

- ▼ Greece: Economic growth alone not enough
- ▼ USA: Obama struggles with debt ceiling
- ▼ Juiced up: Smart grid for smart investors

part

partners' view

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

**Strong franc leads to job losses. Financing problems in Greece can hardly be overcome. Spain wants and needs to save.**

Swiss companies are still remarkably resilient as they cope with the strong franc. But if these currency imbalances persist – especially the weakness of the euro – export-oriented businesses will be forced to shift more production capacity abroad so that payroll costs do not have to be settled in Swiss francs. This will automatically cause unemployment in Switzerland to rise.

## **Burdensome debt service**

While the EU member states are still debating exactly how Greece can be rescued (Germany has proposed the immediate involvement of private investors with a focus on banks and insurance companies), Standard & Poor's has downrated the country's government bonds by three levels to CCC (for details on the rating process, see "R as in rating"). The risk premiums for Greece have risen to an exorbitant 19 percent (see graph). This means that money lent to Greece generates 19 percent more yield than would be the case at the risk-free rate. Conversely, it also means that Greece needs to pay 19 percent more interest – if it can finance itself on the capital market in the first place. It is obvious that lenders cannot be repaid with a debt service burden of this magnitude. Accelerated economic growth can only reduce current debt by a small margin. To achieve the debt limit of 60 percent of its annual gross domestic product as stipulated in the Maastricht treaty,

**CDS spread Greece / euro 5 years**



Greece's economy would have to grow by more than 20 percent per annum for the next ten years! Currently, even the comparatively moderate recession is deemed good news. Consequently, the heavily indebted nations in Europe need a whole bouquet of measures. Apart from announcing massive savings in the public sector, Greece has also submitted a privatization scheme that involves the sale of 23 government-owned businesses this year. In addition to telephone companies, waterworks, airports, lottery organizations, casinos, and railways, properties and motorways are also on the block. But Greece doesn't really have the time it would take to carry out these sales!

## **Refinancing trap**

Besides Greece, Spain has a refinancing problem as well. The terms of more than 50 percent of its outstanding debt must be extended during the next two years. Given the current risk premiums (CDS spread) of over 2 percent, this restructuring will be expensive and constitute an additional burden on the heavily distressed budget. In the coming two years, Spain's government wants to cut spending by 50 billion euro, particularly to the disadvantage of social welfare (benefit cuts), civil servants (dismissals, pay cuts, later retirement), and other investments. With unemployment at about 20 percent, Spain has also had a stubborn structural problem for a long time.

# Currencies and interest rates

**Chinese inflation fears pick up again. US President Obama struggles to raise the debt ceiling. Commodity currencies weaker.**

In China, inflation is still a problem. The country's leaders want to lessen inflation – currently at 5.5 percent (consumers) and 6.8 percent (producers) – by further increasing the minimum reserve requirements for commercial banks. The objective is to bind money flows in banks as equity capital to prevent liquidity from entering the already overheating economy. But more and more Chinese businesses are complaining how difficult it is to get loans.

## The debt ceiling

Fed Chairman Ben Bernanke has a somewhat more skeptical take on the economic trend in the USA, but nonetheless rules out any further easing of the money supply (QE3). Despite the fact that Quantitative Easing 2 is expiring, the financial markets assume that US lending rates will not increase before mid-2012. This suggests that the USA would have cheap and easy access to financial resources for covering its expenditures – a bold assumption, considering the current debt situation. The momentarily valid ceiling of 14.3 trillion US dollars will be attained in August. Now that Obama's proposed debt ceiling hike has been defeated, the USA will go into de-facto bankruptcy. If the Republicans and President Obama do not soon reach a consensus regarding the planned budget cuts, the worst-case scenario will play out. American banks would then no longer be willing to accept

