

- ▼ **Benefits:** Swiss consumers profit
- ▼ **Bullies:** Candidates take aim at the SNB
- ▼ **Buys:** Platinum has upside potential

part

partners' view

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Politics and business

Greece slides into heavy recession. USA wants to keep zero-interest regime until 2013. Swiss consumers benefit from the strong franc.

The debt crises of the Eurozone nations and in the USA will keep us occupied for many more years. For instance, the austerity measures initiated in Greece are leaving the first marks in the gross domestic product. In the second quarter of 2011, the economic outlook dropped by a hefty 8.1 percent. The radical kill-or-cure approach is inevitable and will impact many more countries that need to throttle their government spending. In the midst of this recession, all-important tax revenues are eroding as well; this is a vicious circle that for some countries will invariably end with a haircut on assets. The USA has not even initiated the debt reduction process yet. It merely raised the debt ceiling.

Zero-interest policy

The change in policy by the American central bank (Fed) in favor of keeping lending rates at zero until 2013 can be interpreted as an admission that the US economy is not currently growing. This insight is belated, because not long ago, the Federal Reserve was still projecting a solid rebound. Now that the quantitative easing programs QE1 and QE2 have expired, the Fed still wants to prop up the economy with an expansive monetary policy. At least in the housing market, which by definition would have to react positively to lower debt servicing costs, this mechanism has been ineffective for a long time. Both housing starts

and sales of existing properties have been hovering at record lows. Consumers, who account for a whopping 70 percent of GDP, have more important problems than low borrowing rates: Job security, sentiment, commodity prices (gasoline, heating oil), or the tax burden are just a few factors.

Who's to blame?

Rating agency Standard & Poor's (S&P) threatened the USA with a withdrawal of its AAA rating unless a credible debt reduction plan was submitted (see also partners' view 06/2011) – and it acted on this threat. The two main political parties in Washington are jointly responsible for the consequences of this historically unique downrating. In ping-pong fashion, each party tried to blame the other for failing to cooperate in the debt resolution negotiations and thus overtly and deliberately risked the loss of the AAA quality seal. At first sight, the loss of the top investment grade rating is not a problem and further countries will have to contend with a downrating as well. Then again, this could also lead to sizeable complications. If the other two agencies (Fitch and Moody's) should also lower their ratings for the USA and if S&P even goes a step further (after its downrating, S&P still has the USA on its watchlist with a negative outlook), the consequences could be catastrophic: The USA would incur massively higher borrowing costs. The banks would no longer regard US Treasuries as a pledge worth as much as cash and would apply lower collateralization rates. Those who lend money to the United States would diversify their dollar holdings even more and turn to other assets

(gold, euro, commodities, etc.). China is the largest lender of money to the USA (nearly 1200 billion dollars) and has already fired a first warning shot across Washington's bow.

Purchasing power

In the last issue of partners' view, we pointed out that a strong domestic currency is a key factor in the fight against inflation. After a lot of media hype, Swiss retailers are delivering the proof of the pudding by cutting staple and food prices by an average of 20 percent. Some stores are taking things a step further by boycotting international brand product makers that do not want to pass exchange-rate gains on to consumers. The cost of the average basket of consumer goods (change of consumer price index = measuring instrument for inflation) in Switzerland will decline perceptibly as a result. China faces the same situation: To buoy domestic consumption (at the expense of exports), it would have to tolerate a stronger yuan.

Currencies and interest rates

The prices of US Treasuries are rising despite the loss of the AAA rating. Is a unified European bond the only way out? The Swiss National Bank surprises critics and speculators.

During the forex volatilities of the past weeks, two currencies stood out in the negative sense: The setbacks of the Australian dollar and the British pound attracted attention. Attempts to explain the phenomenon of the weak pound tried to pin some of the blame on the unrest in Tottenham, but the decline of the Australian currency actually reflects the woes of the global economy. The Australian dollar is a classic commodity currency with strong exposure to global business trends.

