

Neue Privat Bank

## Stagflation or "flatflation"?

### Further trouble through exploding energy prices

- As if the circumstances on the financial markets were not already sufficiently troublesome with the smouldering credit crisis, the massively rising energy prices are becoming a second factor of disruption for economic growth.
- The rising prices of oil and agricultural commodities have led to a significant increase in overall inflation. The European Central Bank (ECB) has hinted at further interest rate hikes in order to break the inflation expectations of the market players. However, in the current market circumstances, there is the somewhat paradoxical threat that investors will protect themselves against the risks of inflation by speculative purchases of commodities, which will drive the inflation rates even further upwards.
- The risk of economic stagflation has risen sharply; nevertheless there is a justified hope that inflation will return to a corridor of moderate price increases (so-called "flatflation") in the foreseeable future.

#### A double burden through the credit crisis and high energy prices

After the beginning of the 2nd quarter of 2008, when massive interest rate reductions and targeted rescue measures by the American Federal Reserve allayed the fears of investors that the international financial system was going to collapse, trouble is now threatening from another direction. On the one hand, there are signs that like a smouldering fire, the US real estate crisis will continue to burden the economy for quite a while and will lead to further, massive write-offs at the investment banks. As if that were not enough, the energy and agricultural commodity prices are now also going berserk. Enjoyment of spending on the part of US consumers is being simultaneously braked by increasing credit costs, higher energy prices and poorer prospects on the employment market. Much more badly affected are numerous consumers in developing nations whose expenditure is focussed mostly on food and energy products. The associated deceleration effect on the global economy as well as the annoying development of overall inflation are awakening unpleasant memories of the energy crisis in the seventies, which introduced a longish phase of economic stagflation with low economic growth and high inflation. Do we now, after a long period of fine weather in which the fruits of globalisation could be harvested on the financial markets, have to adapt ourselves to the disadvantages such as exploding commodity prices as a result of strongly increased global demand?

#### Hopes of mere "flatflation"

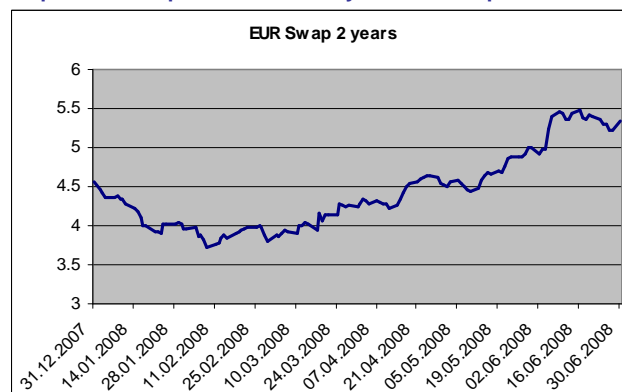
Against this background, can we still hope that after a short phase of economic downturn and higher inflation rates, we can return to moderate inflation in a corridor between 2% - 3% in the USA and 1.5% - 2% in Europe - a scenario which is being called "flatflation" as of recently by the linguistically creative Anglo-Saxons? It appears that particularly the Fed is working on the basis of a comparable scenario in its monetary policy, namely that the current weakening of the economy does not enable most producers to pass higher raw material costs fully on by means of price increases. Price shocks in individual goods must therefore not lead to a wild revolving of the inflation spiral which would affect the entire economy. If the rise in energy prices soon slows down, there is a justified hope that sooner or later the "secret" bet of the top US bankers that inflation might soon flatten could work out.

#### Is the ECB unintentionally becoming an inflation generator?

The European protectors of the currency appear to be basing themselves on a different scenario. They have repeatedly and energetically pointed out the strong threats of inflation in recent weeks and signalled the willingness of the ECB to tighten the monetary reins further. In the good old manner, expectations of inflation should be throttled at birth in order to avoid second round effects such as a general boost of inflation. However, in

the current circumstances on the market, there is a certain danger that the European Central Bank is unintentionally becoming a price generator itself if market players interpret the harsh signals of the ECB as meaning that they should cover themselves against inflation risks by investing in energy and agricultural commodities. Even stronger price increases, driven by speculation, would, in this case, lead to a further rise in inflation, which in turn would trigger even harsher reactions from the ECB and thereby create a factual endless loop of inflation.