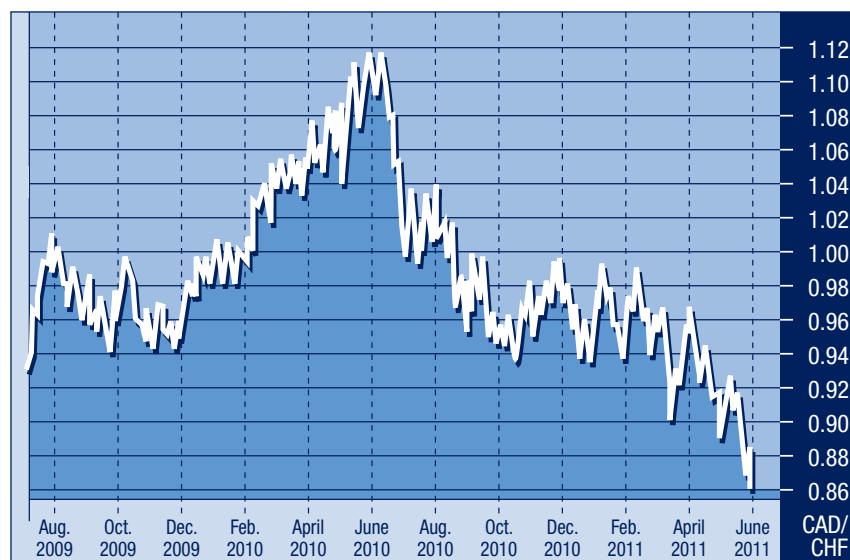
US bonds at current lending rates as collateral for forward contracts. This reassessment would invariably lead to higher interest rates. Another rate hike by the European Central Bank (ECB) is imminent. On the occasion of the last zero-round in mid-June, ECB President Jean-Claude Trichet said that the next interest-rate hike would be forthcoming in July because of the worsening inflation outlook. Instead of 2.3 percent, the cost of the European consumer basket will increase by an average of 2.6 percent.

## Commodity currencies

The flight of money into the Swiss franc is assuming dramatic proportions. The losers are not only conventional currencies such as the

US dollar or the euro but now also include commodity currencies, among them the Australian dollar, the Canadian dollar, and the Norwegian krone. The fall of the Canadian dollar is particularly acute: within 12 months, it lost about 25 percent of its value versus the Swiss franc (see graph). The strength of the franc is especially aggravating for Swiss investors who must absorb twofold losses on their foreign investments: they have to contend with currently anemic equity prices and are disadvantaged because of the reference currency in which they hold investments (see also "Financial markets").

## Canadian dollar versus Swiss franc



# Financial markets

## **Disconcerting bottom line for Swiss investors as regards total return. Energy efficiency and distribution is the next big investment theme.**

The global equity markets corrected more harshly in June than during the entire year. The rationale was disparate: debt problems in the Eurozone, currency turbulence in the US dollar and the euro, inflation worries in China, technical analyses, and the budget theme in Congress. The truth probably lies somewhere in between and hinges on investor fears that might rapidly dissipate again, however.

### **Total return**

The total return for Swiss investors on foreign equity exposure currently reflects the firmness of the Swiss franc to a particularly significant degree. Thus, Japan's Nikkei fell by 8 percent this year, but expressed in Swiss francs, it lost 16 percent because of the weak yen. Even the S&P 500, which advanced in US dollars, translated into a 9 percent performance loss for Swiss investors. The numbers were even worse for those who invested on the stock market in India: expressed in francs, their assets shrank by roughly 20 percent. The assumption that investments in Swiss companies are safe (currency) bets might turn out to be wrong as well. Nearly all listed Swiss companies generate most of their revenues abroad. Whether in Asia, Europe, or the USA: the conversion of the profits they make in these regions into Swiss francs is leaving deep marks, especially if the cost basis

(wages, production) is domestic. So it is not surprising to see ongoing downward revisions of earnings projections due to currency translation effects (strong Swiss franc). The pressure on the Swiss National Bank (SNB) is mounting. But the SNB is between a rock and a hard place: either it intervenes (and books losses in the billions) or it lets the market regulate the strength of the franc. Whatever it decides to do, it is sure to reap criticism.

