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partners' view

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Politics and business

Finally, new jobs are being created in the USA. China's growth engine is faltering. Will the new scandal in UBS investment banking lead to a separation of bank types?

Signs of life in the American labor market: In September, 137,000 new jobs were created, much more than expected. But this snapshot in time cannot dispel fears of the future. Growth slumps in Asia, recessive trends in Europe, and an increase of the savings rate in the USA are bad news for a recovery of the economy with a continued rebound in job creation. It is not the here and now but the path that the highly indebted nations must tread looking forward which will occupy us and have an impact on growth and employment. In this context, the news from China that imports and exports have been declining rubs salt into open wounds. After all, China is deemed to be the growth engine and savior of the western hemisphere.

The end of universal banks?

The trading loss of over 2.3 billion US dollars incurred by UBS in investment banking has intensified the call in domestic politics to split the commercial and investment banking segments. That would mean the end of the classic universal bank. The reason stated for this segregation is that lending, so important for businesses and private households, the lucrative private banking activities, payment transactions, and the rest of the commercial banking services should not be jeopardized by the Damocles sword of investment banking.

There is a deeply-rooted fear of the seemingly uncontrollable risks taken by the happy-go-lucky gamblers in London and New York on behalf of their employers. Instances of a conceivable bailout on the part of the state – when losses have gobbled up all the equity and state-guaranteed savings deposits are endangered – have already taken place during the 2008 financial crisis in Germany, Ireland, France, the USA, and even in Switzerland (UBS). The conflict of interests between banks (high profits through high risk) on the one hand and borrowers, savers, and bondholders on the other (need for security) is quite obvious. Then again, this split of banking activities is nothing new. As far back as 1932/33, the Glass-Steagall Act ratified an introduction into law of the separation of bank types, specifically the detachment of the investment banks. The Act was a reaction to the Great Depression and the 1929 banking crisis and the losses it produced. Its objective was to protect borrowers and savers against the high risks of investment banking, but also to shield the government itself against bankruptcy in the event that it had to honor savings guarantees. The Act survived nearly 70 years until it was abolished by President Bill Clinton in 1999.

Occupy Wall Street

Even though the occupation of Wall Street is giving a comparatively small group of people lots of media exposure, the rationale is driven by clear motifs: Discontent, anger, and – mainly – jealousy. Occupiers are discontent with the government's bailout of banks, angry over the remuneration and bonus policy of investment banking departments, and jealous regarding

the unfair distribution of wealth. Under these circumstances, governments are tempted to invent new taxes and increase existing ones. The internal revenue potential is being tapped at all levels: real estate, inheritances, and financial assets. It is difficult to say whether this sentiment is an advantage or disadvantage for the yet-to-be-ratified tax treaties with Germany and England (and, probably, subsequently with the rest of the EU as well). On the one hand, the expected inflow of money – both non-recurring for past instances and forward-projected for all types of incomes – is substantial, and this is certainly a boon, given the current debt crisis. On the other hand, the oppositional forces on the left are all too willing to label delinquent taxpayers as criminals, so in running up to the next elections, they can convince voters that the lawmakers of incumbent parties have failed. And every accord will be marketed as a tax gift, no matter how lucrative it turns out to be.

“Discontent, anger, and jealousy could lead to new taxes.”

Currencies and interest rates

Government bonds that are still rated safe today are clearly too expensive. The European Central Bank ECB is becoming the banks' lender. Capital adequacy rules produce the wrong incentives.

In Germany, inflation has risen to 2.6 percent, a three-year high. For a ten-year government bond (issued by Germany) denominated in euro, the investor gets somewhere near 2 percent interest and can't even offset inflation with this yield. This shows that flight into quality has assumed dimensions which suggest a bubble and should be warning enough. The prices for long-end German government bonds are clearly too high, and the yields are too low. The same applies to 10-year "Eidgenossen" that yield a paltry one percent. Even though the safety theme is understandable, the choice of long maturities is a risk and could end in painful price declines. Sooner or later, the expansive monetary policy will lead to inflation. For highly indebted nations, this is even desirable, because inflation "eats away" part of the debt.

Preventing the domino effect

Although the European Central Bank (ECB) left its lending rate unchanged, it certainly vigorously supported the European money market. Because banks don't trust each other any longer and the liquidity supply to the money

market no longer works for that reason, the ECB has assumed that role, guaranteeing unlimited liquidity until 2013. So now, banks can get unlimited loans from the ECB at lucrative terms, totally regardless of their credit ratings. This also reduces the danger of contagion due to the counterparty risk. It was the first measure introduced to cushion the impact of a controlled default (bankruptcy) of the state of Greece on the banks and to prevent the feared domino effect.