Graph 1: Development of the two-year EUR swap rate



Source: Bloomberg

#### High price losses on the bond markets

Following the assumption of the markets just a few weeks ago that in view of weak economic signals, the ECB would reject any further interest rate increases, the surprising hint at a possible further interest rate hike by Europe's main currency protector has pushed bond yields, particularly those in the segment of one to five-year terms, sharply upwards (see Graph 1). The result is that bonds with short to medium terms have, in the meantime, higher yields than long-term bonds. Buyers of bonds are apparently assuming that the temporarily higher money market rates will lead in the medium term to a weakening of growth with flattening inflation in Europe.

Following the strong rise in interest rates in the Euro region, we believe that a further rate increase of 25 basis points is already included in the price and Euro bonds with terms of 1 to 5 years again represent an attractive investment. In the segment of Dollar bonds too, shorter terms are advisable, given that due to the US budget deficit continuing to rise in the next few years, one can reckon with a strong supply of treasury bonds. Our attitude is more cautious with regard to bonds in the currencies of emerging nations because due to what has mostly been a strongly expansive monetary policy until now, the local bond markets have not corrected themselves as strongly as has been the case in the Euro.

**"Rien ne va plus" on the stock markets**

How quickly budding hopes can dissipate and forecasts can become waste paper was demonstrated in June on the stock markets. The main spoilsport is, for once, probably the continually rising oil prices which are now about 44% higher than at the beginning of the year in Dollar terms, whilst the price for natural gas has risen by about 70% in the same period. It appears that the pain threshold for consumers and producers has been reached, which does not bode well for the economy and the profit situation for numerous energy-sensitive industries (particularly airlines, car-makers and producers of chemicals). To add to the misery, the prices for numerous credit derivatives based on mortgages have again sunk significantly after having recovered in previous months. The consequence is an expectation of further, painful write-offs, particularly for the major

investment banks. That, in turn, has led to the stock prices of most of the banks sinking to new low levels. Even though we know somewhat more about the causes of the credit crisis, an end of the credit crunch is still not foreseeable because it is hardly possible to forecast how far real estate prices in the USA will continue to sink. One has to reckon in the meantime that the direct damage in the wake of the sub-prime crisis is going to land at closer to 1.5 trillion USDollars than one trillion. Although shares are fundamentally becoming cheaper all the time in historic comparison, the miserable economic circumstances hardly allow a forecast of the point in time at which the mood of investors with regard to dividend-bearing titles will turn positive again.

MR

**Sharply rising prices on the oil market: Start of a price bubble or precursors of further price increases?**

**The oil price only knows one direction**

The rise in the price of crude oil has accelerated massively in the last 18 months. Having almost doubled in 2007, the oil price rose again in the first half of 2008 by 44% to 142 \$ per barrel. 10 years ago, the price of the black gold was at about 10 \$ per barrel, a fraction of what it is today. At the beginning of this year, a lot of people in a lot of places believed that due to the cooling world economy and the associated decline in the growth of demand, the pressure on the oil price would weaken.

**Graph 2: Development of the oil price**



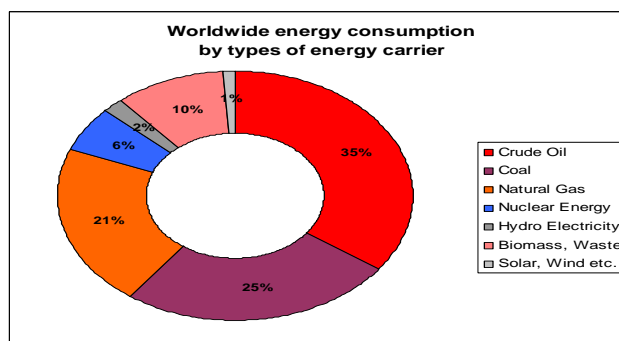
Source: Bloomberg

For this unpleasant development of the price - except for the oil producers - there seem to be two main reasons:

- On the one hand, demand for oil and other energy carriers such as gas and coal is still rising at an almost unchanged rate, especially in the Asian countries. About 70% of growth in global demand is attributable to the Chinese economy. The continually rising demand is met by only a moderately rising supply, given that numerous non-OPEC regions (Mexico, the US, the North Sea states) are recording declining output and, due to the exploding prices, most of the OPEC countries see no reason to increase their own output.
- On the other hand, the effective surplus capacities in oil production in the OPEC states have been continually sinking in recent years and today represent less than 2% of the total demand. If, because of geopolitical risks, the supply of oil from individual countries is stopped, the consequences for the safety of supply are not difficult to imagine, given the low inventory levels which, on worldwide average, are enough for only about 70 days. The accentuated price rise in recent days can therefore also be

associated with rumours of an impending US intervention in Iran.

