- Reforms: The UK's interesting solo
- Europe: Bracing for higher interest rates
- Japan shock: Financial markets stunned

partners' view

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Politics and business

The consequences of the environmental catastrophe in Japan are horrific and not yet quantifiable. The financial resources urgently required there are still parked abroad in the form of US Treasury bonds.

The earthquake in Japan and the consequences of the resulting tsunami as well as the nuclear catastrophe in Fukushima will have an economic, social, and financial aftermath of a magnitude that cannot yet be estimated. At some point, it will be possible to price the loss of houses, roads, and vehicles, and to replace them. But it will take more time to quantify consequential healthcare costs, losses due to production outages, and capital needed for reconstruction. One thing is sure already: very, very much money will be required. Relative to its gross domestic product, Japan is the world's most highly indebted nation, and the repatriation of Japanese assets invested abroad represents an imminent threat. This would impact mainly the American economy, because in addition to China, Japan is the USA's biggest lender and owner of US Treasuries. A selloff would cause interest rates in the US to rise and the conversion into yen would put pressure on the US dollar. If a repatriation of assets becomes a likelihood, it is realistic to assume that this would be jointly engineered by the American and Japanese central banks. A consensus would allow the Fed to further expand its already generous money supply policy.

Britain starts saving

David Cameron, the UK's Prime Minister and leader of the Conservative Party (Tories), is moving ahead with his radical plans for a sweeping reform of Britain's social security system. Announced in the autumn of 2010, the reforms are now being initiated, also with the support of the opposition, the Labour Party. With a new incentive system, for example, people who have been unemployed for years are to be helped to regain an independent life. "Work must pay," say the welfare reformists. But the government also wants to introduce tougher penalties for those who feign disabilities and work-shy individuals who stubbornly refuse to accept reasonable job offers. The austerity program announced by Prime Minister Cameron, who was elected to office in mid-May 2010, is thus being systematically pursued with an increase of tuition fees (now triple the previous cap), a postponement of the retirement age to 66, downsizing of 500,000 civil servant jobs, a freeze on expansions of the Heathrow, Gatwick, and Stansted airports (saving about 10 billion euro), the introduction of new environmental, bonus, and bank taxes, the privatization of Royal Mail, and much more. Cameron's ambitious plan is expected to save over 100 billion pounds by 2015.

The UK goes single-handed

England's big advantage versus the Eurozone is that it has its own currency, which makes the Bank of England independent. Thus, Britain's central bank can pursue its own interest-rate and monetary policy. Currently, the UK has no obligation whatsoever to help bail out the overindebted peripheral Eurozone countries Greece, Portugal, and Spain – it is not even obliged to help Ireland. Of course, England is contributing to the rescue package, but only with a fraction of the amount that Germany must shoulder. It will therefore be interesting to see whether England's stand-alone solution with the implementation of a radical austerity package will be successful more quickly than the approach adopted by Continental Europe, which is trapped in the Union. The comparison of the two strategies will determine whether England's game plan will go down in economic history as a new (good or bad?) model. The labor market will make the difference. Currently, 2.5 million Brits are unemployed. In the short term, the austerity measures will probably increase this figure to 3 or 3.5 million. In Spain, which does not have an ambitious austerity plan, 4.7 million people are jobless today. In other words, Spain has twice as many unemployed people per capita than England.

"Work must pay," say the welfare reformists.

Currencies and interest rates

Inflation in China on the rise due to higher incomes. The European Central Bank tells the financial markets to brace for a first rate hike. Strong yen needs concerted G7 central bank intervention.

An important component is missing in the perceived context of rising inflation in China. While it is true that average consumers must pay considerably more for their baskets (especially for food) than a year ago, it should not be overlooked that disposable per-capita incomes are rising briskly as well. Wages in China are already so high that many European companies have shifted their production operations to Vietnam. Strictly speaking, price adjustments in China are merely a consequence of increased purchasing power.

