2013 the U.S. Federal Reserve is about to finance 80% of new debt, thus relieving the state from the necessity of finding voluntary creditors on its debts and at the same time to keep interest rates artificially low.

CENTRAL BANKS – PRISONERS OF THEIR DECISIONS

The total assets of the central banks of America, Britain, the EU and Japan have doubled since the crisis erupted in summer of 2007. They reach between 20% (U.S.) and 36% (Japan) of the gross domestic product, starting from a pre-crisis level between 6% and 13%. So central banks are increasingly involved directly in economy, whereas inversely to their increasing importance on the political stage there is a loss of independence. The central banks become responsible and vulnerable players on the floor and in the same time are held in captivity of their own policy: The original plan to set the initial impetus for a resurgence of the economy with easy money available and then retire does not work. On the contrary, the necessary initial impetus is much larger than expected and the economic impulse much slighter than suspected, and the risk is high of taking the patient's blood by a retreat from the cash machine. Facing the low efficiency level of central bank policies and political pressure to lead the "unconventional measures" to a success, there seems to be no way back. Instead on the chosen path the speed will be continuously increased. It is noteworthy that the associated risks are well seen. So we can read in the minutes of the Federal Reserve Board meeting of May 17th that



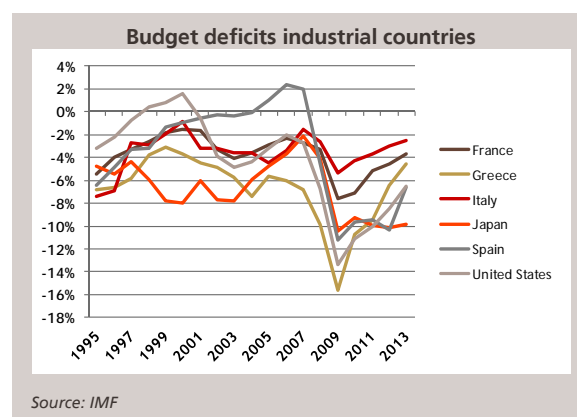
MONEY NEEDS A PRICE

However, the sweet poison of cheap money has numerous side effects which often are seen delayed – but frequently discharge even stronger. Because in a time, where money is lent at bargain prices, companies are easily led to decisions not going to become profitable in future. Existing (simultaneously irreplaceable) resources are misdirected, are a flash in the pan and will not be available for useful and necessary investments when times get rough. Cheap money makes it hard for insurance companies to gain their costs not talking about the yields guaranteed. Would this phase last for a longer time a crash of insurance companies could be the next expected disaster. Cheap money also widens the gap between rich and poor because it raises asset prices. Last but not least vain money seduces politicians to give presents to the People which love the convenient way of today. But at some point the interest rate rises and the bills for promises for the future are settled. The consequences are not carried by the cause but by their children. Money that has no price endangers both social and intergenerational equity. It needs quite the reverse: an interest rate to keep its store of value function, its steering function and simply its disciplinary function. Last but not least it therefore needs a price to remunerate investors the repayment risk so that capital enters the investment cycle. It needs a value so that people are able to make provision for their old age retirement with reliable results. And it needs a price in order to ensure the sustainability and balance of investment decisions and to correlate present consumption and present renunciation.

CLOSE YOUR EYES AND ...

This view is, however, yet not at all subject of debate. Rather politicians everywhere are wishing that a larger share of the new money really arrives in the economy – as at least to be seen from the Fed's statistics. After all, only money acting in the economic cycle is likely to generate inflation and thus devalue debt. It is tolerated that no one has a clue how to get back toothpaste into the tube. At least no examples are known where rampant inflation could be tackled effectively without pressing economy to the ground simultaneously.

Unfortunately it is still spent a lot of energy to cure the symptoms of wrong decisions in the past, while the cause of the problems in many places does not seem sufficiently identified. This would be the understanding of the simple economic necessity to make ends meet and to create buffer for times when the state needs to bridge economic downturns. Still welfare states sew their households "on edge", spend at least what comes in and have to take additional debt if it runs worse than thought. If markets in this case do not trust the creditworthiness of individual countries they are named speculators and the needs assets are alternatively delivered by the central bank. However, those who fight a crisis triggered by too much credit in the world's financial system by multiplying unorthodoxly the trigger and by creating synthetically tons of money – they risk willfully a loss in confidence.



Currently there is obviously still large confidence of markets in the ability of central banks to take any bull by the horn. Hardly discussed is the risk that this confidence could be shaken and fall apart in a cascade. An erosion of trust would widen the debate about the value of the printed paper money which we are discussing in our reports since a longer time. Interest rates would skyrocket maybe and at the same time yen, euro and dollar would lose much of their value (probably in that order). Rising import prices would fuel inflation further.

