

- ▼ Snared: Yuan peg to USD drives inflation
- ▼ Serviced: Ireland yields twelve percent
- ▼ Stymied: Financials suffer from debt crisis

part

partners' view

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# Politics and business

**The labor market fails to support consumer spending and the economy in the USA.**

**China redoubles efforts to combat inflation.**

**The EU grapples with rating agencies.**

Once again, the US labor market has dealt a blow to the economy. In June, only 18,000 new jobs were created in nonfarm payrolls instead of the projected 100,000 (see graph). This is much less than what would be required to perceptibly trim the high unemployment rate of 9.2 percent and reduce it to an acceptable level. This renewed setback will probably keep US interest rates at a low level for some time to come.

## The yuan and inflation

The Chinese leadership's latest five-year plan is aimed at strengthening the domestic market and reducing dependence on exports. But because inflation in China has meanwhile continually risen to 6.4 percent, the Chinese central bank will have to pursue its restrictive policy. Interest rate adjustments and stiffer capital adequacy regulations are worsening the already tight lending latitude in the banking sector. Ultimately, this heavily impacts China's domestic market, making it hardly feasible to continue financing planned growth. By pegging the yuan to the US dollar, China's economic policy so far has focused mainly on strengthening the competitiveness of its export industries. This has eliminated China's ability to benefit from a strong currency in terms of lower import prices. The conventional approach – to free-float the exchange rate – would reduce inflation and buoy the domestic

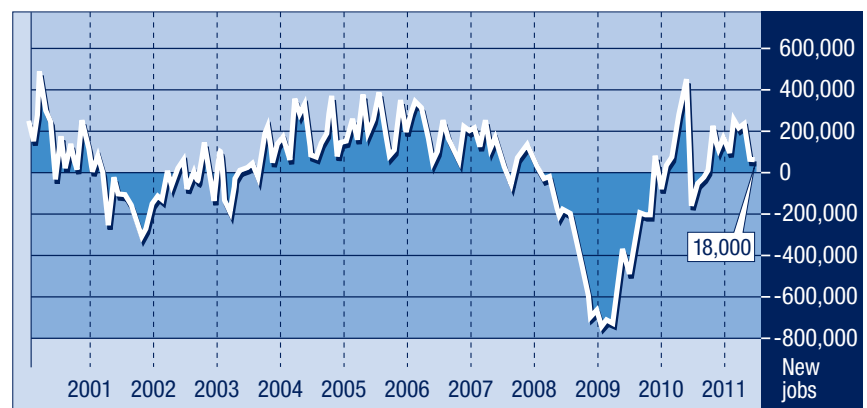
market. As exemplified by Switzerland, a strong domestic currency results in low interest rates and low inflation.

## No rating?

For the members of the EU council, the situation is distressing. More and more money is being printed to bail out the imperiled countries in southern Europe, while the managers of large hedge funds continue to short the euro and make splendid profits with this speculation. The fund managers can rely on the support of Moody's and Standard & Poor's, the two US rating agencies that continue to downward revise the creditworthiness of parts of Euroland despite the generous rescue facilities. The indignant reactions from the ECB and European politicians are understandable but not on target. The rating agencies will certainly refrain from preparing courtesy appraisals as a political favor if they are convinced of the contrary. The

easier way, instead of swamping the unloved agencies with lawsuits, would be to simply withdraw the rating mandate. After all, ratings are prepared only on request, with the intention of providing investors with a financial compass. The problem is that this compass has been going haywire in the recent past, and new investors are more likely to assess the chances of survival of Greece & Co. on the basis of the political agenda than on the strength of current ratings. Accordingly, deficit financing in Greece and Portugal will be handled primarily through the European Financial Stabilization Mechanism and not via the capital market.

**US Nonfarm Payrolls**



# Currencies and interest rates

**Attractive entry windows in Sweden and Norway. The countries in Eastern Europe are underrated. Ireland is making progress and gets kudos.**

Although Sweden and Norway have no problems with government finances whatsoever – as is certainly the case in Norway – are even generating annual budget surpluses, the exchange rate trends of these two countries versus the euro and the Swiss franc are very disappointing. Another characteristic of the krona (SEK) and krone (NOK), not unlike the Swiss franc which is currently a safe-haven currency, is that they involve absolutely no financial obligation in the European bailout package; this commitment is borne exclusively by the EU member nations. For this reason, one would have to assume, even today, that the two Nordic currencies are likely to trend much better than the euro.