Exchange rate yen versus US dollar

Bracing for higher interest rates

The European Central Bank (ECB) has been skillfully cautioning the financial markets that a first rate hike is forthcoming. At its meeting in early March, it decided to leave rates unchanged as expected but did announce that a rate increase might already be possible in April. This gives the financial markets enough time to psych up for the event. At any rate, it is certainly reassuring that this trend reversal is not just a response to mounting inflation but also to the more optimistic growth outlook. The question is: where will growth occur apart from Germany? The latitude of the EU member nations is much too restricted in the wake of the financial crisis and the resulting rehabilitation measures. The coming weeks will show if and to what extent the natural catastrophe in Japan might influence business projections and inflation pressure estimates. The central banks will be well advised to quickly adjust to the new baseline conditions and avoid tightening rates at the most inopportune moment.

Strong franc

In March, the foreign currency markets had a bidirectional phase. In the first half of the month, the euro appreciated, mainly versus the Swiss franc, because of rate-related upside potential. In the second half of March, the downrating by Moody’s of Spain, Greece, and Portugal, as well as the flight of investors into safe havens (yen and Swiss franc) after the earthquake and nuclear catastrophe resulted in an appreciation of the franc with new record highs versus the US dollar and the euro. The post-catastrophe uncertainties faced by the global economy (production outages in Japan) will be detrimental mainly to the financially weak Eurozone members Spain, Ireland, Portugal, and Greece. They urgently need an economic recovery and the higher tax revenues it would entail. The historic magnitude of the yen’s firmness (see chart) was associated with the possible repatriation of the yen invested abroad. For the first time in more than ten years, the G7 central banks decided to jointly intervene against the strong yen.

Financial markets

Financial markets shocked by the devastation in Japan. Don't dump European utilities prematurely. Gold and oil stocks interesting again.

The international financial markets responded very vigorously to the events in Japan. Apart from Japan as the directly affected national economy and the heavily impacted Nikkei Index, all global bourses posted massive losses. The fact that investors were still capable of differentiating was reflected in solar power equities which showed double-digit gains during the days of dramatically plummeting stock prices. Unquestionably, there is a growing demand for alternative energy sources as a replacement of or supplement to nuclear power. Although China has a five-year plan involving the construction of many nuclear reactors, the government simultaneously declared solar and wind as strategically significant technologies.

Boring dividend pearls

Apart from the reinsurance companies, of course, the big losers of the stock price slump included European utilities. Nonetheless, these equities should not be written off prematurely. They stand out with high and stable cash flows, high dividend yields, high debt (capital-intensive business) and rather boring price trends. In addition to RWE and E.On in Germany, Iberdrola in Spain, and Enel in Italy, France is heavily involved in this sector with EDF, Veolia, and GDF Suez. As defensive investments and yield pearls, utilities are very suitable as underlyings in any portfolio. Suez, Veolia, and E.On are particularly interesting after the recent price setbacks. These equities cover the domains of electricity (including nuclear power), water, and waste management.

Gold and oil stocks

The unrest in North Africa briefly faded out of the headlines after the earthquake in Japan until the focus returned to the media following air support for the rebels by France, the USA, and England. The subsequent oil price spike as well as advances in gold (which always benefits from wars) make oil and gold stocks very interesting for investors. Despite increasing commodity prices, Barrick Gold, the large gold miner, as well as the Petrobras and Apache oil and gas companies are still trading far below their previous highs and the outlook is very promising. Especially Apache, a North American company that generates equal shares of its revenues with oil and gas, has profited from the divestitures of BP from which it acquired oil and gas fields at bargain prices. With only 25 percent borrowed capital and a market cap of 50 billion dollars, it matches the predator-prey scheme of defensive investors. Moreover, the demand for alternatives to nuclear energy is greater than ever.

Last but not least

"Banks lend money to those customers who can prove that they don't need it."
Anonymous

Peter Ahluwalia
Robin F. Amacher
Marthe Ballet
Yves Baumann
Johan Buckert
Christ Johann Collenberg
Chantal Cvorovic-Lauper
Ute Dürtscher
Martin P. Egli
Peter L. Einstein
Ben Euving
Chantal Gehri
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Robin Graetz
Narciso Grilli
Patrick Huurdemann
Urs Jäggi
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