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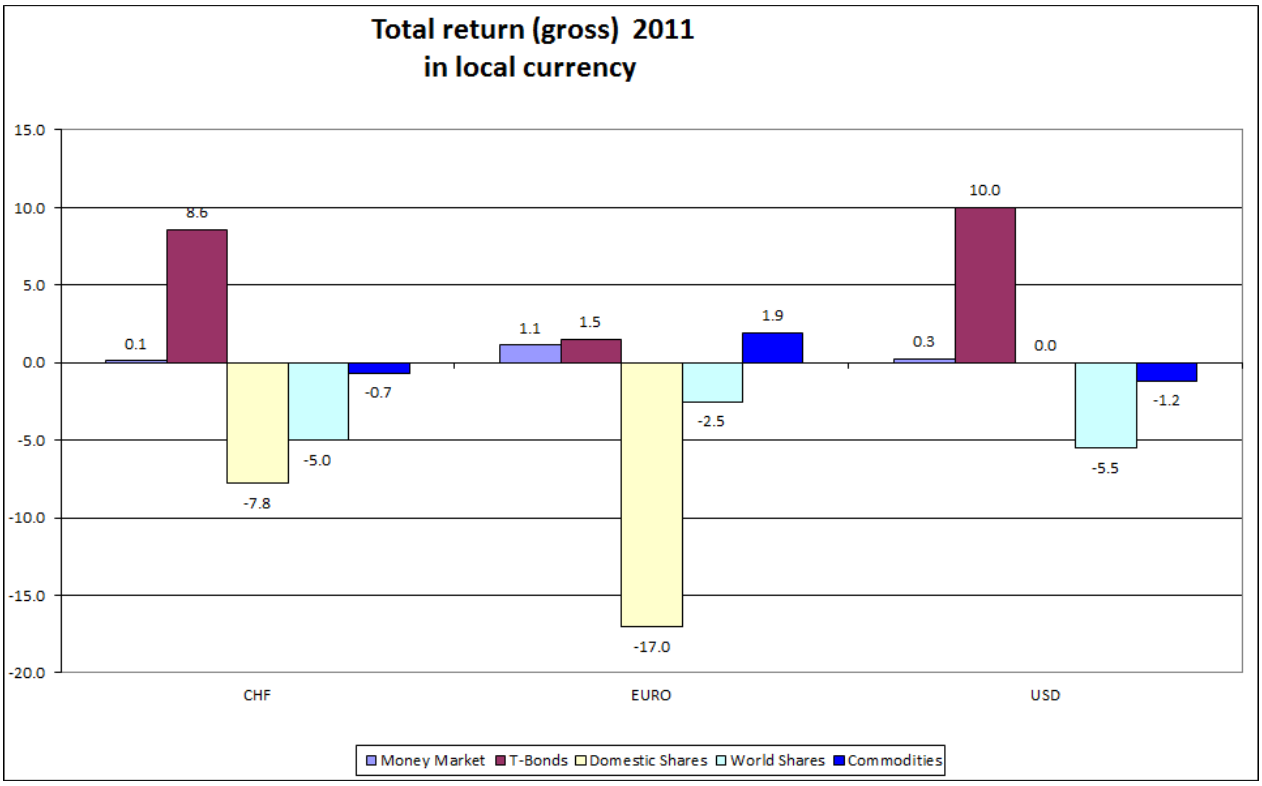
Investment policy 2012: Caught between hope and fear for the global economy

Renato Beckmann

2011: overshadowed by the Eurozone crisis

A year ago the financial community was almost in total agreement that 2011 would be the year of equities. This optimism was curbed for the first time by the unexpected popular uprisings in Tunisia, Egypt and the Arabian Peninsula. The destruction of the nuclear power plant in Fukushima in the wake of a tsunami not only had immediate economic consequences for Japan, but also convinced a number of countries to turn their backs on nuclear energy. Meanwhile the burden of public debt in the industrialised nations increasingly became a dominant factor on the financial markets. The wrangling about the increase in the US debt ceiling degenerated into a disgraceful political spectacle and highlighted the broad divide between the Democrats and the Republicans.

