

Editorial



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After the turbulence in August 2015 and February 2016, we had another shake-up in the markets at the end of the last quarter. On Thursday, June 23rd, after being a member for 43 years, the British people voted with a slim majority of 52% for an exit from the EU.

This decision came as shock to the ruling elite and the completely unprepared bureaucrats in Brussels. The EU has always been focused on its expansion, so much so that rules and procedures on how to handle a reduction in size are, apart from a vague two-year negotiating period, almost non-existent. It is unclear when the UK will initiate this withdrawal process, by invoking article 50 of the Lisbon Treaty. There will be interesting years of negotiations ahead, and depending on what the establishment learned from that vote, the outcome could strengthen or weaken Europe and the UK.

Regarding the financial markets, we will have to see if the quick recovery after the initial shock will continue, or if there will be lasting consequences. The UK property market might become one of Brexit's first victims; there are already seven UK real

estate funds curbing or freezing redemptions.

Due to the Brexit vote monopolizing the headlines, other events might have gotten too little attention. One of them is the Chinese Yuan. Early this year, a depreciation of the Chinese currency led to a severe stock market selloff. Further depreciation over the last three months, brought the Yuan to its lowest level to the USD since November 2010, but went so far unnoticed by the markets. Concerns could, however, quickly return and present yet another challenge for investors. Also, we have the globally intensifying «war on cash», an issue on which we have elaborated in a dedicated article in this publication.

In recent years, the market impact of political decisions, including central bank policies, has grown tremendously. In Europe, we have the ongoing migrant crisis, a looming banking crisis, with the epicenter presumably in Italy, and three major political events in October: The Italian constitutional referendum, the re-run of the Austrian presidential election and the Hungarian referendum on Brussels' plan to impose refugee quotas across EU countries. In the US we have, of course, the presidential election entering its critical stage.

It will be important to closely monitor the aforementioned factors and relevant developments, as they could play a major role in shaping the financial landscape that lies ahead.

The Zulauf Perspective

The industrialized world and a large part of the Emerging markets are in a down cycle. Government interventions are failing to bring the economy back on a growth track, keeping us in “muddle through” mode for another few quarters.

In the Limelight: War on Cash

We take a closer look at the globalized policy trend, dubbed “War on Cash” and we examine the origins, evolution and far-reaching implications of this phenomenon.

The Zulauf Perspective

Felix Zulauf, the founder of Zulauf Asset Management, has worked in the financial industry and asset management arena for almost 40 years. He was one of the first successful hedge fund managers in Switzerland, and he is well known for his excellent market timing and market cycle predictions. Based on his unique expertise, Felix has been a prominent member of the Barron's Roundtable for almost 30 years.

Felix is a good friend and strategic advisor of BFI. We have the privilege to regularly consult with him on the financial market and geopolitical trends and gyrations. In this section of Insights, we have summarized some of his latest outlook and logic for you.

Overview

The economy moves in cycles. Currently, the industrialized world and a large part of the Emerging markets are in a down cycle. Government interventions are failing to bring the economy back on a growth track, and the mid-term assessment is that the world will somehow continue to “muddle through” for another few quarters.

The recent Brexit vote has brought to light the widespread and growing public discontent with the establishment and presented real challenges and concerns over the future direction of the EU. Additionally, significant risks are arising from China, that could trigger another downturn for the world economy. These factors, combined with geopolitical tensions and systemic problems in Western economic structures, raise concerns that sometime within the next 3-4 quarters, and the years thereafter, we could see another major economic crisis beginning.

Brexit Aftermath

The surprising victory of the Leave campaign in the UK referendum was a clear manifestation of the growing disillusionment and discontent of large parts of the population against the establishment,

a trend that is also present in most industrialized countries. The Brexit vote, far from being an isolated incident, is in fact part of a process at work: the democratic process, whereby the public can express their disagreement with the direction of the European project. This type of populist movements could persist in years to come, and increasingly affect capital markets. It is therefore important to monitor closely both the institutional and market reactions, as well as the developments in political and economic policy directions.

Even after the initial Brexit shock is overcome, the EU will still be faced with an historic challenge: Reevaluating its political and economic strategy and aims, rethinking and reshaping the monetary union into a more sustainable entity and addressing the public's and the market's concerns could be decisive in shaping the future of the EU.

