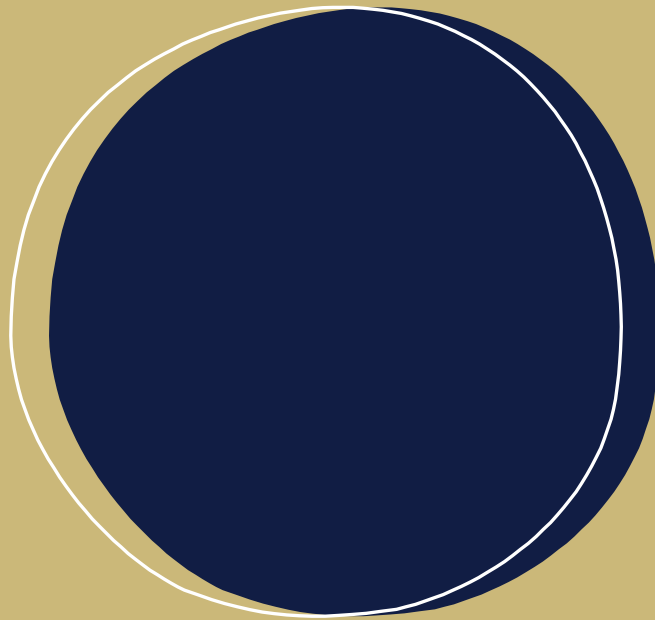


News from the financial markets

The post-crisis world

Volume 3: Inflation fears and inflation protection

October 12, 2009





The post-crisis world

Volume 3: Inflation fears and inflation protection

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Inflation fears are premature. The central banks can initiate countermeasures if necessary. We anticipate price stability in 2010 and therefore consider inflation protection to be unnecessary. However, a number of investment opportunities are available to investors whose inflation expectations are high.

A. Negligible inflation in 2010

Inflation fears are premature

The crisis-related surge in the global money supply is fanning inflation fears among many investors. In the absence of a corresponding increase in the amount of available goods, a bloated money supply normally leads to higher prices.

However, the current economic crisis has interrupted this causal relationship: the impact of monetary policy has weakened significantly. Among other things, the demand for money has increased. Heightened default risks continue to reduce banks' willingness to extend credit, even as decreased capital spending lowers companies' demand for credit. Thus the growth of lending volumes and inflation-relevant pool of money is in fact sinking despite the central banks' bloated balance sheets.

The recession-related surplus production capacity of many companies is keeping a lid on supply-side price pressures. For that reason, an expansive monetary policy does not become inflationary until the normalization process is in an advanced stage.

Central banks are keeping their powder dry

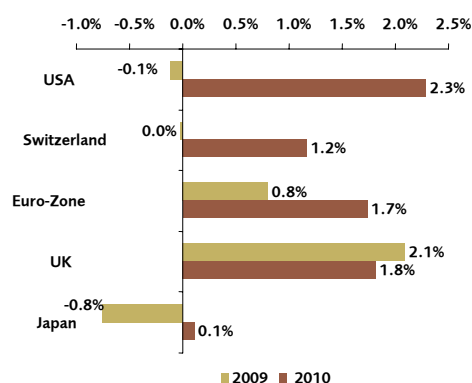
The central banks have at their disposal a wide array of mechanisms for exiting the "pump-priming" mode, among them: (a) the base lending rate; (b) minimum reserve requirements for banks; (c) new conditions on lending growth; (d)

the sale of government bonds; (e) the payment of interest on commercial banks' surplus reserves; and (f) the issuance of proprietary debt instruments. A convincing means of communicating the existence of this arsenal is necessary to prevent heightened medium-term inflation expectations and a rise in long-term interest rates.

Deficits are an impediment to growth

The world's governments must contribute to the stability of risk premiums and markups at the long end of the term structure by presenting credible medium-term consolidation plans for their budgets (see our News issue dated 01.09.09). The budget deficits for next year do not appear to pose an inflation threat. For one, overall economic demand will not increase excessively. And secondly, the central banks will step away from being a perpetual source of financing for national budgets (the markets would be quick to punish any policy to the contrary). A strict orientation toward price stability is firmly anchored in the independence of the central banks (see Economic Outlook, Investment Views, October 2009).