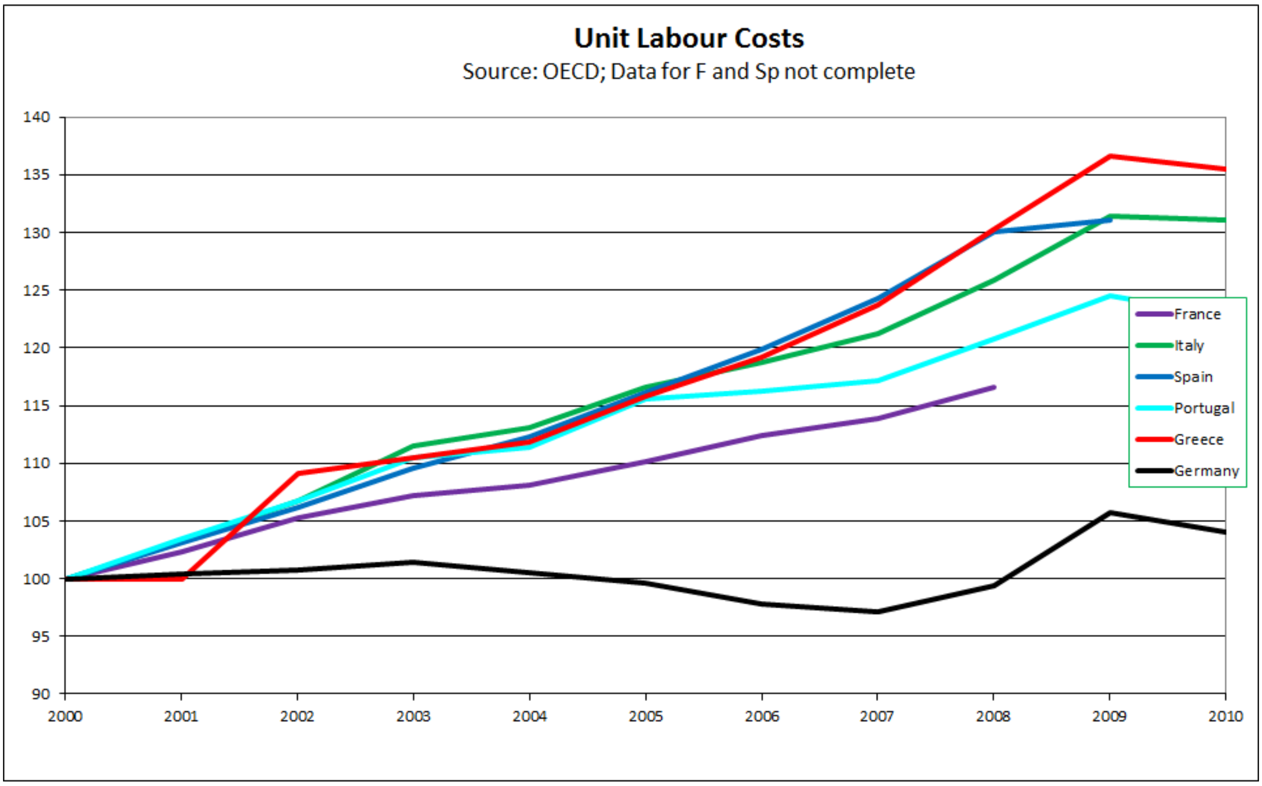
The Eurozone crisis committees were also plagued by the same fundamental difference in approach to finding solutions to the sovereign debt crisis. Given the political hesitation, not only did investors' risk aversion grow rapidly, but mistrust in the (European) banking sector increased substantially because of the sector's exposure to problem countries. The threat of a European collapse raised concerns about the development of the global economy; particularly as the US economy at times showed signs of slackening and important emerging markets such as China had turned their attention to fighting inflation.



Investment capital flowed into US, German and Swiss government bonds which reacted with substantially lower yields, while problem countries in the Eurozone were penalised by a massive rise in interest rates. Gold as a safe harbour in turbulent seas strengthened once again, while the price of silver dropped after a substantial increase. The currency markets saw great turbulence with the escalation of the European debt crisis, and the Swiss franc and Japanese yen in particular were catapulted to new heights. The Swiss National Bank decided to defend the level of 1.20 to the euro at any price after the euro temporarily dropped to parity with the Swiss franc. However, the most important currency relations did not change significantly for the year on balance. The equity markets came under selling pressure in spite of good corporate earnings reports, and the US markets managed to reverse the loss towards the end of the year.