... PRESS ON THE REGARDLESS! – THE JAPANESE EXPERIMENT

That the Bank of Japan – knowing all this and bearing in mind – now admits to a much more daring experiment is at least noteworthy.

Within two years it plans to double the circulation of money. So it buys government bonds in a volume which in relation to America represents about three times the local bond purchases. The goal is to take debt off the market, to keep interest rates low, to fuel inflation with the money supply and to devalue the yen. By this and with the help of (still to vote through) economic policies the economy should be stimulated, so that by increasing tax revenue the reduction of public debt may be facilitated.

Thus Japan is trying to adapt the established success of American central bank policy to its own system, but it has to take into account significant differences to the role model. While America is rejuvenating - in Japan more diapers are sold in adult than in baby sizes. An aging society has significantly lower resource flexibility. Moreover the consumption is weaker and tax income erodes for years, while costs for social security are exploding.

Japan does not have the lower costs of falling energy prices (fracking), but on the contrary has to calculate higher prices for imported energy due to the weak yen, which is countercyclical. In contrast to falling interest rates in the U.S. interest rates in Japan for a long time tend to zero, so that a further supply of liquidity is not expected to show some effects. Also the accepted collateral damages have to be exponentially overrated because national debt is two-and-a-half times deeper. It should not be left aside that the deflation in the last 25 years is deeply rooted in the Japanese collective memory. At the moment first actions work, set impulses to economy and encourage consumers to abandon their years of lethargy. The deliberately devalued yen improves the competitiveness of Japanese suppliers in the global market and opens up additional sources of revenue. It is quite possible that this trend will continue for a while. It would be dangerous if disillusion quickly sets in and caution reflexes trained in past decades would start. Then this for Japan last possible economic experiment could end up in a disaster.

Because with the policy goal – and now by depreciation inevitably now coming – inflation

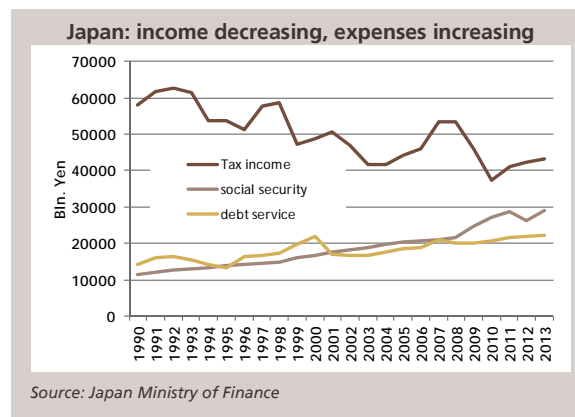
is always inherent in the system the seed sown of higher interest rates. Nowadays Japan pays on its debt only about 0.8% interest pa. Despite significant increase in government debt, interest service in the last 15 years has not become more expensive because interest rates were declining. It would run even more effective in the opposite direction, if it failed to prevent a strike-through of inflation on the level of interest rates. Even at 2% interest rate (which is what England pays at the moment for 10-year-bonds) the interest expense of 78 billion € in the current Japanese government budget would rise to 196 billion €. The national

debt would rise to 250% of the gross domestic product in 2015 (today 238%), even under the dynamic growth assumption which IMF assumes for Japan. Even at an average yield of 3.5% (last in 1998) nearly all tax revenue would be fizzled out for debt service – at least then Japan would be bankrupt. So we see: the experiment started now has to be successful. If it fails

the world will face challenges compared to which the so called euro crisis is a storm in a teacup. That is why it is desirable that the signal of monetary policy soon will be followed by fiscal policy decisions. As in Japan continually a third of Japanese government spending is not covered by tax revenues we urgently need a credible idea to solve this problem.

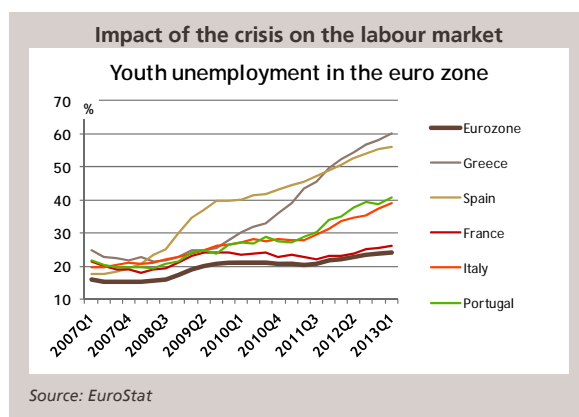
EUROPE AND THE EURO

Also the look at our continent where the effects of the crisis have already forced far-reaching decisions in the right direction is still sobering. The Draghi-Effect “The euro is irreversible) improved on the one hand the situation on the credit market, on the other the actors in politics. Still on the path of consolidation targets are stretched or weakened. Europe increasingly struggles with the socio-economic consequences of birth defects of the euro. It is understandable difficult to survive politically in this battle. According to a study by the American Per Research Center the popularity of the European project decreased within a year from about