VP Bank inflation forecasts for 2010

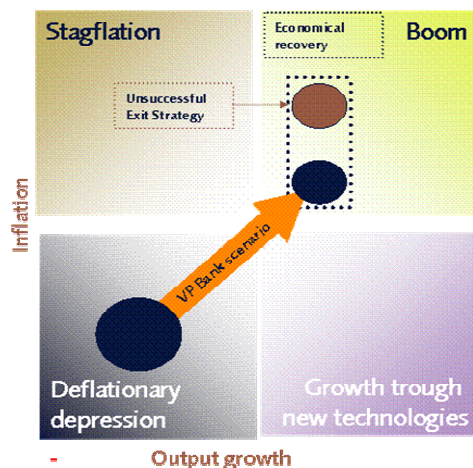


Source: VP Bank

VP Bank inflation prognoses for 2010

We expect to see price stability next year (ca. 2% inflation rates) in our core markets. With this forecast, we are currently even a tad above the consensus estimate. We are anticipating a more rapid upside correction in GDP growth rates than foreseen at present by most analysts (see our News issue dated 02.10.09). For that reason, our oil price forecast is also slightly higher. However, many market participants are currently in the process of making upward adjustments to all of these prognoses.

VP Bank macro scenario for 2010

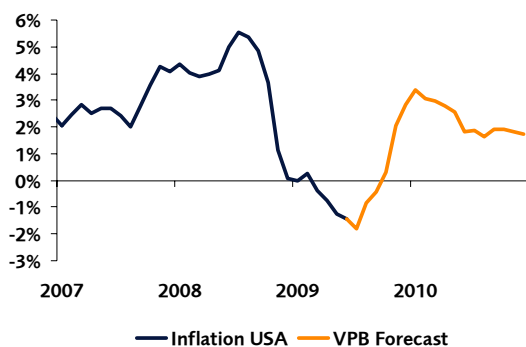


Source: VP Bank

Oil price to rise in 2010 above USD 80

We currently reckon that the price of crude oil will be at least USD 80 by the end of 2010. This past September, the average per-barrel price was roughly USD 70. That represents a year-on-year decline of 33%, but nevertheless a 112% increase compared to the USD 33/bbl low recorded in February of this year.

US Inflation, and VP Bank forecast for 2010



Sources: Datastream, VP Bank

Turbulence after the turn of the year

The base effect attributable to the February low in oil prices will soon cause a significant (optical) bump in inflation that will persist into the second

quarter of 2010. Especially in terms of the energy-cost-sensitive US consumer price index, we expect there will be several consecutive months that show more than a 3% annualized rate of inflation. Price increases of that magnitude, however, are not likely to be long-lived. Energy-related price inflation will ease significantly during the second half of the year. Nonetheless, numbers such as those will undoubtedly fuel a heated political discussion about the course Fed is taking.

In our scenario, the core inflation rate will amble along at a considerably easier pace: for the aforementioned reasons, it can be expected to rise gradually through the end of 2010 to a modest level slightly in excess of 1%.

Money market alternatives in a low interest rate environment

In our scenario, USD, EUR and CHF benchmark rates are likely to remain mired at their current low levels for a further six months.

For investors who share this view and also do not expect to see a pick-up in inflation, the money market offers so-called "inverse floaters" as an alternative. These instruments pay a comparatively high fixed rate of interest, from which the actual short-term interest rate is subtracted (e.g. 6% minus 2x EURIBOR). If short-term rates in fact remain low, the instruments will generate a handsome return compared to that of a normal money market investment.

Another means of circumventing the low level of interest rates is the so-called "floored floater", which affords a guaranteed minimum yield (e.g. 2.5% in EUR) if rates remain constant. However, if short-term interest rises to a level that exceeds the minimum (i.e. the floor), then the coupon is adjusted to reflect the going short-term benchmark rate (e.g. 3-month EURIBOR).

Accordingly, the investor receives the higher of either the guaranteed rate or the applicable short-term rate of interest. So regardless of whether rates rise or fall, investors earn a comparatively higher return and their holdings do not lose value in response to rising interest rates. As is the case with any bond, issuer-related risk must be taken into account. A number of banks (e.g. JP Morgan, Deutsche Bank and HSBC) do not offer these structured products, probably due to their lack of need for refinancing facilities. Other banks that tend to have greater refinancing needs (e.g. Citigroup, Royal Bank of Scotland and Nomura), offer them with attractive interest floors.

Inflation risks on both sides

If the global recovery were to be less robust than we expect, inflation is likely to decelerate accordingly. A failed or delayed "exit" on the part

of the central banks harbors risks in the other direction. Whatever the case, energy price inflation over the coming six months will represent a challenge for the central banks' communication work.