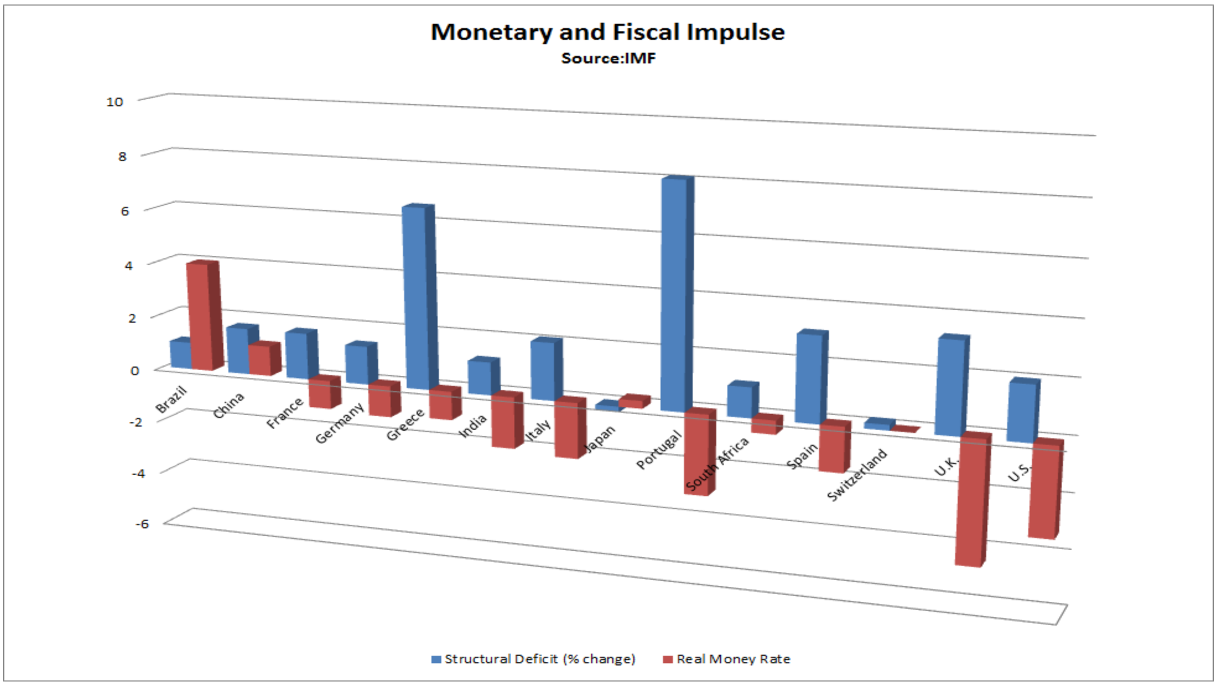
Focus on the Eurozone and the US election as the source of the fire

Although it cannot be excluded entirely, the probability that the euro might collapse in the foreseeable future can be described as small. Such a collapse would, however, have catastrophic consequences that would resound far beyond the Eurozone. A more realistic scenario is that the Eurozone will continue on the road to fiscal integration as there are hardly any other options that would guarantee the politically desired euro cohesion. The stabilisation fund, IMF support and the ECB's periodic intervention in the market for government bonds at risk are instruments that can only bring short-term relief unless structural improvements are initiated at the same time. These include all measures at country level that improve competitiveness as well as a fiscal integration programme that not only allows budget monitoring with sanction powers but also substantial transfer payments within the Eurozone. As the euro crisis is to a large extent also a crisis of confidence, a credible political breakthrough in the direction of a community of solidarity would substantially reduce risk premiums and thus also ease the actual debt problems.



The graph shows the diverging development of unit labour costs in the Eurozone which gives an indication of the tremendous change in competitiveness over the last ten years. Not surprisingly, Germany remains the best in class whereas Greece and other Mediterranean countries are in a delicate situation and corrective measures will take time and will hurt.
The debt situation in the US is just as bad as in the Eurozone and should be expected to be a central topic in November's presidential election. As Obama is unable to secure majority congressional support for his spending cuts, the still entirely undecided outcome of the election will determine whether and how the US gets a handle on its public household.
Spending cuts in the public sector will threaten social peace, and protests such as those seen in Greece are likely to happen more and more in other countries too. This will without a doubt injure political stability and demonstrably influence investor behaviour.

