

- ▼ Praise: Mario Monti gets free kudos
- ▼ Precipice: German interest rates too low
- ▼ Pick: Buy oil conglomerate Hess

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

Democracy not wanted in Euroland. Monti more credible than Berlusconi. Germany's growth engine stalls.

Analysts predict gloom for the Swiss economy next year. A significant chill in economic output is expected, perhaps even a relapse into a recession with increasing unemployment and deflation. Thus, the Swiss National Bank is exposed to mounting pressure to further weaken the franc.

No democracy

It has been demonstrated on various occasions that the Eurozone does not tolerate basic democratic principles. For important decisions, the EU contracts stipulate unanimous votes. More recently, however, too many rules have

had to be revoked and a comprehensive overhaul of the regulatory framework is urgently needed. In the case of the referendum first threatened and then rescinded by Greece (which ultimately resulted in the resignation of Prime Minister Georgios Papandreou) and in the popular vote in Slovakia regarding the extension of the EU bailout package, the other nations would have probably just ignored a negative outcome.

New brooms

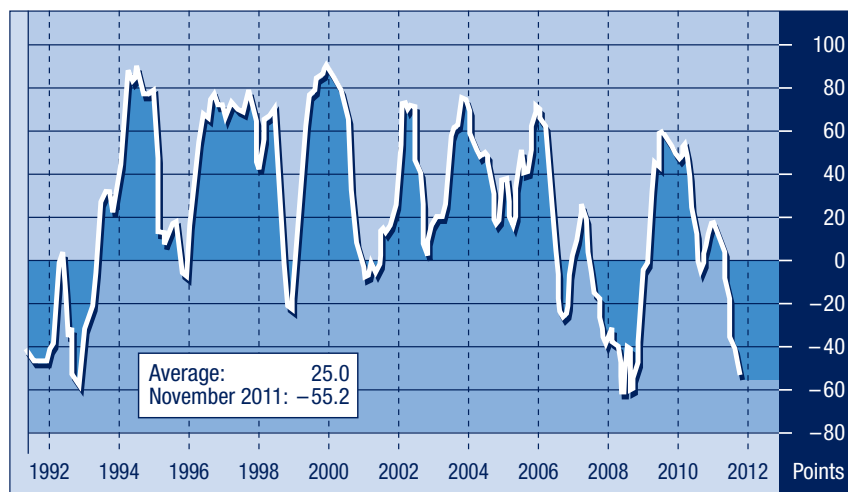
In the past weeks, a lot of political processes were set in motion. Europe's problem children Greece and Italy have new governments that want to expedite the necessary reforms. Although new brooms sweep cleaner, as the adage goes, a considerable amount of opposition is expected in the populace.

Indeed, all segments of the population will be affected by increases of the retirement age, wage cuts or jobs downsizing, subsidy cuts, or tax hikes. It would be naive to assume that anyone might voluntarily reduce, share, or sacrifice his personal wealth in favor of the community. Nonetheless, demands for austerity in Italy sound more credible when voiced by Mario Monti as opposed to his predecessor Silvio Berlusconi.

Unblocking the reform logjam

The current reform backlog is unacceptable both for the lenders in Northern Europe and for the recipients in the South, so it is a ticking time bomb for the affected populations. The debt burden in Southern Europe is simply too monumental to be sustained and financed in the long run. Only credible reforms in the borrowing nations will convince the lenders to release funds. They owe this to their own taxpayers, after all. This applies in particular now that Germany, net euro financier No. 1, is also facing economic growth problems. The leading indicator of the Center for European Economic Research (ZEW), which measures economic sentiment, dropped much more dramatically than had been expected and is now at its lowest point in three years (see graph). No wonder, given the fact that about 60 percent of all goods exported by Germany go to the European Union.

ZEW economic sentiment in Germany, 1992 to November 2011



Source: Center for European Economic Research (ZEW)

Currencies and interest rates

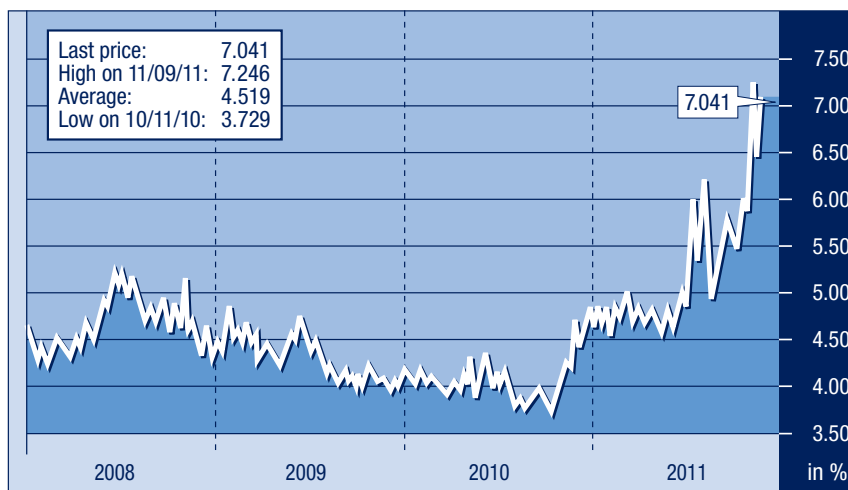
The US dollar still benefits from the euro crisis. Record-high interest rates in Belgium as well. The EFSF pays twice as much interest as Germany.