60% approval rate to just 45%. In the constant stress of the crisis the nature of Europe falls by the wayside. The interest rate structure – penalty interest for the lazy south, money for free for the disciplined north – cements the division; national interests are in the centre of attention. The euro as a chopping axe in Europe endangers the social peace on our continent. In this respect last year's donated Nobel Peace Prize may express appreciation of the achievements in 60 years time but as well be a reminder to remember the possibilities of a really united Europe and to make all efforts for it. In this moment people lose faith in the common project. This should be no surprise because lots of the agreements stipulated at midnight are without effect. Last year's Pact for Growth and Employment had the goal to increase investments, to secure old pensions systems, to improve credit loans to economy and last but not least to fight unemployment and its social consequences. Exactly one year later we see that none of the goals is reached. Investments decreased quarter by quarter with rates of more than 1% and discharging the old pensions systems has not gone beyond discussion. Liquidity disposed by the central bank does not arrive where it is most urgently needed, because the banks in the European periphery forced to consolidation are becoming more and more risk-averse and do not give loans to the economy. The European Investment Bank is ready to help but does not get its money to the companies because approval by EU commissioners is slowly. Meanwhile the unemployment rate in the euro zone reaches 12.2% (and growing)

Youth unemployment in Greece, Spain, Italy and Portugal is dramatically higher than a year ago and in Italy twice as many people live under the poverty line than two years ago. Projects to stabilize the euro architecture fail on national interests and people are concerned whether the crisis returns to Europe. – No it never was gone. Disillusioned voters give politicians a warning. The "alternative for Germany" positions and in Italy the people voted the technocrats out which personified



the current strategy of the euro. Subsequently a solution was made possible which however has to prove its sustainability. In the banking system of the country new risks appear in the meantime: While economy faces a credit crunch Italian banks hold record amount of 386 billion € in government bonds, with which they also realize a higher margin than with corporate loans. The systemic risks of this creditor position however are forgotten.

In the meantime the unprofessional handling of the Cyprus bankruptcy shows to which breaking of taboos the EU council, Eurogroup and troika are able. The current president of the Eurogroup Dijsselbloem praises the way chosen for Cyprus as a role model for Europe; this must make aware investors in the whole world that savings deposit are only partly a suitable storage-of-value-strategy, but rather a loan to the respective bank. The Cyprus strategy will stay in the memory of the people.

Meanwhile economy in the euro zone is slacking and only ECB supposes growing prosperity. In its last monthly report it claims that companies in euro zone would profit from a recovery of global demand by exports. At the same time the Netherlands, Spain and France deviate from originally agreed deficit goals and mainly France seems to be a long way from growth. The politically weak government is not able to reduce the incline in ration of public spending to GNP and social costs.

So benefits paid at 17% of GDP¹ are almost top level in Europe. Unemployment is at its highest level ever recorded, nevertheless labor market supports the wealthy and offers little flexibility. The added value of industry in GDP is in France only half of the German figure. There is a real estate bubble, too, because in the last 10 years house prices in France doubled. While OECD in its March report suggests a "complete turn round" of the system staying "clearly below its potential" the government reaches no quantifiable progress. That is why IMF recently revised its economic forecast for France to minus sign and expects in 2013 a 0.2% decline for the second largest economy in Europe. But Europe cannot afford a weak France. As Europe lives from bilateral exchange and has to grow inside.

¹ GDP, Gross domestic product

RAY OF HOPE

Despite all misaligned incentives and policies there is still a ray of hope.

With the aggressive policy of the Federal Reserve Bank there seems to be an economic recovery in the United States. IMF estimates this year's growth to nearly 2%. Employment figures are rising for several months, capacity utilization rates are good and the consumer sentiment index has been recovering since mid last year. Also the housing market – import for America – has stabilized and it is expected that the classical economic support in America, that is consumption increases continuously. It is not clear which of these positive parameters are based on the current flood of money and what will happen when exit of the policy of easy money start as Bernanke told a few weeks ago. In Europe there is a more differentiated picture. On the one hand consumer confidence lightens up despite high unemployment rate. The Target2-balances discussed in our former reports are declining and are signaling rising trust in the financial system. Unlike the U.S. and Japan budget deficits have reduced significantly and currently are at 3.7% in average EU17 compared to 8.5% in the U.S. and 10% in Japan. A structural deficit (before interest) does currently not exist in the euro zone. Fiscal restraint policies are obviously successful. Everywhere it is now recognized that saving in times of need is too late and therefore should not be too hard. Europe has gone a long way which America and Japan still have to go. Nevertheless – or because of it – many of our neighbors suffer from structural weakness and there is an urgent need to break free from the bonds of national interests and a revival of the European idea to achieve the untapped potential.