Concerns over China

In response to the 2008 crisis, China unleashed a stimulus program of an unprecedented scale that kept the world economy afloat. This move, however, led to a gigantic investment and credit boom, which in turn created an excess, and overcapacity of dramatic proportions. At some point, this will have to be addressed, by supporting restructuring. This policy direction will require substantial liquidity for the banking system to support the necessary write-offs, which could lead to a lower Yuan in the currency markets: that would be seen as a devaluation of the Chinese currency. Since China is the largest exporter in the world, a devaluation would put pressure on earnings of its competitors and on profit margins, and it would increase the deflationary pressure on their economies.

Impact of the US Fiscal Policy

Uncertainty and doubts are steadily increasing over the promised rate hike that now seems unlikely to be enforced in the coming months. Although new highs in the S&P500 are possible in the short-term, we do not see this move supported by improving

fundamentals at the moment. Current valuations are elevated and any further increase carries the seeds of an exhaustion that could lead to a temporary trend reversal and ensuing medium-term correction sometime later this year.

Structural problems, however, remain lodged at the core of the American economy; a major restructuring of the tax system, addressing the debt burden, reducing the size of government, would be necessary steps to allow the economy to “breathe”. Tackling such issues, however, would without a doubt require fiscal support, which could take the form of government projects and much-needed infrastructure investments.

Gold Prospects

Loose monetary policy adopted by all central banks and rising uncertainty over when the monetary direction will be normalized, have contributed to a renewed interest in gold, even after the latest correction. It could trade erratically in the short-term, however, the longer-term expectation is that we will see a gradual upward trend in the gold price, towards our target level of \$1400 and later even beyond that. Therefore, a strategic bullish position is recommended: As long as the overall sentiment of unease continues about the monetary excesses by central banks around the world and about the rising political uncertainty, investors are likely to seek refuge, for at least part of their capital, outside of the credit and banking system.

Investment Implications

Overall, the long-term view is that in the next five years we could see vast changes in the world economy and financial markets. Agility, adaptability and an open mind will be essential tools for investors. In the grim period that lies ahead, it could become increasingly difficult to earn decent returns with traditional assets. It is unlikely that equities will generate returns similar to historic levels without a major technology or innovation boost. Treasury bonds can also no longer be considered the go-to “conservative investment” option that they once were. Bond yields are so low that inevitably they will have to pick up at some point, which would translate as a severe blow to bond holders.

In the short-term, Brexit indeed shocked the markets, but since it was a political and not a credit event, the expectation is that a highly volatile summer lies ahead, followed, however, by a rise in the global equity markets into late 2016/early 2017, before returning to the norms of this multi-year worldwide bear market. Bond yields are temporarily overshooting on the downside, but are expected to bounce back, in tandem with stocks, as soon as the shock is overcome. However, the upside potential will still be limited by the fundamental deflationary pressure that remains unchanged, along with increasing political uncertainty. Regarding money market rates, their decline is expected to persist and could reverse only after the next major crisis.

A successful investment strategy should be focused on preservation of capital. Risk management is key and a precautionary approach will be essential in the defense against the negative economic surprises that lurk ahead. Naturally, given that world markets are in a constant state of flux, outlining a specific and detailed strategy plan, would be as unwise as it would be ineffectual. However, as a general rule, in the coming years it might be best to err on the side of caution.

In the Limelight: War on Cash

When the term first made it into the mainstream media, about 6 years ago, to describe the rise of anti-cash regulations, it was hard to predict the international snowballing effect that would today establish it as one of the most powerful monetary policy waves in modern economic history.

