- USA: Improved labor market situation
- Central banks: The end of cheap money
- Speculation: Gold bubble ahead?

partners' view

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

Politics and business

Switzerland is facing stiffer headwinds. Financial crisis in Dubai ends skyscraping exaggerations.

Swiss businesses fear “Swiss bashing” abroad with negative consequences for the domestic economy. The minaret dispute, Swiss banking secrecy, UBS’ client data disclosures to the USA, and the looming restriction of free movement rights for EU citizens have resulted in more than just Islamic boycott calls against Swiss companies. While internationally active Swiss businesses could afford to respond to Muammar al-Gaddafi’s saber rattling with a smile, the global reactions to the ban on minarets have been noted with uneasiness. After all, Turkey, Saudi Arabia, Malaysia, Indonesia or the United Arab Emirates are much more significant importers of Swiss products than Libya.

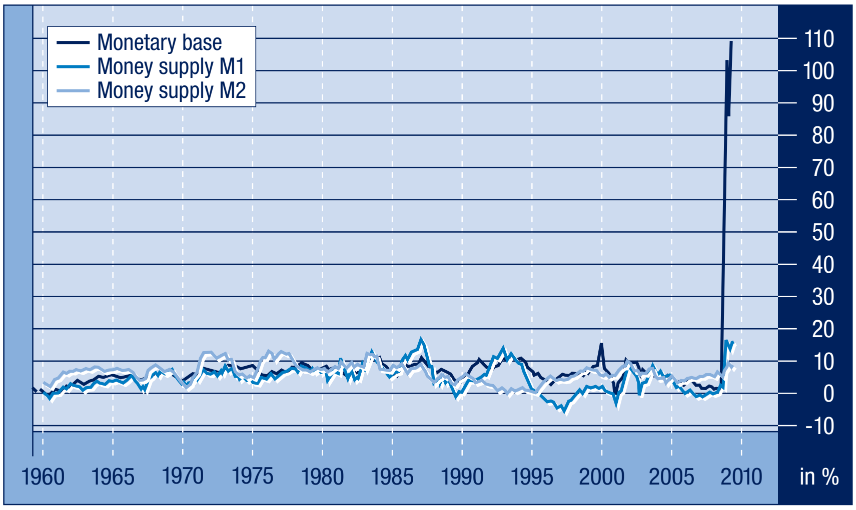
High rollers

The financial crisis in the desert state of Dubai took the global financial markets by surprise. With a huge heap of debt in the magnitude of USD 60 billion, the government-run investment company Dubai World is teetering on the precipice of financial ruin. Half-finished real estate projects have literally been built on sand. The 818-meter Burj Dubai, the tallest skyscraper in the world, illustrates the high-rolling attitude of a Gulf state that has virtually no oil to sell. The fact that the Nakheel Tower is supposed to rise over 1,100 meters reflects a loss of contact with reality among the desert dwellers. Nakheel, a subsidiary of Dubai World, can no longer repay its loans. It gained recognition as the builder of an artificial palm-shaped island studded with luxury villas. It remains to be seen whether the situation can be saved with the announced refinancing of part of the company’s USD 26 billion in debt. Even in the event of a total default, Dubai does not pose a risk for the international financial markets, but it does point at an impending problem: an enormous mountain of debt. All the while, western industrialized nations are also sitting on debt that they cannot possibly service.

Crisis overcome?

It seems that the crisis of the US labor market is over. The loss of merely 11,000 jobs in November was much lower than expected and corresponds to the smallest rate of decline in two years. Since the results of the two prior months were revised downward as well, it seems that employment is looking up again. We don’t yet know how good the quality of the jobs is, because many of them are temporary. Whether or not the new hires can retain their jobs after the limited terms are over depends on how the economy fares.
A large part of this gain is no doubt attributable to government subsidies. The associated money supply expansion will keep us occupied for the next two years, especially when the time or need has come to shrink “M” again (see graph).

US money supply, year-on-year changes in percent



Currencies and interest rates

Europe goes on hold, changes policy. Australia increases rates for the third time. The Dubai crisis rekindles flight into government bonds.

In some respects, the European Central Bank (ECB) has backed away from its expansive monetary policy. It is leaving lending rates unchanged, but longer-term liquidity infusions are over. Next year, the ECB no longer wants to issue annual tenders (refinancing transactions of the central bank with commercial banks). This is of import inasmuch as banks briskly took advantage of this new instrument. In June 2009, on the occasion of the first tender, banks borrowed EUR 442 billion at a lending rate of one percent. The ECB justifies this change in policy with the economic projections for 2010 that suggest an overall improvement. This is the beginning of the end of an extremely expansive monetary policy.

