

- ▼ Money or goods: Inflation or price increases?
- ▼ Lending rate: Hats off, ECB
- ▼ Recommendation: Novartis and Petrobras

part

partners' view

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

China is growing unabated; unfortunately, so is inflation. Disparate economic trends within the Eurozone obstruct fiscal policy.

Despite government tightening, China's economy is still growing at a rate of 9.7 percent. Since consumer prices also picked up by 5.4 percent, more briskly than hoped for, and a real estate bubble could be forming, the state will initiate further braking maneuvers. With its recently ratified five-year plan, China's National People's Congress defined clear goals: Growth should be around 8 percent, supported mainly by domestic consumption. This is a striking paradigm change: reduction of dependence on exports and strengthening of domestic demand.

The flip side of heterogeneity

The price of oil is still reacting sensitively in both directions to news from Libya and in early April reached the highest level since July 2008 with a barrel of Brent Crude trading at 125 US dollars (see graph). This is heating up the debate on whether an inflation spike is imminent. A monetary policy designed for stability restricts the latitude of the central banks. The zero-interest policy pursued so far is history. The rate hikes that are now pending are particularly ill-timed for the southern periphery of Euroland (Greece, Spain, Portugal). On the one hand, this puts an extra debt servicing burden on the already heavily indebted deficit nations and on the other, a restrictive monetary policy amplifies the recession trend, which to some extent is a motive behind the interest-rate increase. The disadvantage of heterogene-

ity in Euroland is obvious, because given the disparate economic situations, it is not possible to pursue a monetary policy that is acceptable to all countries.

Inflation or price increases?

Although the two terms are largely interchangeable, there is a fine distinction: Inflation describes changes in the money supply while price increases describe volume changes in goods produced and services rendered. The reactions of citizens to inflation and price increases are not identical. In response to strong inflation, investments are funneled into assets such as real estate and equities. When goods become pricier, individuals have little leverage to react, because this can happen due to a failed harvest (coffee, wheat), a government intervention (VAT increase), or

a deliberately engineered supply-side shortage (e.g. wine, champagne). The reason behind a price increase has a direct impact on interventions by a central bank. With the mechanism of monetary policy, it can only influence inflation, but not price increases. Experts are struggling to find a consensus as to whether the increase in food prices was caused by investors via ETFs or by a supply-side shortage (harvest) or an increase in demand (e.g. for corn for conversion into fuel). If the first reason applies, the increase would be liquidity-driven and could be influenced by a restrictive monetary policy.

Oil price



Currencies and interest rates

Euro firm versus dollar despite similar problems. European Central Bank stands by its announcement and increases lending rates for the first time since 2008.

The appreciation of the euro versus the US dollar continues unchecked. Since early June 2010, the advance has been a hefty 23 percent even though the problems of the southern Euroland nations have tendentially worsened. Since the euro is meanwhile heavily overbought, mostly versus the US dollar, a major countermovement can occur at any time.

Hats off, ECB

As projected in the last issue of partners' view, the interest-rate reversal is taking place in Europe. On April 7, 2011, the European Central Bank (ECB) raised lending rates by 25 percentage points for the first time since 2008. Even though ECB President Jean-Claude Trichet hastened to point out that this would not be followed by a series of further hikes, his focus is clearly on combating inflation. This means that money shortages (i.e. rate increases) will be inevitable if prices continue to rise. The financial markets were well prepared for this first interest-rate step, which affirms the policy quality of the ECB – hats off! Accordingly, the stock, bond, and forex markets reacted to the decision more or less with nonchalance.

Too many misjudgments

The genuflection of Portugal before the EU when it opted for financial aid did not come as a surprise for the markets. Although Portugal had repeatedly denied the need to resort to the

4 ¼ McDonald's, 06/10/2016



euro rescue umbrella, the reaction of the financial markets, especially of the forex market, was virtually nil. Previously, Moody's and Standard & Poor's had downrated Portugal's debt to junk bond status in several consecutive steps. Greece also fell from grace among the rating agencies and now has to cope with a BB-. But the judgments of Moody's and Standard & Poor's have long lost their luster, with too many maladroit rating assessments in the past years. Besides, procyclical activism is not helpful to investors at all. Usually, they find out only in retrospect that the credit risk of their bonds is no longer investment grade. In this respect, the market – where nominal debt is priced – is more liquid, faster, and therefore much closer to the real-world action. The bond market as the hub

of securitized debt trading responded to the lending rate increase long ago. Yields have risen massively since early September 2010, and concurrently, bond prices have slumped. As an example, the euro-denominated McDonald's corporate bond illustrates the price loss incurred, which in this case has nothing to do with a reappraisal of debt quality. Within a year, the price dropped from 111 to 103 percent (see graph).