### **Homogeneity**

The Swiss equity market and its index, the SMI, present a fairly consistent picture when comparing the performance of the individual sectors. The interest-rate-sensitive financial services industry (banks, insurance companies, asset managers), the defensive food and pharma industries (Nestlé, Novartis, Roche), the export-oriented luxury goods industry (Swatch, Richemont), and the cyclical industrial sectors (Holcim, ABB, Sulzer, Fischer) all posted massive corrections in the past weeks. With the notable exception of ABB and Roche, nearly all equities in the SMI have dipped into double-digit negative territory this year. Such a homogeneous trend across the board is rare. Usually, at least one industry is a positive or negative outlier, because not all industries are equally affected by interest-rate, economic, or exchange-rate fluctuations.

### **Energy efficiency for the portfolio**

Since the nuclear catastrophe in Fukushima, the focus on energy as an investment theme has been almost exclusively directed at energy generation, the production of electricity with coal, gas, oil, or renewable sources.

Indeed, energy efficiency and energy distribution are at least coequal themes. The acquisition of Landis+Gyr by Toshiba must also be viewed in this context. It makes the Japanese corporation the world market leader in smart meters, the communication channel that links power utilities with their end customers. Smart meters not only measure and constantly monitor the delivery of electricity to consumers but ultimately will also intelligently control all electrical appliances in a household. Energy efficiency – particularly in private households which consume over 30 percent of the electricity generated – is a big investment theme with only a few players entirely dedicated to this topic. For investors, it is therefore advisable to close this gap with a fund. Because energy generation (nuclear, gas, oil, solar, wind, water, etc.) is already covered in most portfolios (for instance with Royal Dutch, Gazprom, Petrobras, Vestas, solar funds, etc.), 4Q Smart Power is ideally suited as an instrument in this investment category. The fund channels 80 to 90 percent of its assets into intelligent power grids (smart grids) and energy efficiency. This latter theme also includes electricity storage and the new generation of LED lighting.

# R as in rating

**News that companies – and more recently countries – have been upgraded or downgraded is an everyday occurrence. Ratings are sort of like a seal of quality as regards the creditworthiness of a company or nation.**

Most ratings are provided by two organizations: Moody's Investors Service (Moody's), a rating agency founded in 1909, and Standard & Poor's (S&P) Rating Services. Fitch New York/London have also established good reputations. In Switzerland, domestic issuers are periodically assessed primarily by Zürcher Kantonalbank and Credit Suisse.

## **Ratings from AAA to D**

Ratings are indicated with the letters AAA (S&P) or Aaa (Moody's) to D. To demonstrate relative standing within a rating category, S&P uses plus and minus signs, and Moody's uses the suffixes 1, 2, and 3. At S&P, ratings from AAA to BBB– indicate investment-grade securities; the Moody's equivalents are Aaa to Baa 3. Obligations rated BB or Ba and lower are called speculative. A rating of D says that a company can no longer meet its financial commitments on time and/or has filed for bankruptcy.

Ratings make sense because they can easily be communicated across language barriers and are universally understood. Their purpose is to give investors a unified benchmark for measuring risk.

Ratings allow the credit risks associated with borrowers around the world to be compared with one another and help people make investment decisions. Ratings are not investment recommendations. They are indicators of the probability that issuers of debt securities will face solvency problems. As a seal of quality, a rating is important for both the borrower and the lender. It allows borrowers to derive their debt service costs from market rates. For them, it is significantly cheaper to fund an investment via the capital market than with a bank loan. For investors, ratings have the function of a risk management instrument.

