- Historic: Changing of the guard in Japan
- UBS AAA bonds: Shifting the rating
- Advancers: Gold shines

partners' view

January	February	March	April	May	June	July	August	September	October	November	December
1/09	2/09	3/09	4/09	5/09	6/09	7/09	8/09	9/09	10/09	11/09	12/09

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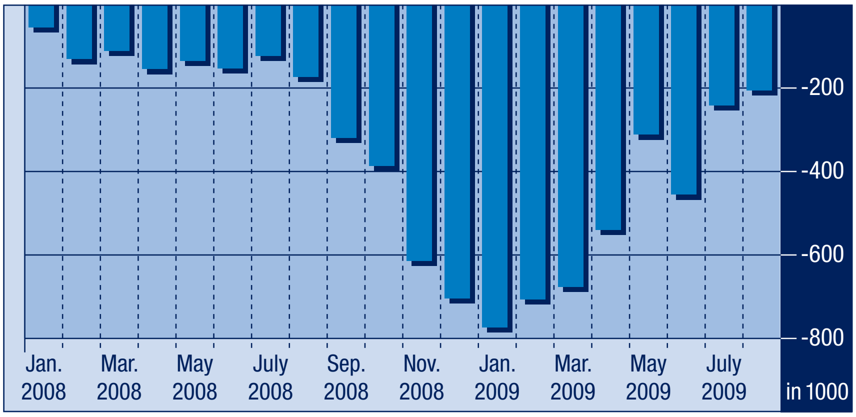
Politics and business

Government incentive packages are taking hold. Historic power shift in Japan. Massive decline in US consumer borrowing.

The most recently published business data from the USA – for instance the Purchasing Managers' Index – suggest a further improvement of the economic environment. The question is: how much of this rebound originates from the fiscal stimulus? When the one-time incentive packages expire, the economy should be able to stand on its own feet in order to start growing again.

US job cuts



Source: Bureau of Labor Statistics

Elections in Japan and Germany

A historic power shift has taken place in Japan. After nearly 54 years at the helm, the Liberal Democratic Party (LDP) has lost its dominance. The erstwhile opposition, the Democratic Party of Japan, gained the largest number of seats in the House of Representatives and will govern the country for the first time since 1955. The new administration promises to pursue a consumer- and family-friendly policy and is focused on the domestic economy. Because deflation (declining consumer prices) has been a problem in Japan for years, a number of observers assume that the changing of the guard will have a positive effect on economic growth.
The super-election year in Germany is already casting the first shadows. In Thüringen, the CDU received a sharp slap in the face in the form of a dramatic loss of votes. Subsequently, CDU Minister President Dieter Althaus resigned from all his posts with immediate effect. The SPD and FDP were the biggest winners, each logging a four percent gain in votes. In view of the Bundestag elections (which took place after this issue of partners' view was printed, the FDP is aiming for a coalition with the CDU/CSU, putting an end to the grand black-yellow-red coalition. The latest successes at the polling stations indicate that Guido Westerwelle and his FDP are on track: the path to the government is via the FDP.

Jobless

The latest US labor market numbers show an improvement in the job downsizing trend.
In August, 216,000 jobs were lost – fewer than expected. The metrics have improved continuously since the peak in January when 741,000 people lost their jobs (see graph). While the downslide is easing, which is a good sign for the financial markets, jobs are still being eliminated and ultimately, this keeps having a negative impact on unemployment statistics. At 9.7 percent, the figure is not only far higher than anticipated, it is nearing the magic 10 percent level. The unemployment rate is clearly reflected in consumer borrowing. In July, consumer credits dropped by a record amount of USD 21.6 billion. As is the case in the banking industry, this is a form of private deleveraging … the reduction of (household) indebtedness. The trend will accelerate as unemployment rises.

Currencies and interest rates

UBS refinances. Euro and US dollar soften versus Swiss franc. Norwegian krone attractive.

Despite the European Central Bank's decision to leave rates untouched, long-duration bonds showed a negative reaction and lost ground. The reason: an upward correction of economic and inflation forecasts. This means that market players expect a monetary policy change with initial lending rate increases next year.