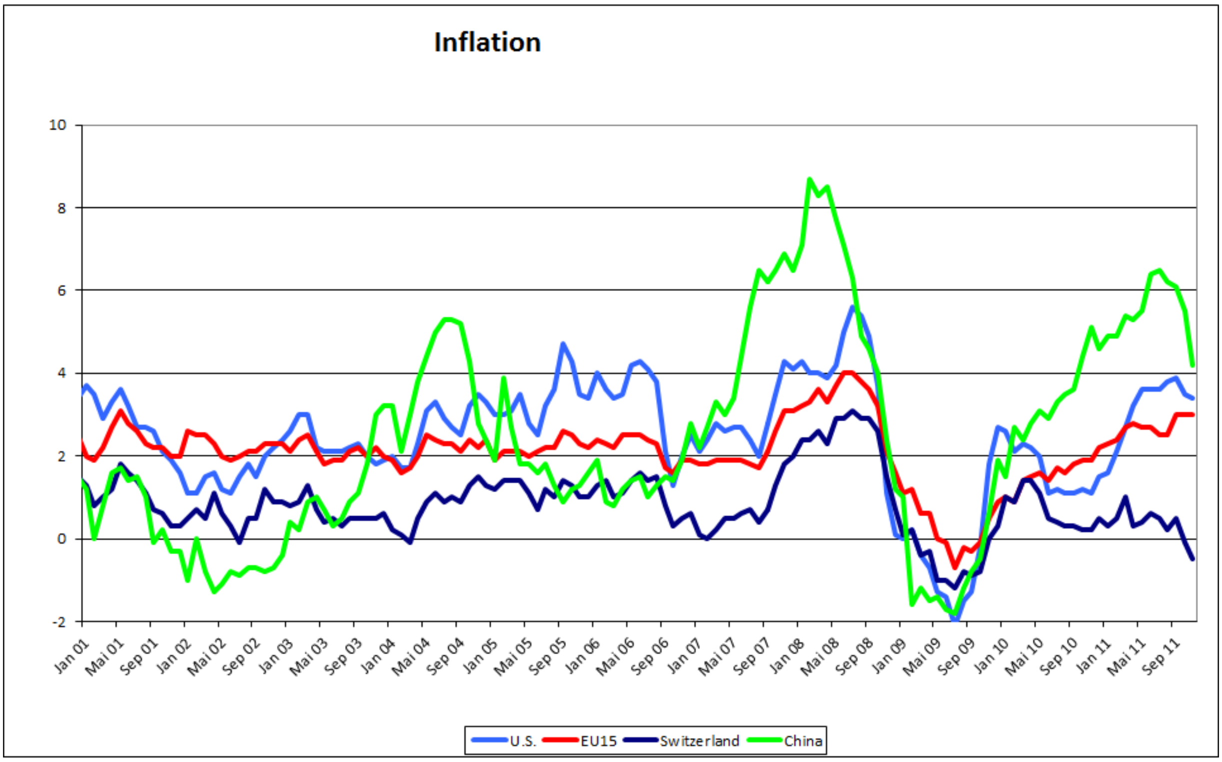
Economic uncertainty is persisting
In most countries the mix of economic policy means that fiscal policy must initiate spending cuts while monetary policy is more or less responsible for stabilising the economy. This is particularly true for the US and the UK, while spending cuts take centre stage in the Eurozone but monetary policy only hesitantly follows economic reality. Due to their healthy levels of sovereign debt, China and Brazil have little need for spending cuts but still follow a strict monetary policy of fighting inflation.
Given these constellations it is likely that the US will see moderate growth. The fiscal braking effect remains modest and the money tap is fully opened, but consumers will continue the process of reducing their debts. The current leading economic indicators also leave room for some optimism. Europe is likely to plunge into a recession - at least in the short term - as fiscal savings measures become visible, while the slightly stronger monetary support will only take effect later in the year. As key interest rates were reduced again in two steps to 1% at the end of 2011, another reduction to 0.5% in the course of 2012 is quite possible. Inflation can be expected to ease somewhat in the emerging markets, which will leave room for stabilising or promoting growth by way of interest rate cuts. As economic development in the industrialised world is unsteady, economic development in the emerging markets is also quite uncertain.



The above graph shows the intended reduction in the structural budget deficits in 2012 compared to 2010 (blue bar) and the real money market rates as an indicator for the tightness of monetary policy (red bar).