Australia for the third time

Yet again, it is the Australian central bank that forayed ahead with the third lending rate increase. Although this anticipates a recovery of the Australian economy, the country's currency did not further appreciate. The Australian dollar is currently trading 30 percent higher than at the beginning of the year.
After a phase of weakness of the US dollar, labor market data buoyed the US currency again. The brief 1:1 parity with the Swiss franc has since been clearly exceeded.

Flight into quality

Bond yields dropped to new record lows in the wake of the Dubai crisis. A flight into quality drove prices up and yields down. Thus, 10-year government bonds in Switzerland are returning a scant 1.8 percent. Investors who think they are in a safe haven here will have to contend with negative surprises next year. But the situation in Dubai is bringing a totally different topic into focus: the liability problem in bonds. The government of the small desert nation does not want to assume any responsibility for the debt incurred by the state-run Dubai World holding company. In the same breath, the sheikdom's rulers declared that Dubai would not be liable for the debt racked up by Emirates, its state-owned airline. Investors who purchased "Dubai" mere received a financial instrument from Dubai for whose debt no one is responsible any longer.

Who is liable?

The international bond market is designed in such a way that money is rarely ever borrowed by a parent company. At UBS, the true borrower is usually domiciled in Jersey, a 118-km^2 Channel Island, and Holcim often chooses Bermuda as the legal venue for its bonds. In such cases, lenders have to figure out how the guarantees are governed (in the two above cases, the parent company is liable). The situation is even more exotic as regards Germany's landesbank system. State guarantees have been banned by the EU Commission since 2005. Earlier issues are still backed by the government, but the legalese has to be carefully sorted out for later ones. Automakers also take a special approach to borrowing. In most cases, debt is serviced by their own financing companies. Consequently, the borrower is not Volkswagen, but VW Credit Canada or BMW US Capital, even if the transaction involves a bond denominated in Swiss francs. No stress test has yet been imposed on such instruments because it has never been necessary so far to fall back on the guarantees – existent or non-existent.
The Dubai crisis, Greece's financial woes, and the negative outlook on Spanish bond ratings have generally added some momentum to credit default swaps. Although corporate bonds are not yet really attractive, a circle of nervous investors might create entry-level metrics again in the coming weeks. Our suggestion: wait for setbacks, focus on short to medium durations, place greater emphasis on borrower names than ratings, and stay away from complex structures.

Financial markets

Gold is becoming more volatile and speculative. The bull market is feeding itself. Roche as an add-on for Novartis shareowners.

As bizarre as it may sound, the excellent labor market data and the likely economic recovery ahead could burden the equity markets next year. The financial markets have long expected better corporate earnings but they are not ready to cope with faster-than-expected central bank lending rate hikes.

Gold rush

The gold market has entered a hectic phase. Even though fundamental factors speak in favor of higher gold prices (danger of inflation, massive government debt), speculators are mostly responsible for the price uptrend. Just like the gold rush once attracted workers, surplus liquidity is now being lured by the mystical sheen of the yellow metal. Going forward, the price decline of eight percent in a single day suggests the likelihood of a bubble.

Novartis

The great fool

In late September, a major Swiss bank eloquently described why it had resolved to keep underweighting equities. According to the "greater fool" theory, "an even greater fool will follow in my footsteps to rescue me from my foolish investment decision". The bull market is self-propagating. Two months later, the same chief strategist increased the equity exposure. This is not a criticism of the investment decision. It is an example that shows how much pressure underinvested money managers are facing. No matter how convinced they are, the members of the guild have a hard time remaining underinvested in stocks when the markets advance. A lot of activity is packed into the last few weeks of the year because this is when annual performance is measured. The performance of Novartis stock since its lows in the early summer of 2009 has been constant and impressive. A 35 percent rally without noticeable fluctuations suggests that shares have migrated into the hands of investors with long-term horizons (see graph). A 3.5 percent dividend yield, a packed pharmaceuticals pipeline, and a fair valuation are solid pointers for continued momentum. Novartis' 33.3 percent participation in Roche is a welcome bonus.

Last but not least

"Democracy is a device that insures we shall be governed no better than we deserve."

George Bernard Shaw

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Yves Baumann
Jörg O. Blickensdorfer
Johan Buckert
Christ Johann Collenberg
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