**Graph 3: Worldwide energy consumption by types of energy carrier (2004)**

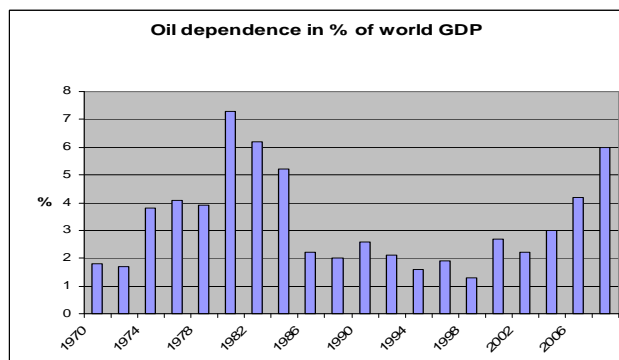


Source: Economist

**Oil dependence like that at the end of the seventies**

The price level reached in the meantime for oil leads to consumers having to spend an ever larger part of their income for energy, similar to the situation which existed during the energy crisis at the end of the seventies (see Graph 4). Even though it is conceivable that the prices could be corrected in the short term, we will almost certainly have to become accustomed to a higher price level in the medium and long term because the demand for oil, gas and coal will continue to rise, the supply capacities can only be increased to a limited degree and alternative sources of energy will only be able to make a modest contribution to the supply of energy in the foreseeable future (Graph 3).

**Graph 4: Development of oil dependence**



Source: IAE

MR

## Recommendation of a structured product: CHF Hedge Funds Portfolio with a minimum pay-out on maturity

### Basis of product

At the moment - due to the very turbulent markets - products with capital protection are enjoying huge popularity. On the one hand, opportunities should be granted to achieve a positive yield in comparison with a fixed deposit, and on the other hand, the product should include for all possible cases a capital guarantee on maturity and therefore a safety net. The NPB Neue Privat Bank has created a product of this kind which not only offers those two advantages but even guarantees a minimum interest credit on maturity.

### Product details

The product runs over a term of 10 years. On maturity, the issuer guarantees 110% of the capital invested. The sum invested is credited with minimal interest and simultaneously invested in a broadly diversified Fund of Hedge Funds portfolio, which is characterised by very limited price fluctuations and an attractive yield. Through use at the outset of 9 different funds of hedge funds, the investor obtains access to about 400 individual funds. If one of them – which is not be expected but also cannot be categorically excluded - runs into serious difficulties or even has to be closed, the influence on the overall portfolio would be extremely low.

### Double control

The NPB Neue Privat Bank is responsible for the management and choice of funds in the portfolio. As, however, the issuer of the product has to secure the capital guarantee and minimum crediting of interest on maturity, each fund of hedge funds that we propose is again subjected to an intensive examination. Only when the fund has taken that hurdle too can it be integrated into the portfolio. This procedure gives the investor double security because the funds of hedge funds used are meticulously examined.