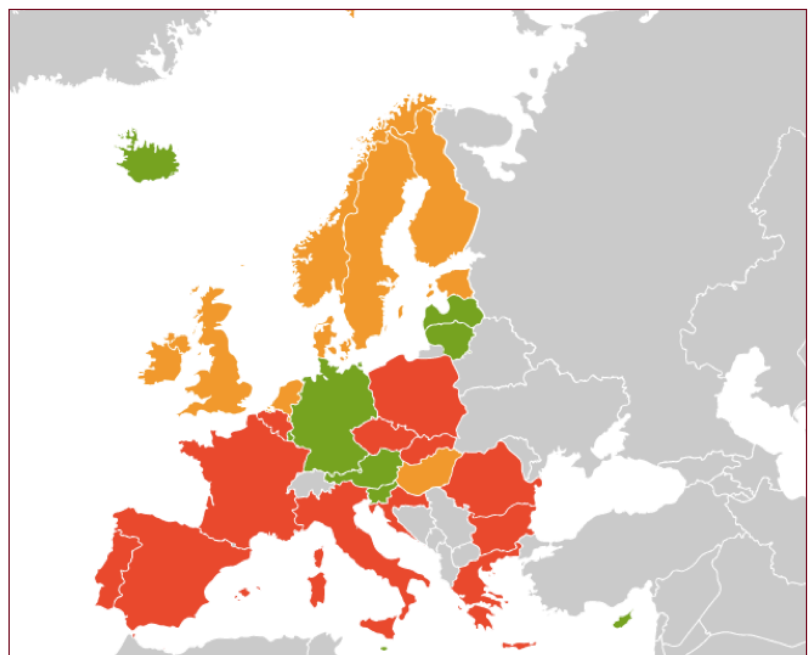
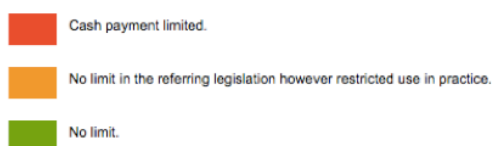
At first, national governments started gently “nudging” citizens to embrace more modern and convenient alternatives, initially by transitioning state-related payments and services, like tax collections and welfare payments, into the banking system. Soon thereafter, they also began placing restrictions on cash transactions. Starting in 2011, Spain and Italy outlawed cash transactions over certain limits, €2500 and €1000 respectively, then Belgium and Portugal followed suit and France reduced the limit from €3000 to €1000 in 2015, while Germany, to the public’s great displeasure, announced plans to ban cash payments of more than €5000. As shown in the chart below, the regulatory wave effectively swept through Europe and soon became the “new normal”. In the meantime, Norway’s biggest bank DNB called for a total ban

on cash, while Sweden’s plan for a cashless society, meant that now in more than half of the branches of the country’s largest banks, no cash is kept on hand, nor are cash deposits accepted. However, the term “war on cash” was really catapulted into the headlines this February, when ECB President Mario Draghi announced his plans to scrap the €500 note. The very next day, Harvard economist and former Secretary of the Treasury, Larry Summers called for the elimination of the £50, the €500, the Swiss CHF 1,000, as well as the \$100.

Official narrative vs. Counter-narrative

The reason given for the escalation of governmental efforts to restrict or, indeed, outlaw cash transactions is the same in all of the above-mentioned cases: cash is the “instrument of choice” for terrorists, drug lords, money launderers and tax evaders; law-abiding citizens have no real use for it anymore. With the rise of credit and debit cards for everyday payments, online banking and wire transfers for large sums, all being embraced as modern alternatives to cash, the average citizen is now actively being encouraged to

Overview of restrictions on cash transactions in Europe



Source: European Consumer Centre, quarry.com

abandon physical currencies and digitalize all their transactions, for the sake of transparency. In other words, the official narrative, reading between the lines, roughly translates to “you have nothing to fear, if you have nothing to hide”.

“Without being able to use high-denomination notes, those engaged in illicit activities — the ‘bad guys’ — would face higher costs and greater risks of detection. Eliminating high denomination notes would disrupt their ‘business models,’” argues Peter Sands, the former chief executive of Standard Chartered.

Upon closer inspection, these arguments generally fail to stand up to factual scrutiny. The abolition of €500 banknotes or \$100 bills is unlikely to have any effect on serious crime or terrorist operations. Merely switching to another denomination, or any other currency for that matter, be it conventional or not (blood diamonds, drugs, art, etc), would not significantly impact organized crime operations, nor would it make any real difference in the fight against terror. Only last November, the official investigation into the horrific Paris attacks, revealed that the IS- affiliated terrorists used prepaid bankcards to rent hotel rooms outside the capital the night before. As for money laundering and tax evasion, both most commonly involve sneaking “ill-gotten” gains into the conventional financial system in the form of real estate, stocks, bonds or other assets, or as the Panama Papers showed us, often using obscure regional legal loopholes, intricate “Russian doll” schemes of shell companies and creative accounting. So far, no scientific evidence, nor research findings, other than anecdotal, have been presented to substantiate these claims as the basis of the anti-cash crusade.

Another way, however, to look at this policy trend, is to juxtapose the so-called War on Cash with the concurrent and increasingly widespread adoption of negative interest rates by central banks worldwide. The core rationale of this measure is rather simplistic: Negative interest rates are, in essence, a tax on bank deposits, ultimately aiming to discourage depositors from saving and to incentivize spending instead, thereby stimulating economic demand. In this light, cash is the fatal

flaw of this plan, as it places serious constraints on the central banks’ power to practically enforce the strategy. As long as paper money is available as an alternative store of value, customers have leverage against the bank’s negative interest rates. They can simply withdraw their deposits to avoid being penalized for saving and just hoard cash instead of spending it; a course of action greatly simplified by using large-denomination bills, that would allow for efficient storage. Naturally, such a choice would imply shouldering various risks and expenses, mostly security- and convenience-related. However, as the penalties for saving become steeper, there comes a moment where the cost-benefit analysis would dictate that cash is the preferred vehicle of storing wealth and would provide a viable “way out”, if negative rates become “too negative”.