Financial markets

At depressed prices, oil stocks are a buy. Alternative energy players' profits revised. Novartis attractive.

A slight decline of oil prices, following the multi-year highs that were recently attained, had a disproportionate effect on oil stock prices. Petrobras in particular, which lost over 10 percent within just a few days, is very attractive at its currently depressed price. Apache, mentioned in the last partners' view issue, has dropped to an entry-level price as well.

Inadequate profit projections

Meyer Burger is a good example of how much analysts need to get their act together when assessing the ROIs of equities in the domain of alternative energy generation. The supplier to the photovoltaics industry, which manufactures solar cells mainly in Asia, is specialized in milling machines for silicon wafers. Meyer Burger has repeatedly announced excellent new order figures, whereupon UBS has meanwhile upward revised its profit estimate for the next two years by no less than 100 percent. As early as September 2010, the company communicated sales expectations in the magnitude of 1.5 billion Swiss francs for the next three to five years, but in March 2011, UBS estimates fell short of 900 million Swiss francs for the next two years. In the meantime, the bank has corrected its projection by +50 percent. This is only one example in an investment universe that presents a totally new outlook since the catastrophe in Japan. The company's momentum also reflects in mergers

and acquisitions, with takeovers of Schulthess (heat pumps), 3S (solar), and Roth & Rau (solar). The big players are eager to optimally position themselves for the forthcoming up-swing in alternative energy sources.

Buy Novartis

On the Swiss stock market, Novartis is a phenomenon – a negative one, alas. The stock price is lagging far behind the overall market. It has lost about 10 percent since the beginning of the year, of which roughly half is attributable to dividend payouts. With a dividend yield of 4.4 percent, the pharma giant's stock pays more than double that of a 10-year Swiss government bond. For current investors, the envisaged payout increase will probably mean a yield of over 5 percent in the future. Additionally, with a P/E of 9.5, the stock is favorably valued. Moreover, the successful completion of the acquisition of Alcon (eye care) gives Novartis access to a promising new business segment. The Basel-based company is also appealing because it is the largest single shareholder of competitor Roche. For all these reasons, it makes sense to hold Novartis as a core portfolio position or, as the case may be for fortunate first-time buyers at this price level, to build one up.

Last but not least

“Buy in May and stay that way.”

“Sell in May and go away.”

Anonymous (but certainly not the same person)

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

Gerhard Gottet

Robin Graetz

Narciso Grilli

Patrick Huurdemann

Urs Jäggi

Claude R. Jenni

Beatrice Kern

Daniel Kössler

Thomas Kostkiewicz

Markus Linke

René Meyer

Rainer H. Moser

Jos Raafs

Christian Rockstroh

Mark Rüegger

Manuela Schlegel

Bernhard Schürmann

Richard Smith

Dominique J. Spillmann

Barbara Stacey

Carsten Tillner

Bettina Wälti

Ralph Weidenmann

Markus Wintsch

Christian zu Pappenheim

swisspartners Investment Network AG
Am Schanzengraben 23
P.O. Box
CH-8002 Zürich
Phone +41 58 200 0 000
Fax +41 58 200 0 100

swisspartners Investment Network AG
Steinengraben 18/22
P.O. Box
CH-4002 Basel
Phone +41 58 200 0 500
Fax +41 58 200 0 595

swisspartners Investment Network SA
rue Neuve-du-Molard 24
P.O. Box
CH-1211 Genève 3
Phone +41 58 200 0 200
Fax +41 58 200 0 210

swisspartners Wealth Management AG
Am Schanzengraben 23
P.O. Box
CH-8002 Zürich
Phone +41 58 200 0 400
Fax +41 58 200 0 490

swisspartners (Liechtenstein) AG
Feldstrasse 16
FL-9490 Vaduz
Phone +423 239 79 70
Fax +423 239 79 80

www.swisspartners.com
info@swisspartners.com

swisspartners 