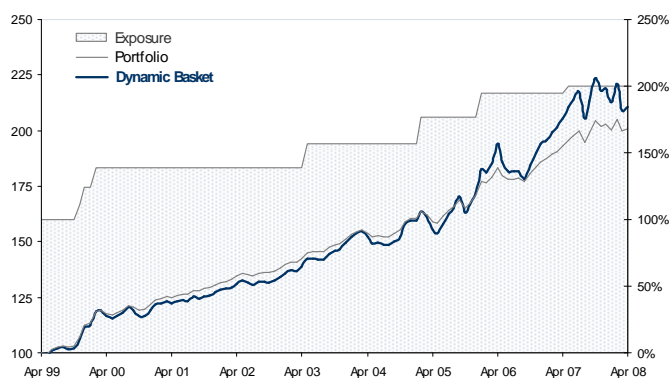
### Portfolio / Backtest

The initial portfolio is comprised of 9 different funds of hedge funds which invest in a total of about 400 individual hedge funds. The selection of the 9 funds takes place from the point of view that a so-called core portfolio (approx. 70%) should be comprised of diversified multi-strategy funds. But accents were set here because certain funds have a strategy focussed on fixed-interest investments, others focus on share strategies. The core portfolio is supplemented with about 30% of satellite investments, where somewhat more specific funds are included. These are currently two multi-strategy funds of hedge funds which invest exclusively in commodities.

	Annual Perf	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2008	-1.05%	-1.28%	2.15%	-2.43%	0.57%								
2007	9.14%	0.61%	1.18%	0.66%	1.21%	1.53%	0.93%	1.08%	-2.51%	2.06%	2.70%	-1.13%	0.56%
2006	9.02%	3.76%	-0.41%	1.44%	2.48%	-2.00%	-0.97%	0.22%	0.12%	-0.79%	1.94%	1.66%	1.36%
2005	6.48%	0.09%	1.91%	-0.84%	-1.80%	-0.37%	1.71%	1.70%	0.98%	2.02%	-2.25%	1.26%	2.01%
2004	5.85%	1.22%	0.82%	0.49%	-0.94%	-1.05%	0.27%	-0.38%	0.21%	0.88%	1.03%	2.44%	0.77%
2003	9.43%	0.98%	0.80%	-0.10%	1.20%	2.01%	0.35%	-0.30%	0.25%	1.37%	0.69%	0.40%	1.41%
2002	5.83%	0.64%	0.46%	0.65%	1.07%	0.76%	-0.17%	-0.39%	0.87%	0.05%	0.09%	0.53%	1.13%
2001	7.44%	1.68%	0.39%	0.85%	-0.41%	0.73%	0.54%	0.12%	1.27%	-0.24%	0.76%	0.41%	1.13%
2000	8.30%	0.99%	4.47%	0.54%	-1.42%	-0.24%	0.66%	1.10%	1.81%	-0.46%	-1.48%	0.25%	1.91%
1999	16.47%	0.48%	-0.32%	1.48%	1.98%	-0.61%	2.26%	1.03%	0.33%	-0.48%	0.69%	3.94%	4.72%