The only way, therefore, for the central banks’ scheme to work, is to eliminate this leverage and to block the exit route. Without a physical currency that can be withdrawn and stored outside the system, deposits would be essentially held hostage by the banks, and the customer could only either spend it or watch it shrink over time, crunched away by negative rates.

Social and economic casualties

The official narrative, and often the counterarguments as well, focus exclusively on the ex post facto effects of this policy wave, largely ignoring the invaluable role that cash plays in the lives of ordinary, law-abiding citizens today. For one thing, cash enables legal transactions to be executed efficiently and in real time, without either party paying any fees. It does so, without the risk of getting hacked, or having one’s identity stolen or being subject to disruptions due to power cuts or system failures. It also facilitates the economic inclusion of low-income or low-tech segments of the population that do not have access to an account, i.e. the “unbanked”: That’s 8% of the U.S. population according to a 2013 FDIC survey, and 2 billion adults worldwide, according to World Bank figures.

Naturally, privacy concerns take center stage in this debate. In a world where all accounts and transactions can be recorded and monitored,

combined with the increasing technological capacity for big data management and manipulation, the amount of power handed over to governments and central institutions would be unprecedented. By simply tracking the spending patterns and financial activity of individuals and companies, and thus enabling profiling, a long list of potential abuses instantly springs to mind, while serious questions are raised about the future of confidential information and right to privacy.

Proactive Defense

Assuming that the rate of victories that the war on cash has scored already continues unabated, in combination with negative interest rates being adopted even more widely, it is reasonable to expect that the average saver will soon face considerable barriers in attempting to “cash out” their deposits or to store them out of the banking system. And if the single viable option in order not to lose value over time would be to spend, then the wiser choice would obviously be to opt for investment over consumption.

As a precautionary strategy, the saver’s aim should be focused at wealth preservation. This might be achieved by investing in a diversified set of conservative, low-risk investments. Of course, the “right” strategy depends on the structure and the aims of each investor’s portfolio and one size does not fit all, however in general, actively managed hedge funds with a strategy that is not correlated to the stock market, as well as gold, can provide options to fill the void of cash and facilitate the storage of wealth outside of the cash system.

Questions & Answers

1. What do you expect for the CHF?

The Swiss Franc is and will continue to be a strong currency. The political stability, the economic strength of Switzerland and its neutrality support this view. But, as has been the case in the past, increased demand can drive the CHF maybe too high and thus the SNB might be tempted to intervene again, to keep the lid on a strong appreciation.

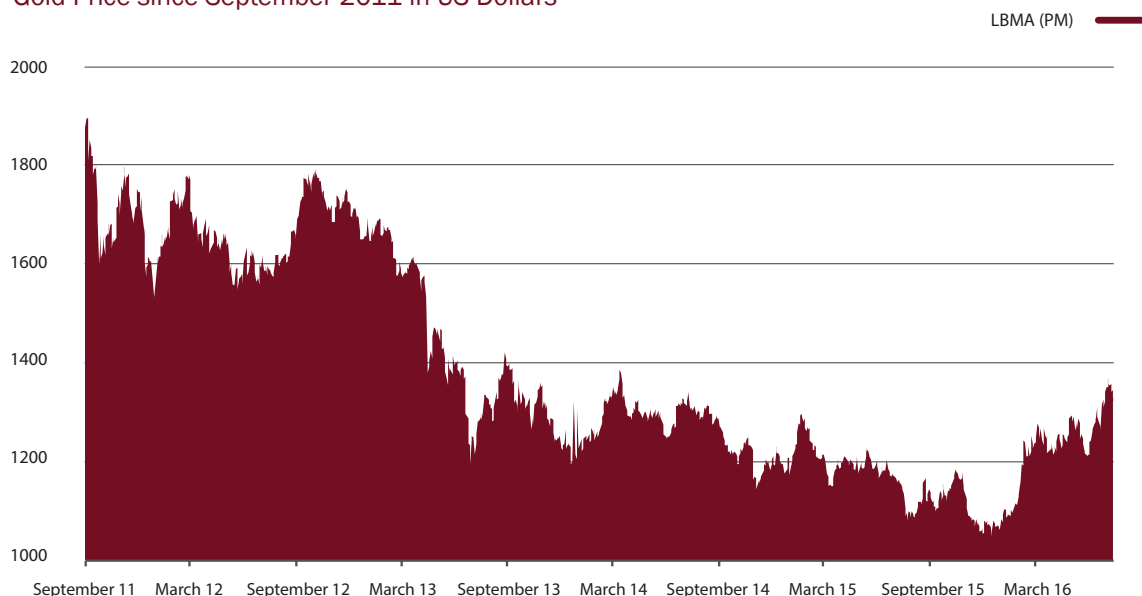
2. I noticed that there were some changes in your Mountain Vision publication. What happened?