Münchhausen

The second measure followed a few days later when the Belgian-French financial institution Dexia was nationalized. With guarantees of up to 90 billion euro backed by Belgium, France, and Luxemburg, attempts are being made to cover a potential writedown in the group's exposure in Greece (Dexia has 5 billion euro invested there). But there's a legitimate question: Aren't the guarantors themselves (the countries) the root cause of the evil? After all, the beneficiaries of the guarantees (the banks) only got themselves into this predicament because they invested in the guarantors by purchasing government bonds. This reminds us of the tall tale recounted by Baron Hieronymus Carl Friedrich von Münchhausen, who said he had pulled himself and his horse out of the quagmire by his own bootstraps. Further candidates for government bailouts are Italy, France, and Spain. The situation in Spain is compounded by the still unresolved real estate crisis, which may well trigger considerable writedowns. Spain has already announced that it intends to nationalize weak banks.

The wrong incentives

Further measures include forced recapitalization to attain capital adequacy requirements, either via the capital market or through government aid. The required equity will be determined with a stress test. However, the crux of the equity regulations is to reallocate government bonds into the riskless class. This eliminates the need of banks to back their presently somewhat riskier government bond exposure with equity. Misallocations in bank balance sheets have been the result of this approach. It is reminiscent of the subprime crisis during which banks parked seemingly safe AAA-rated real estate products in their balance sheets. Because of the uncertainties involved in government debt, the high exposure of banks in government bonds, and the financial links between the commercial banks (counterparty risk), considerable caution is advised in the domain of fixed-income paper in the financial sector. Investors cannot always count on the assumption that ailing banks, as in the Dexia case, will be underpinned by their governments. And an implied government guarantee is likely to encourage banks to tolerate uncontrolled risk in the first place.

Financial markets

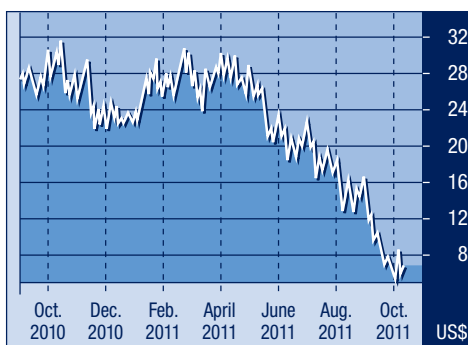
“Boring” equities lost the least. Sound banks are resisting forced measures to comply with the stricter capital adequacy requirements. Alternative energy stocks are a bargain.

For equity investors, boredom does not necessarily have to be negative: The rather sluggish Novartis, Roche, and Nestlé stocks have been topping the performance list this year. With a gain of about 8 percent, Roche beat the SMI by nearly 20 percent.

Setting buy limits

The recommended shopping list in the last issue of partners’ view will only work for those investors who define realistic buy limits for selected stocks and then actually buy when these limits are attained. For a little help, here is a list of Swiss companies with the respective buy limits (prices in CHF): ABB (less than 15.50), Givaudan (less than 700), Holcim (less than 48), Syngenta (less than 235),

Trina Solar



Xstrata (less than 12), and Swatch Group bearer shares (less than 300). Although we are still far away from these limits, they were all reached once already during the month of October. The risk tolerance of an investor determines whether the industry allocation fits a particular portfolio. By the way, you will not find any financials in this list, because the risks involved are incalculable at the moment. Moreover, the looming threat of recapitalization due to stricter adequacy requirements will lead to capital increases and thus to diluted earnings.

Shadows on solar stocks

Particularly long shadows were cast on the equities of companies involved in the alternative energy sector. Despite confirmed withdrawals from nuclear energy and despite the boom in solar and wind stocks in the wake of the Fukushima catastrophe, the largest Asian producers of photovoltaic cells are now trading at about 70 percent below their prices at the beginning of this year (see graph). This is because on paper, they have surplus capacities; however, it is liquidity bottlenecks that have halted production, so the apparent overcapacities will disappear in the coming quarters. The stocks of the largest manufacturers (Yingli Green, Trina Solar, GCL Poly, Renesola) are trading far below book value and are clear buys, especially via a fund specialized in Asian solar producers.

Last but not least

“Who wants to grow old in decency?
I’d rather stay young indecently.”

Olga Chekhova

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
Martin P. Egli

Peter L. Einstein
Ben Euing
Chantal Gehri
Gerhard Gottet
Robin Graetz
Narciso Grilli

Urs Jäggi
Claude R. Jenni
Beatrice Kern
Daniel Kössler
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