### Certificate / Backtest

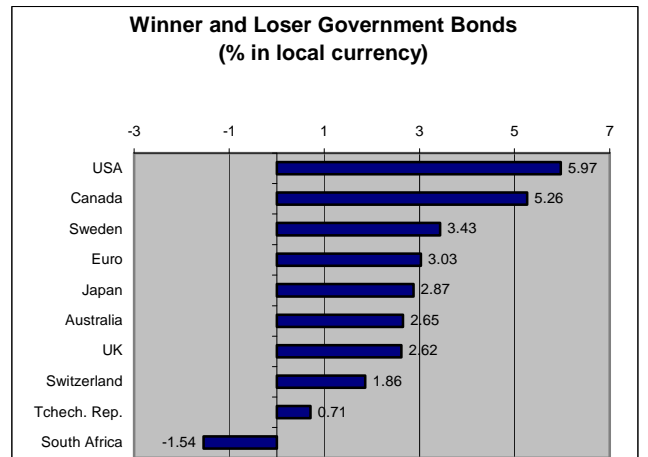
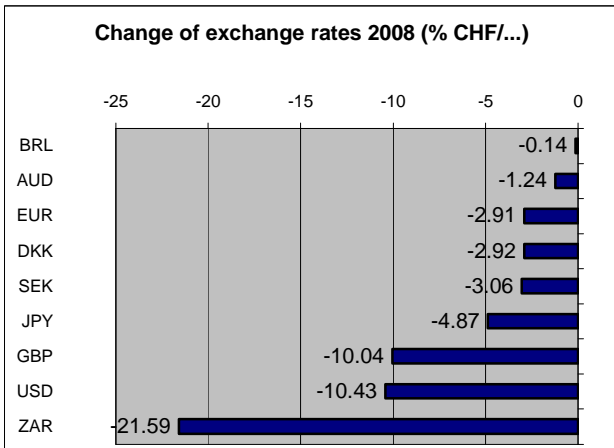
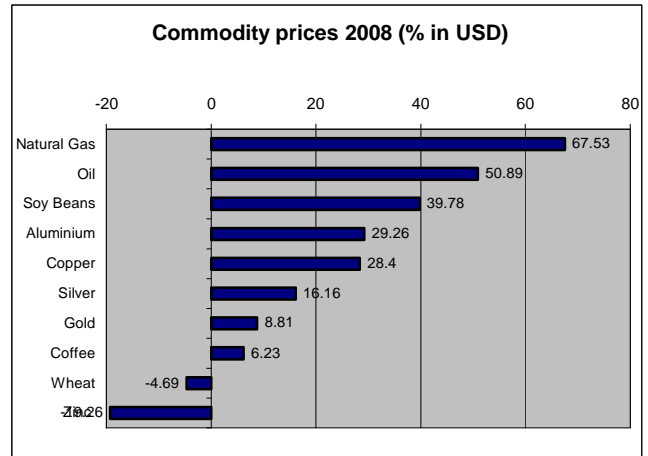
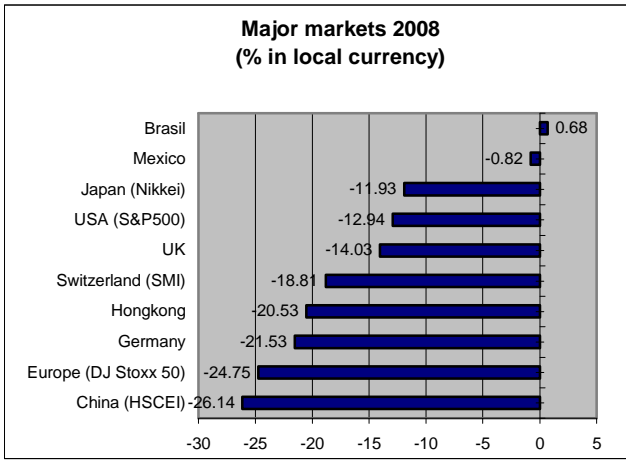
We subjected the portfolio of the selected funds with a backtest in order to show how the portfolio as such, but also the product, would have developed over the last 9 years. At the same time, the following graph also shows the exposure, i.e. the share of capital which is invested in the hedge fund portfolio. The exposure begins at 100% and then - thanks to a positive development of the portfolio - is successively increased to a maximum of 200%. The graph also illustrates how, thanks to the increase in exposure, a direct investment in the portfolio, even with a capital protected product, can be exceeded. The yield resulting from the backtest reached 8% per annum.



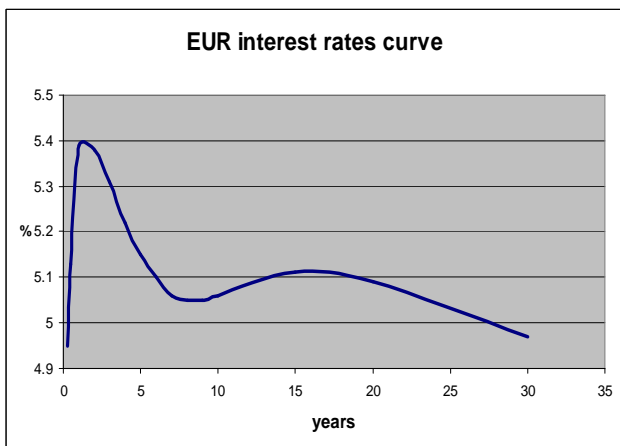
### Key data of the issue

Issuer:	BNP Paribas
Rating:	Aa1 / AA+ (Moody's / S&P)
Currency:	CHF
Denomination:	50,000 (expected)
Launch:	01.08.2008
Initial fixing:	01.08.2008
Final fixing:	30.07.2018
Repayment:	at least 110% on maturity
Basis value:	Hedge Funds Portfolio
Initial exposure:	100%
Maximum exposure:	200%
Minimum exposure:	25%
Participation:	90%
Return:	monthly
Notification time:	75 days
Expected yield :	>5% per annum

**Development of the markets in the 2nd quarter of 2008**



**Interesting charts**



Source: Bloomberg