False sense of security

Before it happened, the downrating of America's creditworthiness from AAA to AA+ was termed a catastrophe and a financial drama. But when it occurred, the bond markets reacted in a totally irrational way. US Treasuries, the single security class most directly affected by the downrating, posted price gains, after which yields declined. It was a flight out of stocks and into fixed-income paper, gold, and Swiss francs. The apparent security now slightly scratched by Standard & Poor's is deceptive, however. Investors who tie capital up in American government bonds for ten years with a yield of 2.2 percent must expect considerable price declines when interest rates pick up due to rising inflation or a further erosion of creditworthiness. The negative response of government paper in

Spain, Portugal, or Italy to the debt crisis should be enough of an alert signal that shows how quickly secure bonds can turn into book losses.

Joint Eurobond

If the much-discussed Eurobond – a bond jointly issued by all EU member nations – should materialize as hoped for by so many parties, Germany will lose most of the interest-rate leverage it has been able to wield so far. This is because while refinancing costs for Spain, Italy, Greece, and Co. would fall (they would benefit from the guarantees of the financially solid member nations), Germany would be faced with a hefty debt service cost increase. This projection also makes it clear what the recommendation is: Sell your long-duration German government bonds and take the profit!

Even if Germany's pols are against the creation of a joint bond, the country runs the risk that this approach to handling the debt crisis will find many followers in the EU for obvious reasons and might ultimately be the survival strategy of choice. Most Eurozone countries would tap into the Eurobond as a source of credit, so they would benefit directly from it. The Ifo Institute estimates that with the introduction of the joint bond, German taxpayers would be hit with an extra cost of up to 25 billion euro (difference of current interest payable and the average of the other euro countries).

The SNB and its critics

The Swiss National Bank SNB has to endure permanent criticism, and no matter what it

does, it gets blasted. This probably has less to do with its actions than with the parliamentary elections scheduled for October. The closer the deadline for the vote, the more self-proclaimed economic experts are seen populating the political landscape. After all, politicians cannot get better media exposure than by constantly demanding the opposite of what the SNB happens to be doing. Although its elbow room is limited, the reassuring continuity in its zero-interest policy, a liquidity infusion in the Swiss money market, a lower minimal target rate of the euro versus the Swiss franc and a further forex intervention, the SNB made it clear that it intends to deploy these tools even more aggressively in favor of the Swiss export industry. The reaction followed swiftly, and on the bottom line, the euro advanced versus the franc by nearly 15 percent at the peak. Many critics will now feel inclined to tone down the rhetoric they have been firing at the SNB. As regards its activism, the SNB is by far not alone. All major central banks intervened, either in favor of a weaker currency (Japan, Switzerland), to combat inflation (China, Australia, Norway, Sweden), or to curb rising interest rates in government bonds (ECB). Nonetheless, in the currently volatile market scenario, the sustainability of such interventions is questionable, given the serious imponderables and the many factors (including political ones) that intermesh in the global forex circus.

Financial markets

Sell-off in stocks and corporate bonds. Platinum lags in the vigorous silver and gold rally. Gold stocks shine.

Corporate bonds were also impacted in the negative sense by the general uncertainties on the financial markets. Most corporate bonds lost a few percent, while German or US government bonds picked up again. This has considerably improved the appeal of corporate bonds, particularly relative to American and German government bonds.

