

TYCHE SPECIAL MARKET UPDATE

TYCHE INVESTMENT STRATEGY REVIEW – 8 AUGUST 2011

U.S. DOWNGRADED - WHERE IS THE SAFE HAVEN NOW?

The downgrade of the United States by Standard & Poor's has taken many investors by surprise, and brought clearly to everyone's attention the fact that the financial crisis may not be over just yet.

One could see it coming a long way though, since high deficits and government debt had long been on a worrying trajectory, even starting well before the US sub-prime and financial crisis of 2008. And with the bank bailouts of 2008 and more recently the PIIGS countries bailouts, the sovereign debt problem only got worse, since the balance sheets of even the supposedly stronger Western nations including Germany, France the UK as well as the United States (regardless of the debt ceiling increase debates), have all continued deteriorating at an accelerated pace.

In such a precarious environment one should think that the security of capital should become more important when investing, than the expectation of, or the gambling for high and fast returns. (In particular, we still advise against using leverage for investing, including the use of mortgages on properties.) The question that remains though is what exactly security and what exactly 'safe' assets really represent now, at this moment, given that the security of previously perceived havens of government bonds of the US or major European nations are starting to be questioned now, including their respective currencies, amid the rising inflation risks resulting from unsustainable debt/deficits.

Currency-wise, it seems that the market has found for itself one answer so far, and that is the Swiss Franc. This is a matter that we discussed in the November 2007 Market Truth, when again most did not see this coming:

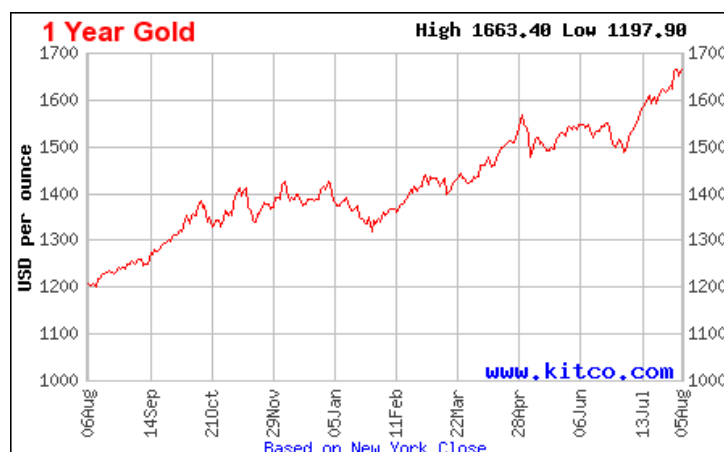
"We believe that the CHF may soon benefit from relative EUR and GBP weakness, as well as from a potential unwinding of carry trades. Investors holding CHF-denominated loans are advised to repay (or currency-switch) such loans. Investors with a considerable exposure to the EUR or GBP are advised to consider diversifying some of these holdings into CHF or CHF-hedged assets." (Market Truth, November 2007)



But at its current high level, it appears that the Swiss Franc's safe heaven status may already be 'priced in', given that Switzerland's tourism industry and exports are now struggling, and that the size of the major Swiss banks is enormous compared to the Swiss economy, which can be dangerous in bad times, as the cases of Iceland and Ireland have shown.

There is also talk of possible currency intervention on behalf of Swiss politicians/central bankers (as is the case in Japan), and this indeed appears to be a risk of any other relatively strong currency as well, remember the 'currency war' buzzword, anyone?

So, fortunately, unlike in 2008, this time around investors have started to wake up to just those global currency devaluation risks, and do not sell gold and silver on 'bad' news, but instead buy the metals. Certainly, this trend is also helped by expectations that the United States may have no alternative to launch into further QE measures soon, as is the case in Europe, where the ECB announced last week to be 'actively implementing' its bond buying program to buy Italian and Spanish debt.

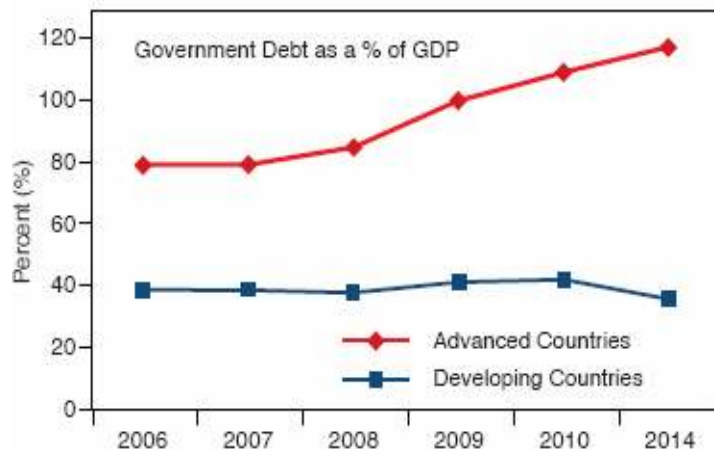


The rise of gold/precious metals prices may soon be followed by other commodities, as investors may increasingly be realising that this time around commodities generally may be a safer and more inflation-proof haven than Western bonds and currencies, since hard assets cannot be printed, as downgrades start, deficits get out of control, and the effective reduction of debt through further quantitative easing (money printing) appears to be the only path to avoiding a default.

It should also be noted though, when discussing the sovereign debt problem, that the balance sheets of emerging markets generally, and Asia in particular, tend to be much healthier than those of the West.

Even in China, when adding the much-discussed Chinese local government debt to the national debt, the country's debt level is still well below that of the average levels in the West, while the Chinese economy remains strong, and tax revenues have jumped 30% in the first half of 2011 to 5 trillion Yuan, which goes a long way to enhance China's ability and financial strength to deal with any potential fallout from local government debt.

Who's Riskier?



So in the relatively healthier economies of this world, the current equity-market rout may actually represent an opportunity to selectively gain exposure to convertible bonds and equities (where investors are not exposed to leverage, and already hold sufficient gold for crisis protection), given that equities represent companies, and companies (as long as they have got a competitive edge in the market) can put up prices for goods and services sold in line with inflation – unlike bonds or cash which do not have an intrinsic value but are fully exposed to inflation risks as they rely on government promises of purchasing power of currency.

The best investment strategy therefore appears to be an un-leveraged portfolio that is diversified across different asset classes, with a focus on precious metals and commodities and the one hand, as well as selected equities, convertible bonds and local currency bonds across Asian and other relatively more healthy economies of this world.

Should you wish to discuss this or have any other query regarding financial matters please do not hesitate to contact your Tyche Adviser.

Tyche Investment Committee
08 August 2011