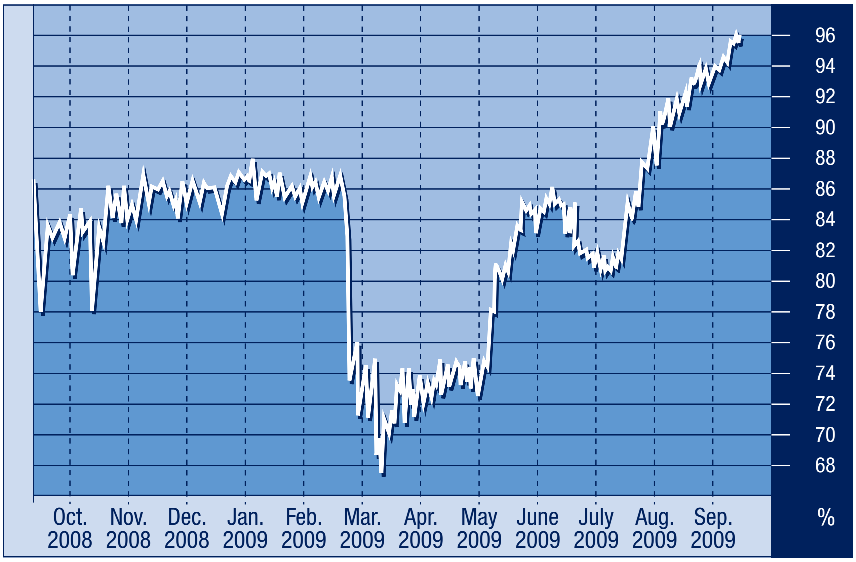
In motion

Things were moving at the currency front. The euro lost nearly two percent versus the Swiss franc. The dollar softened by three percent and is currently trading at a 2009 low. This year's high flyers, mainly the British pound, had to give up a part of their sizeable annual performance. The Norwegian krone is repeatedly mentioned as an interesting forex admixture. Closely coupled to the price of oil, the currency is solidly financed because the Norwegian government achieves substantial surpluses from oil exports that are paid into the state oil fund.

UBS issues covered bonds

UBS is issuing specially backed bonds. As such, this is not seismic, but it means a lot for creditors of record in a worst-case scenario. The new bonds are collateralized with existing mortgages (covered bonds), giving UBS favorable terms as it picks up money on the capital market. Because of their special cover, the new bonds are rated AAA. In case of bankruptcy, however, the collateral set aside for this program is no longer available to previous owners of bonds that have already been issued. This reduces the credit rating of legacy bonds because the "prime ribs" have been segregated from the bank's balance sheet. In reality, the issuance of covered bonds is not unusual. In Switzerland, though, UBS is the first bank to have chosen this approach. This evokes some bad memories, because Swissair also transferred collateral to subsidiaries in order to take out loans that it would otherwise never have received. This ran against the interests of long-time bondholders, as later became evident.
UBS emphasizes that the rating might even improve under certain circumstances. It refers to an analysis prepared by Fitch, a rating agency. Investors who own unsecured bonds should carefully monitor the placement of the covered bonds and consider selling their legacy paper. Quite likely, this would not be asking too much, since UBS bonds have significantly recovered from their March lows (see graph). This applies particularly to UBS subordinate bonds whose prices advanced by no less than 35 percent in half a year!

Subordinate 2⅜% UBS CHF bond June 30, 2015



Financial markets

Further advances in gold and silver despite strong financial markets. Barack Obama endorses protectionism against Chinese competitors.

The financial markets are stoutly defining their gains since the lows in late March. Every price dip is cushioned by the gigantic mountain of liquidity because investors immediately seize opportunities to build up their positions. Thus, the increase of exposure in stocks is two-pronged: through natural growth via price gains and through active portfolio additions.

Gold shines

Gold and silver are still advancing despite the strong equity markets and a calm on the credit market, easily clearing strategic resistance lines (see graph). The repeatedly invoked reason for the negative correlation relative to the US dollar is not really convincing. Although gold trades in dollars and is thus cheaper to buy with a lower forex rate (which explains some of the movement in gold), this rationale would also have to cause all American stocks to rise. The fact that gold is purchased as a substitute currency for diversification reasons when the dollar softens is also only part of the story. The underlying reasons for the sizeable advances are the precarious level of government debt and the looming inflation trap. Moreover, chart-driven buys in response to overrides of previous highs suggest that speculators, especially those with short-term horizons, are back in the market.

Gold price

US protectionism

President Obama is trying to bolster the American economy with unfair practices. With punitive customs duties slapped on imported Chinese auto tires, Obama's administration wants to throw the unwelcome competitor out of the race. China responded rapidly and sternly by having the World Trade Organization review American exports of chicken and auto parts for signs of unfair competition. So countermeasures are rather likely. In partners' view 8/09, we already identified protectionism as a potentially dangerous concept. If the health of the global economy has to rely on the quick recovery of the Chinese economy, the prospect of a tariff war between the US and China is alarming.

Last but not least

"Every time I try to run away from my shadow, somebody turns off the light."

Art van Rheyn

Marthe Ballet
Yves Baumann
Jörg O. Blickensdorfer
Johan Buckert
Christ Johann Collenberg
Chantal Cvorovic-Lauper
Martin P. Egli
Peter L. Einstein
Boris Eschmann
Ben Euving
Chantal Gehri
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Urs Jäggi
Claude R. Jenni
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