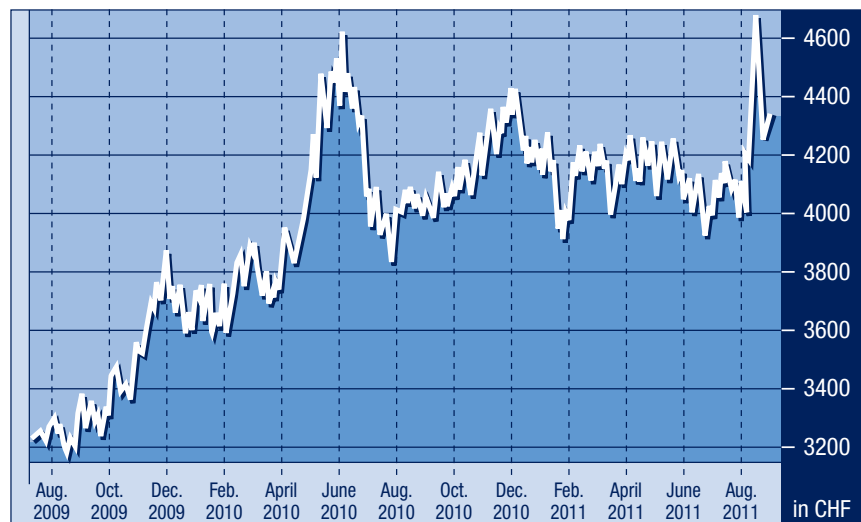
Platinum

Because of the weakness of the franc and the concurrent increase of the price of gold, the precious metal (expressed in Swiss francs) advanced by an astonishing ten percent in only four trading days! The result: a new high for the year, in francs (see graph). Silver moved along similar lines, but platinum has yet to follow this trend. At times, an ounce of gold cost almost as much as platinum, which earlier in the year traded 30 percent higher than gold. Consequently, platinum should have some untapped upside potential.

High volatility

The financial markets are experiencing a wild ride with a vigorous increase in volatility (fear barometer) and a veritable sell-off in stocks. Many mid-year reports, particularly of Swiss companies strongly involved in exports (which is true for most internationally active businesses) showed clear forex-induced skid marks. As already mentioned elsewhere, exchange rate swings in the magnitude of the

100 grams of gold in Swiss francs / ZKB ETF



past months affect income, albeit, of course, in the negative sense for Swiss exporters. With a credible and successful SNB intervention, it seems as if the worst-case scenario might have been averted, at least as far as regards the parity of the euro versus the Swiss franc. Price setbacks of 30 to 40 percent within two weeks in equities such as ABB, Holcim, Sulzer, Fischer, Rieter, Geberit, Schindler, and others offer quite a bit of upside potential in response to a weakening of the franc. But we have to remain grounded: Volatility – the amplitude of the swings – will stay high and investors will need stronger nerves than they did in the past. Some consolation can be found in the high dividends of companies that have enough free cash flow to uphold such distributions in the future. Gold mines

and producers such as Barrick Gold were able to escape the generally negative vacuum on the stock markets. Finally, they have reacted to the higher price of gold and present themselves as good diversifications in times of crisis. Since their performance is still negative for this year, there's also plenty of room here for further price advances.

M as in Maastricht

This time, we will take a closer look at the “Maastricht Criteria”, the often-quoted cornerstones of the European Union. We will review the origins and key tenets of the treaty, the current situation, and possible future amendments to the existing treaty.

The so-called Treaty on European Union was signed in Maastricht, Netherlands, on February 7, 1992, by the members of the European Community: Belgium, Germany, France, Italy, Luxembourg, Netherlands, England, Ireland, Denmark, Greece, Portugal, and Spain. The key issue of the treaty was the creation of a monetary and economic union which also provided for a single currency with the introduction of the euro effective January 1, 1999. Since the member nations were to remain responsible for domestic revenue (taxes) and spending, emphasis was placed on household stability. The EU convergence criteria were ratified as a set of rules with the objective of establishing price stability. Five specific cornerstones were defined:

- The inflation rate of any member must not be more than 1.5 percent higher than that of the three most stable member nations
- Government debt must not exceed 60 percent of GDP
- Net new debt per year (current household deficit) must not exceed 3 percent of GDP
- A new member must have participated in exchange rate mechanism II (preparatory phase for the introduction of the euro) for at least two consecutive years without having to devalue its currency and remain

within a +/- 15 percent bandwidth of the agreed exchange rate

- The long-end rates for government bonds must not be more than two percent higher than the average rate of the three most price-stable members