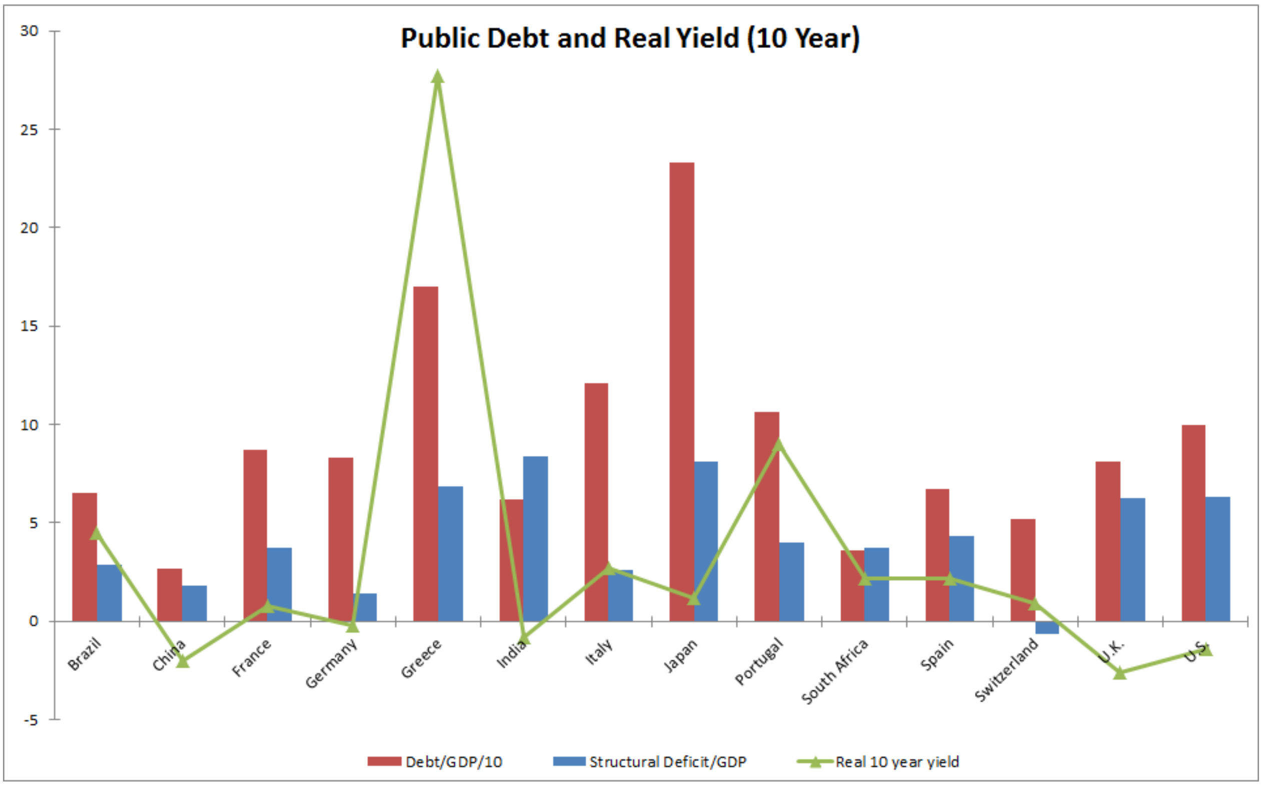
No inflation in spite of open money floodgates

Although the acceleration of inflation predicted by many pundits was much less dramatic than feared, inflation temporarily reached unwelcome levels in the wake of the economic recovery from the real estate crisis in the three most important economic blocs (see graph below). This is to a large extent the result of rising prices for raw materials, whose effect on inflation figures is now gradually tapering off. The economic parameters are also supporting a slowdown in the inflationary trend in these blocs. In spite of the massive liquidity injections by the central banks, in particular in the US, the much feared inflation spiral is not really taking effect. There are several factors that contribute to an explanation. The targeted purchases of US government bonds by the Fed contributed to inflationary pricing, at least in this investment segment. Much of the liquidity also remains in the banking system and never finds its way to the real economy. This is related to the increase in risk aversion and the banks' need for greater capital resources (deleveraging). Companies also reported record earnings and built up better-than-average liquidity reserves. In addition, smaller companies that rely on traditional bank loans are running aground on the banks' risk aversion. To avoid a credit crunch the European Central Bank initiated unusual measures by providing unrestricted funds to the commercial banks for three years.