Mountain Vision features several articles per week, providing thoroughly researched market insights and expert analyses to its readers. In a global financial environment that is becoming increasingly complex and risky, this platform aims to maintain focus on the fundamental issues that really matter, with articles on a mix of relevant topics and current market trends. Mountain Vision's editorial team is keeping pace with the ever-changing online media landscape, that often calls for forfeiting quality for the sake of quantity, and by refusing to make this concession, the team reaffirms its commitment to quality content. A free newsletter is also available, "Mountain Vision Weekly Digest", summarizing the highlights and top articles of the week. Readers can easily sign up through the website: mountainvision.com.

3. What's your take on gold right now?

Gold has likely passed its bottom point from its downside trend that started in September 2011 and is currently resuming the uptrend that started back in 2001. The risk that gold recedes back to the USD 950 levels appears increasingly unlikely. This does not, however, mean that its upward trajectory will be completely smooth from now on, and it is possible that we might see fluctuations in the meantime, but the Risk/Reward ratio is now again clearly tilted on the reward side.

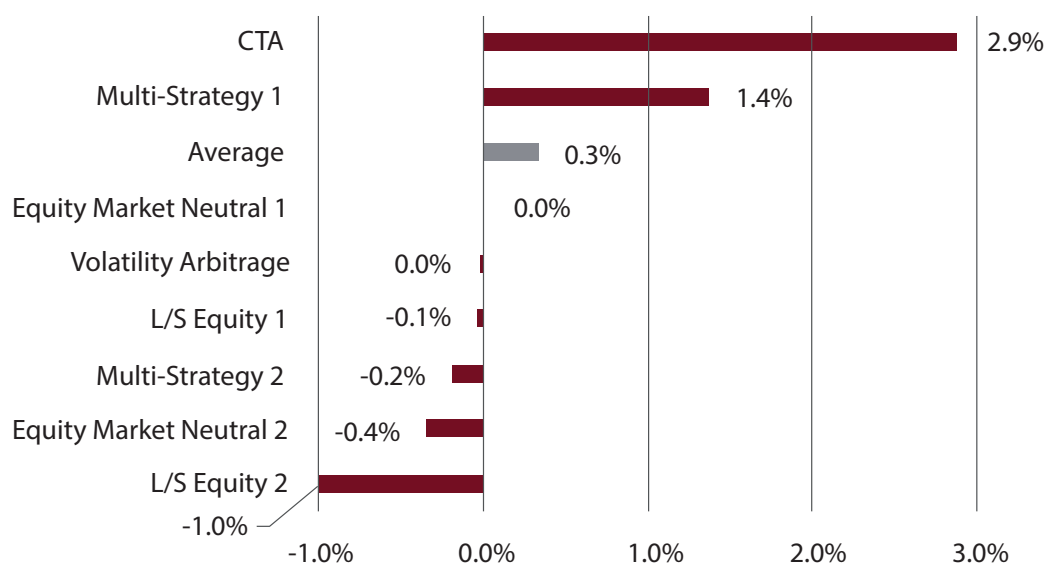
Gold Price since September 2011 in US Dollars



4. How did BFI's hedge funds perform during Brexit?

BFI's hedge funds achieved their main goal, both in the beginning of this year and upon Brexit: to preserve capital. Specifically on Brexit, the One-Day Performance ranged from +2.9% for our CTA to -1% of one L/S Equity Strategy, while on average our hedge fund positions were up 0.3% on that day. In contrast to this performance, Eurostoxx 50 lost -8.6% and S&P500 closed at -3.6% in red. After having passed the two tests of this year and holding strong against the general downward trends in the markets (January/February and Brexit), we expect a solid positive performance for the rest of the year.

Hedge Fund Performance on Brexit





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