## **Southern Europe**

Europe's south remains in turmoil. After Greece's parliament approved the rigorous austerity package and thus paved the way for the next EU aid installment, the relief of the markets was palpable. The euro immediately advanced by five cents, or four percent, which nurtured hopes that the markets would calm down. But disillusionment set in just a few days later, triggered by the rating agencies. Standard & Poor's interpreted the European refinancing solution for Greece – a voluntary extension of maturing bonds in line with the French model – as

a selective default. For all of Greece's outstanding credit default swaps, this would be of considerable significance and would trigger default payments in the magnitude of billions of euros. Soon thereafter, Moody's, the second large rating agency, downrated Portugal's creditworthiness by no fewer than four notches from Baa1 to Ba2. This dropped Portugal out of the investment grade category into the junk-bond class (see partners' view 07/11 for an overview of rating quality classes).

## **Eastern Europe**

Subsequent to the downrating of Spain, Portugal, and Greece as well as the placement of Italy on the watchlist, Europe was split into two factions. But the positive surprises came from Eastern Europe, not from the north. In early July, Romania received a BBB rating, elevating the country to the status of an investment grade bond and liberating it from the captivity of the junk-bond class. A closer look yields a surprising lineup of solid ratings in many countries of Eastern Europe: Czech Republic (A+), Slovenia (AA), Slovakia (A+), Poland (A-) and Croatia (BBB) have been rewarded for their low government debt. The strict Maastricht criteria (60 percent government debt as a percentage of gross domestic product GDP) are fulfilled by Bulgaria, the Czech Republic, Latvia, Lithuania, Romania, Slovenia, Poland, and Slovakia. Only Hungary is confronted with the same debt problems as the euro countries mentioned above. The front runner in the positive sense: Russia, with government debt at less than ten percent of GDP.

## **Ireland**

Although the European Central Bank's (ECB) recent interest rate hike of a quarter percentage point was expected, the euro benefited only briefly. Because of the ECB's systematic stance in combating inflation, the markets are anticipating another one to two hikes before the end of the year. The future value of the euro, especially relative to the Swiss franc, will not depend on the interest rate regime but instead on the development of the debt scenario. At this juncture, it is absolutely appropriate to commend Ireland's efforts. The country is making good progress in cutting its household deficit and both the ECB and the IMF have praised Ireland's measures to ease the debt crisis. Contrary to Spain or Greece, Ireland's problems are not structural but attributable to the overindebted banking sector. Prior to the financial crisis, Ireland's national budget was in better shape than Germany's. Currently, investors who buy euro-denominated Irish government bonds with residual maturities between five to ten years are reaping a solid 15 percent interest.

# Financial markets

**Gold and other precious metals are en vogue again. Gold mine stocks have upside potential. Financials are suffering from the euro and debt crises.**

Within the scope of the debt crisis and the flight of money into the Swiss franc, it is hardly surprising that gold, given its function as a substitute currency, has reached new highs. In retrospect, the only strange aspect is that it took so long. Investors who didn't yet own gold positions had plenty of time to fill the gaps in their portfolios. It is almost inevitable that major gold producers will soon beef up their so far poor annual performance. This year, the prices of major gold mine stocks – Barrick Gold or Newmont Mining, for example – fell by about ten percent, despite the gold price as it stands! Even though exploration costs have risen, the higher price of gold has boosted earnings and improved the bottom line.

## Many losers

In mid-July, because of the fears of a brushfire in the wake of the crisis in Europe, the turnaround on the financial markets escalated. Financials in particular (insurance companies, banks) have suffered most from the debt and euro crises. On the one hand, commercial banks have granted loans to companies or countries in the imperiled economic area and, on the other, have invested parts of their equity capital in bonds issued by governments in this region. The total amount of assets managed by Swiss banks is also declining, because much of the

wealth is invested outside the Swiss franc. Additionally, the resulting revenues such as commissions and custodian fees are being eroded due to the depreciation of the euro, dollar, and pound. Insurance companies are also facing larger write-downs. To a great extent, premium revenues are typically invested in bonds, among others in those issued by peripheral euro nations in the south. Major losses are imminent there. The community of losers also includes companies that generate revenues mainly with exports into euro or dollar markets but incur costs in their domestic markets, viz. in Swiss francs. Within the past 18 months, both the dollar and the euro lost 20 percent in value. This leaves deep marks in the statements of income. But there are always two sides to a coin: The positive aspect of the firmness of the franc is that Swiss companies have amply filled coffers for investment purposes. Today, expressed in their home currency, they can acquire US or European businesses with discounts in the order of 20 percent. In turn, this can be a welcome opportunity to outsource portions of their production capacity out of high-priced Switzerland to a newly acquired subsidiary and thus to swap costs out of the Swiss franc into euros or dollars.

## Last but not least

“On average, even the guy who doesn't eat a steak eats one if someone else helps himself to two.”

*Willi Bongart*

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

Herman Buhl  
Christ Johann Collenberg  
Chantal Cvorovic-Lauper  
Ute Dürtscher  
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Peter L. Einstein  
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Beatrice Kern  
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