## **Fallen angels are undesirable**

If, during a periodic review, a rating agency downgrades its rating, this can have catastrophic consequences for the borrower. A fall beneath the BBB– rating, the lowest investment-grade category, will instantly turn the borrower into a fallen angel. The prices of outstanding obligations will be depressed because the lower rating forces investors, especially institutional investors, to sell. This in turn influences the company's stock price. Experience tells us that only very few companies have succeeded in working their way back up the ladder from fallen angel to investment-grade status. It must be pointed out, however, that a rating change hardly ever comes as a total surprise.

Before being downgraded, borrowers are placed on a watchlist and their financial status is monitored. This can be the result of a merger or acquisition, refinancing problems, significant earnings fluctuations, or government interven-

tion. Usually, the addition of a company or country to a watchlist is not a reason to abandon the bonds that it issues. Such borrowers know that they are under scrutiny and will spare no effort to deliver credible proof of their continued eligibility for their current credit rating. From this perspective, the inclusion of an entity on a watchlist can also be interpreted as a shot across the bow. Let us not forget that the USA was just recently placed on the watchlist!

The rating agencies themselves repeatedly come under fire as well. They are criticized for being too late to react to an event or a deterioration of solvency. For this reason, the market for credit default swaps (CDS) that insure lenders has gained importance. The financial market reacts instantly and is usually on the mark, as suggested by the adage "don't fight the market, it is always right". However, if a bond is downgraded to below investment grade (BBB–), that doesn't automatically mean it will not make money. The contrary is often true! High-yield bond funds are specialized in buying the best among the worst ratings and in passing on to investors the high interest rates in the form of price increases (profits reinvested) or as coupon payments. Well-known names can be found in this segment and from the current perspective, a lot of them deserve to be trusted more than many government bonds: Fiat, Jaguar Land Rover, Remy Cointreau, Hornbach, Levi Strauss, Alcatel, TUI, or e.g. Bombardier.

In the past two years, this investment class has outperformed almost everything, especially government issues that were deemed safe so far. But here, it is necessary to abide by the

strict principle of diversification that can be achieved only via a fund. This makes even a total default by a borrower digestible with comparative ease.

| Rating categories |   |     |
|-------------------|---|-----|
| Moody's           | Rating definition   | S&P |
| Aaa               | Highest rating. The borrower's ability to repay interest and principal is extremely strong.   | AAA |
| Aa                | Good capacity of issuer to service debt.  | AA  |
| A                 | The obligations exhibit high-quality attributes but can be affected by political or economic circumstances.   | A   |
| Baa               | The likelihood that debt will be serviced in a timely manner is adequate. However, a change in economic parameters may affect the solvency of the borrower. For Moody's, paper rated Baa and lower is speculative.                          | BBB |
| Ba                | Obligations in this category have speculative characteristics. The borrower's ability to service debt appears to be reliable only if the economic environment remains stable or improves. For S&P, paper rated BB and lower is speculative. | BB  |
| B                 | The characteristics befitting a long-term investment are not present. The probability of the debt being serviced over a long period of time is compromised.   | B   |
| Caa               | Obligations with this rating are low in standing. The debt may become nonperforming or interest and principal are repaid only with great difficulty.  | CCC |
| Ca                | Obligations in this category are highly speculative. The borrowers often default.   | CC  |
| C                 | Very low probability of the debt being serviced in full. At least one interest payment is already overdue.  | C   |
| D                 | In default.   | D   |

#### Last but not least

"He that is of the opinion money will do everything may well be suspected of doing everything for money." *Benjamin Franklin*

Peter Ahluwalia  
Robin F. Amacher  
Kristian Bader  
Marthe Ballet  
Yves Baumann  
Johan Buckert

Herman Buhl  
Christ Johann Collenberg  
Chantal Cvorovic-Lauper  
Ute Dürtscher  
Mario Economou  
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Robin Graetz  
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Urs Jäggi  
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Thomas Kostkiewicz  
Markus Linke  
Rainer H. Moser  
Jos Raafs  
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