Debt limit still applies

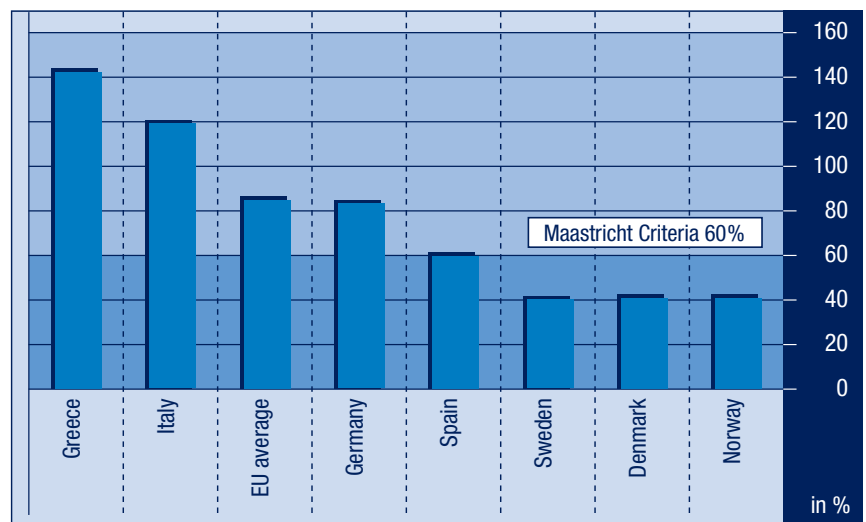
Today, these EU convergence criteria defined in 1992 are referred to as the Maastricht Criteria. Even after joining the monetary and economic union and after the introduction of the euro, new and existing members must fulfill the cornerstones of the convergence criteria under the terms of the stability and growth pact. The limits on government debt (max. 60 percent of GDP) and on current household deficits (max. 3 percent of GDP)

still apply. The violation of these criteria entails sanctions and, ultimately, fines.

Scandinavia does it better

The financial and economic crisis of 2008 left its marks in the balance sheets of the euro member nations. Billions of euros spent on stimulus programs, guarantees, or the nationalization of banks as well as crisis-induced tax revenue losses made it virtually impossible for most euro member nations to comply with the stipulated debt limits. The numbers as at December 31, 2010, look gloomy. The average debt of all euro countries is 85.1 percent. Italy and Greece top the list with 119 and 142 percent, respectively. Surprisingly, the official government debt in Spain – 60.1 percent – is noticeably lower

Government debt relative to GDP



than that of Germany (83.2 percent, see graph). The annual household deficits that are causing debt levels to rise incessantly also clearly exceed the Maastricht Criteria (max. three percent). Estimates for 2011 show that, apart from Greece (10 percent budget deficit relative to GDP), Europe's problem children also include Ireland (12.1), Spain (8.8), Italy (5.0), Portugal (7.9), England (10), and – surprisingly – France (7.4). Conversely, the Scandinavian countries such as Sweden (40 percent government debt), Denmark (41 percent), and Norway (47 percent) have problems neither with government debt nor with current household deficits. Norway even generated a surplus of 12 percent, which means that its government generates about 50 billion US dollars in revenue more than it spends!

New approach

The stability and growth pact with the convergence criteria is linked to GDP. Since GDP corresponds to the aggregate value of all goods and services produced by an economy in a given year, the question is: Is this the right yardstick? Why is Spain's annual household deficit measured against the added value of an entire economy despite the fact that the state is only a small part of the economy? Why isn't it compared with metrics that can be more readily influenced by the state, for instance with annual government income? The debt crisis resulted in a marriage of convenience of the European community that by far transcends the Maastricht Treaty and the concept behind the introduction of the euro. The transfer union, i.e. the equalization payments made by Germany, France, and Co.

in favor of Greece, Ireland, and Portugal also merits a critical look at the disparate structures of the member nations and particularly of their governmental machinery. It is legitimate for a German taxpayer to ask why he cannot retire before the age of 65 while civil servants in financially distressed countries are entitled to social security payments at a much earlier age. The disparate tax regimes also come to the fore when a tax haven like Ireland suddenly needs financial aid from countries that impose higher taxes and consequently have balanced budgets.

The European community has no option but to amend the Maastricht Treaty with further criteria – and can view this crisis as an opportunity. Retirement age, value-added tax, and corporate taxation are merely three contenders in a catalog of parameters that should not differ too significantly among the 27 members of the EU or at least among the 17 countries that have already introduced the euro.

Last but not least

“If you would know the value of money, go and try to borrow some.”

Benjamin Franklin

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