IMPLICATIONS AND RECOMMENDATIONS

Which conclusions can be drawn from the above? We continue to see quite significant risks to the international monetary system, which are implied by decisions of politics and central banks. They may not be left aside when considering investments. At the same time the flood of cheap money raises economy; from two directions investments in companies are favored and returns in these markets even at low rising economy are possible. On the contrary a “too good” development of the

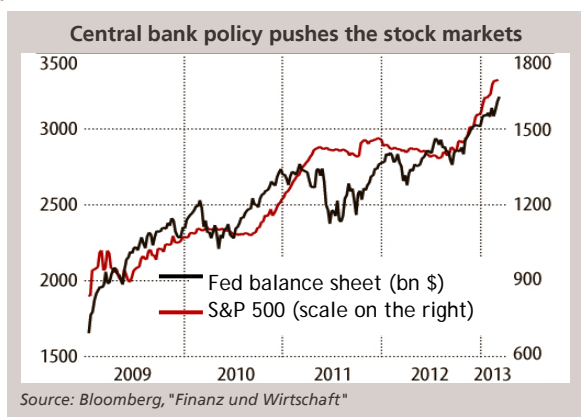
economy could lead central banks to leave the policy of easy money. It must be shown whether a self-sustaining recovery can occur and we could see where and how much capital was misallocated in useless projects and investments. Such transitions are often accompanied by confusion and valuation adjustments. The last weeks of June showed that the mere announcement of impending liquidity withdrawal impress the markets. The announcement of the Federal Reserve Bank to resign from the excess supply of money will keep investors busy for some time. At the same time the question whether a contrary monetary policy of two leading central banks – opening up in Japan and turn off in America – can work out. In addition the cornerstones in prior named for quantitative easing² which are a U.S. unemployment rate less than 6.5% with an inflation up to 2.5% not in sight at all. That is why we expect rather a later than a sooner retreat.

For the moment investment decisions are accompanied by extremely low interest rates. Especially institutional investors such as insurance companies and pension funds are extremely over-invested in bonds and correspondingly under-invested in fixed assets like stocks. Each bond maturing in their portfolios increases the pressure to find a new investment with adequate returns. That is why we expect a gradual shift from bonds to stocks by these investors. The medium-term support by liquidity from the Japanese and – in our opinion – from the U.S. central bank also provides a line for the markets. Although we expect in the latter half of the year increased volatility in the stock and commodity markets we see in these assets continuously the best opportunities to realize adequate returns and protection against disasters in the world monetary system. The associated fluctuations are the price for being able to safeguard relatively the most assets. That is why we recommend to endure them.

Undifferentiated investments in „the markets“ are in our view not suitable. Companies offering future-oriented products and services demanded even in crisis scenarios are according to our opinion the best protection in a mid- and long-term time horizon. If they also have a strong market position and have little or no debts as well as sustainable dividend policy, volatility can be balanced in these assets with

² Quantitative Easing is a monetary policy.

good prospects and the possibility to buy more at reduced prices. Assets fitting into this scheme we find continuously in the technology sector, with manufacturer of daily consumer goods and in the sectors healthcare and pharmaceuticals.



Regionally our main view is still on America where Fed and government go together united and coordinated to act with the lowest transformation losses globally. In Europe we are also increasing investments. Although there is a lack of a common and coordinated economic policy and growth prospects are therefore mainly cautious. Additionally we have to consider that the anticipated upward valuation adjustment at the stock markets is due to excessive liquidity. However we find here as well several companies in globally competitive position with positive development prospects. And we expect that there will be a stronger focus on the above described companies taking into account the missing alternatives for investments. Last but not least Japan is of interest – at least for the moment. Liquidity raises the stock market and the declining yen improves the profits of the companies. Due to the uncertain success of an up to now untested economic experiment it is important to watch the scene closely and to consequently sell assets again if necessary.

Precious metals as money of last resort will remain the foundation of our investment considerations in the light of the discussed risks. After all there has been little to stabilize the global financial system. Although the expectation of the end of loose monetary policy with rising interest rates and positive real returns dampen the markets for precious metals, the question arises whether the economic consequences of the first braking maneuver do not have to lead immediately to a rejection of the original intent. According to

current signs this is quite probable because at the moment each supposed prosperity faces a financing with reservation by money without value. If central banks after a first retreat had to return to a monetary policy supporting economy and state, the hopelessness of the situation would be clearly documented. The learning curve of people would incline steeply because more and more people realized that after years of crisis at last no problem came closer to a solution. Facing attempts again to buy more time by possibly an exponentially increased money supply, the value of money would be doubted ultimately. We live in a historic phase with uncertain success of various political and economic experiments, that is why we consider an insurance against loss of assets in form of gold still not only appropriate but essential.

Matthias Steinhauer
 Bielefeld, 27th June 2013

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