B. Inflation protection possible, but superfluous

Hardly any attractive fixed income products

When short-term interest rates are low and inflation expectations high, it is difficult to find an attractive fixed income product. A "normal" bond with a fixed coupon loses value in response to rising interest rates. Thus the investor is penalized twice because the bond also depreciates in real terms, and longer maturities lose even more of their current market value.

Inflation protection in the investment decision

Inflation protection is afforded by an array of investment possibilities that we describe briefly in the following section. Our Client Advisors are available at all times to provide more in-depth investment suggestions that take into account clients' existing holdings.

Inflation-indexed bonds: Treasury inflation-protected securities (TIPS) offer maximum protection against inflation. They are issued by a number of countries of differing creditworthiness and available in various currencies. Given implied inflation rates of one-half percent (USD, 2-year) and two percent (EUR, 10-year), the current prices for TIPS are only interesting as an entry point if the investor is reckoning that, over the same time frame, inflation will rise significantly above those levels and thereby justify the costs involved in a portfolio shift.

The real yield on TIPS is low and has fallen further in recent weeks. And especially in a growth scenario, going forward they are likely also to lag the returns of other investment classes. Granted, the anticipated high rate of energy price inflation in the months ahead could lend further support to the TIPS market. But those gains will probably not hold up once inflation rates start to retreat again. Moreover, core inflation remains extremely low. TIPS promise to pay the investor a "real" return, this because inflation is compensated according to a predefined method over the bond's entire lifespan. The implied inflation rate of a TIPS bond issue provides an indication as to how high inflation must be at minimum in order for its yield to exceed that of a normal government bond of equal maturity. However, interest rate and market risks remain intact during the entire term to

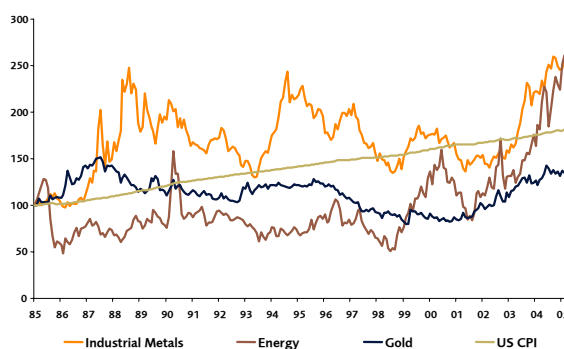
maturity – hence TIPS do not solve the problem of low interest rates, for one reason because price fluctuations are probable. A diversified investment solution is afforded by the inflation-linked Deutsche Bank x-Tracker ETF (LU0290358224).

Inflation-coupled "floored floaters": A further evolution of the "floored floater" is the "inflation floater" that provides a minimum yield for investors who also desire protection against rising inflation. A potential EUR-based variety has a 4-year term and a fixed year-one coupon of 3%. In the subsequent years, the coupon is dependent on inflation: the precise annual rate of inflation (based on the CPTFEMU Index) is paid out.

Commodities: In the '70s, an investment in commodities provided over time the best protection against inflation. The supply of commodities is cumbersome, thus their price reacts rapidly to monetary policy changes. With a broadly diversified investment in commodities, the investor can simultaneously participate in an economic upswing.

Within the commodities universe, gold in the past has frequently offered the best protection against inflation. The first oil crisis (August 1973 – December 1975) led to price increases amounting to 23%. During the same time frame, the price of gold rose by more than 35%. In response to the second oil crisis in the late '70s, the price of gold outpaced inflation by an even wider margin.

US consumer price index versus commodity prices (1985 = 100)



Sources: Datastream, VP Bank

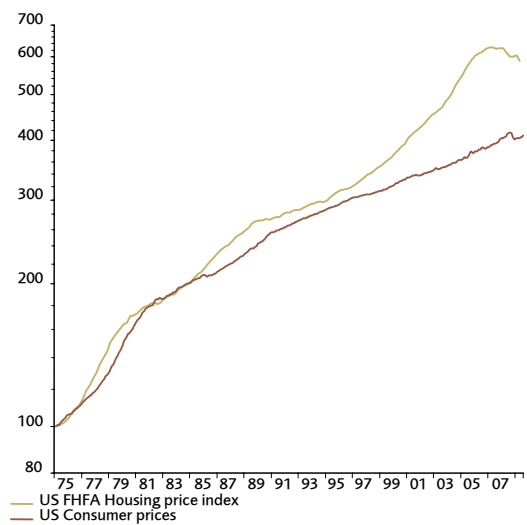
In the following decades of moderate inflation (less than 5%), gold was clearly less successful. Cumulative inflation totaling 81% far exceeded the 34% increase in the price of gold. Thus in that phase, a participation in nominal GDP (e.g. via shares, energy sources or industrial metals) would have been considerably more rewarding. In order to reduce individual commodity risk, we would recommend investing in a commodity

index. However, a number of points must be taken into account in this approach:

- The inherent risk of commodities can be reduced through a capital protection feature. Otherwise, the investor is exposed to the risks of a highly volatile asset class that can far exceed the risk parameters of his/her portfolio. Capital protection can be best derived by means of a structured product, however that insurance limits the upside potential of the investment.
- Any such investment should be made in the reference currency of the investor. Because commodities are generally traded in USD, a EUR-based investor should hedge the related currency risk, for example via a EUR-denominated *Quanto* product. Otherwise, it can happen that the profit from a commodity investment is reduced or even eliminated by a lower EUR/USD exchange rate.
- Proper selection of the specific commodity index is of central importance. The performance difference between the various commodity indices since the beginning of this year has been a whopping 40%. We recommend "second-generation" commodity indices, for example the UBS CMCI Index or the DBLCMREU Enhanced compiled by Deutsche Bank. We currently advise against using first-generation indices such as the DJ-UBS (formerly, the DJ-AIG) – they are not roll-optimized and therefore generate lower returns in a contango market environment.

Real estate: In the past, a direct investment in real estate has proven to be a good hedge against inflation also over long periods of time. Expenditures on housing constitute more than 40% of the US basket of goods and services used in the calculation of the consumer price index. A mortgage-financed property offers a dual advantage: the value of the property increases while the "real" value of the mortgage decreases.

US housing prices and inflation (1975 – 2009)



Exchange-listed real estate companies (REITS) are less suitable as a safeguard against inflation. Although there is a strong positive correlation between real estate prices and the general level of prices – frequently, lease contracts for commercial properties are directly tied to inflation – this relationship varies greatly because commercial real estate prices are also subject to sharp cyclical fluctuations.

Equities: Shares are attractive in a growth-friendly environment that is accompanied by inflation rates in the vicinity of price stability (VP Bank's scenario). In the highly inflationary atmosphere of the late '70s, equities provided little if any protection. Such an environment is growth-averse and thus lowers anticipated corporate profits. For example, from August 1973 through September 1978, US stocks advanced by all of 23% while purchasing power collapsed by roughly one-third. Within the equities universe, those companies with a solid market position have an easier time passing on inflation-related price increases to the consumer. Utilities, as a general rule, tend to benefit additionally from their high debt/equity ratio (inflation-related diminution of the real value of outstanding debt). Owing to their position at the front of the value chain, commodity (raw materials) producers as well as mining and energy companies are initially protected against higher procurement prices. An investment in stock indices of commodity-producing countries (e.g. Canada, Australia) represents an alternative to share- or industry-specific investments.

The bottom line:

An emergence of galloping inflation remains highly unlikely. We are going on the assumption

of price stability. Therefore, as the recovery evolves, equities offer sufficient inflation protection thanks to their attractive anticipated returns.

TIPS are the most reliable source of protection against above-average rates of inflation, however the investor waives the opportunity to participate in the economic upswing. Real returns vary because of price fluctuations.

Over a short period of time, commodity investments can offer both inflation protection and a chance to participate in the recovery, but their sharp price fluctuations mean there is no guarantee of favorable results. With all of the investment possibilities we have described, it is important that the associated risks not be overlooked.

Inflation protection afforded by various investment classes:

Asset Class	Inflations prtotection	Notes
Cash	↓	
Bonds	↓	Prefer short maturities & floating rates. Avoid long maturities
Inflation protected bonds (TIPS)	↑	Reliable inflation protection. Risk of interest rate change.
Convertible bonds	↗	Equity component protects partly against inflation.
Stocks	↗	Materials (Mining), Utilities and stocks with pricing power, and commodity exporters provide best protection
Real estate	↗	Mortgage financed direct real estate investments provide long term protection.
Commodities	↗	Effective short term protection with gold. For long term protection favor commodity indices.

Source: VP Bank

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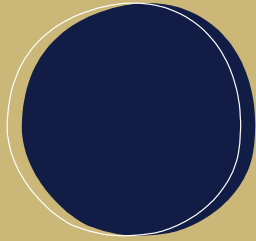
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