In the current phase of the euro crisis, the US dollar is truly the one-eyed man among the blind. The greenback advanced versus the euro and (because of the fixed exchange rate) versus the Swiss franc. It will be interesting to observe the reactions of the forex markets when the European Central Bank (ECB) begins to get more involved in debt management. So far, it has insisted on preserving its political independence. But it lost its virginity long ago when it began buying large volumes of government bonds issued by countries in Southern Europe. As a lender of last resort, the ECB – in its capacity as the bank of all euro nations – had to fire up the banknote presses to refinance the debt. In the long run, the consequence of such quantitative easing can only be inflation.

Interest rates rise across the board

Following Greek and Italian government bonds, fixed-income instruments issued by Belgium and Spain are now being targeted by speculators. Belgium has to shoulder the nationalization of the failed Dexia Group. Backed by France and Luxembourg, Belgium received over 90 billion euros in guarantees. Massive sales are driving the yields of debtor nations to dizzying heights. For the respective economies, this means that they can only refinance their debt to extend maturing government bonds if they accept significantly

Yield of 10-year Italian government bonds



higher interest rates. The following calculation illustrates the impact of this escalation: Italy has a total debt of 1900 billion euros and of this amount, some 300 billion will become due and need to be extended at new terms and conditions. Today, investors charge about seven percent interest on 10-year Italian bonds (see graph). The resulting debt burden of 21 billion euro is equivalent to about 1.5 percent of Italy's total gross domestic product.

Joint eurozone bonds

To protect Italy, but also Portugal, Ireland, Greece, and Spain against the brunt of these problems, the European Financial Stability Facility (EFSF) is to be allowed to take out loans at more favorable terms and then pass them on to its members. In early November,

the EFSF became active on the capital market and placed a 10-year bond with a volume of three billion euro. Despite its top-tier AAA rating, the borrower needed unexpectedly deep pockets given the 3.6 percent rate. By comparison: Role model Germany pays exactly half of that – 1.8 percent – for its 10-year bonds. This also illustrates the risk involved in German bonds. Ultimately, Germany's rating will suffer because of the European debt crisis, and it will be required to accept higher interest rates. So far, things were the other way around: The higher the interest rates rose for Spain, Portugal et al., the more Germany profited from its safe haven status thanks to lower interest rates.

Financial markets

The oil price ignores the difficult economic scenario. Oil company Hess a strong buy. Keep hands off financials.

Companies are still presenting good quarterly metrics, the financing bottleneck for corporate bonds has been defused, most companies have solid balance sheets, the profit versus earnings ratios are attractive, and dividend yields are multiples of bond yields. These are good reasons why equities still belong in every portfolio.

Buy Hess

The increase in oil prices had almost no repercussions on the stocks of major oil producers and service companies. The price of a barrel of oil increased by nearly 40 percent since early October and is only about ten percent below the highs in late April. Just like gold equities in comparison with gold, oil equities in comparison with oil have a lot of catching up to do. Hess Corporation is one of the favorites. With an estimated price/earnings ratio of about 6 for 2012, the American company is a bargain. The spread between the current stock price and the price in late April is about 40 percent. Too much, given the price of oil!

Hands off

The current government debt crisis will probably destroy more jobs in the financial services industry than the actual financial market crisis in 2008. Because of a loss of ten billion euro in the third quarter, Unicredit, Italy's largest bank, will have to lay off more

than 5000 employees. Switzerland's financial services industry is reacting and casting as well. UBS has a new boss and is imposing stricter constraints on its investment banking arm. Credit Suisse is cutting jobs and has integrated the private banking units of Clariden-Leu, which will also result in job downsizing. Bank Sarasin is being intensely wooed. The scenario is very uncomfortable for the financial industry: Higher capital adequacy requirements, lower profits in investment banking, larger money drain because of fiscal harmonization (Switzerland), cost-intensive regulatory issues, and taxes to some extent invented explicitly for banks (England) are making life difficult for financial players. The situation for insurance companies has been compounded by low interest rates that make it virtually impossible to cover costs with investments. The pension business, one of the mainstays in insurance, already had to respond with a reduction of the minimum interest rate. The bottom line for investors: Hands off financials.

Last but not least

"I made my money the old fashioned way. I was very nice to a wealthy relative right before he died."

Malcolm Forbes

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

Christ Johann Collenberg
Chantal Cvorovic-Laupier
Malcolm W. Dermitt
Ute Dürtischer
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Peter L. Einstein
Ben Euving
Ruud Flipse
Chantal Gehri
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Markus Linke
Rainer H. Moser
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