Although the monetary conditions for high inflation are met, the threat of inflation will only become serious when the money and financial markets have returned to normal and the real economy is on a solid expansionary course. It can only be hoped that the central banks will then be able to reverse their current policy in a suitable manner and in good time. We cannot yet foresee when this will be, but it could become an issue in 2012 if the economy should develop better than expected.

Risk-premium game on the capital markets?
In terms of yield, US, Canadian, German, UK, Japanese and Swiss government bonds have reached their lowest point ever. The 30-year bull market expanded in the wake of the financial crisis. Within the Eurozone, however, spreads for government bonds of problem countries widened substantially. After many years of almost no differentiation, the market probably overreacted with some of the spread mark-ups. The following graph shows the debt position of selected countries (gross debt and structural budget deficit measured against gross domestic product) and the real yields. In a similar inflationary environment it can generally be assumed that the better the debt position of a country, the lower the interest rates will be. A comparison between the Anglo-Saxon countries, where real interest rates are in negative territory, and Spain and France, for example, shows that reality deviates considerably from this principle.

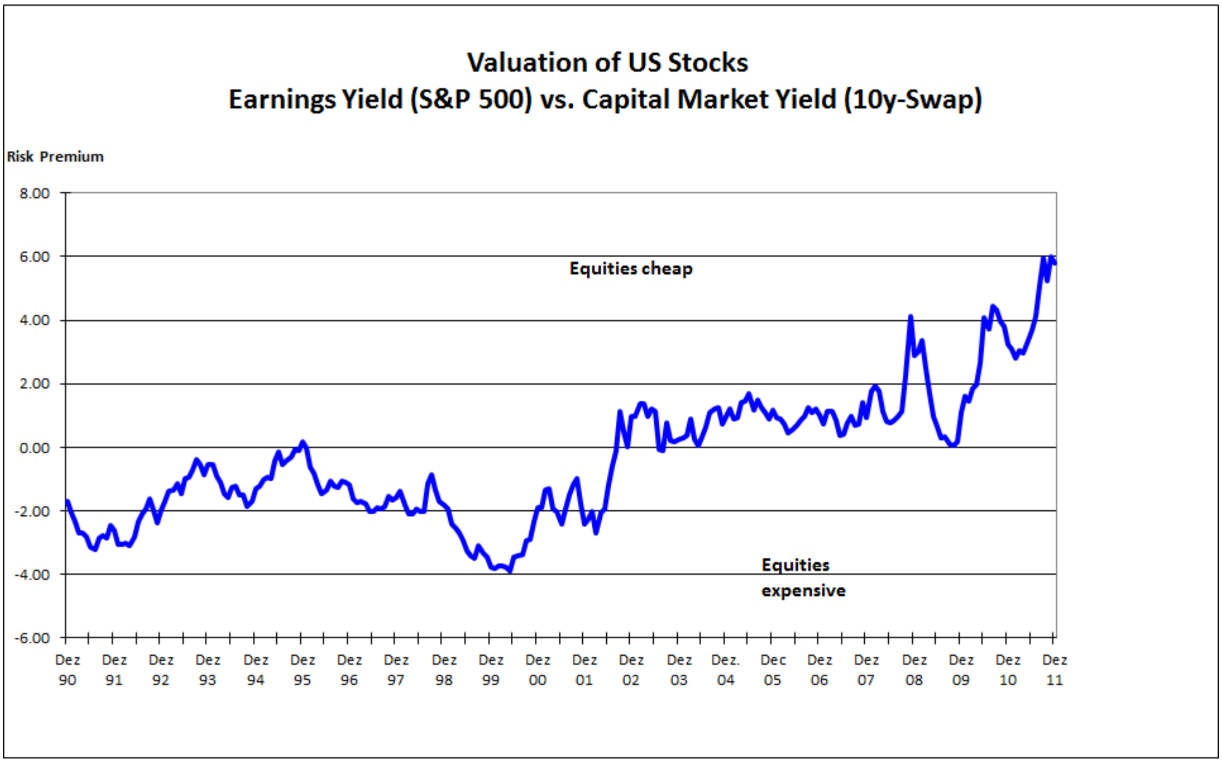


Unsurprisingly the risk premiums for private borrowers have increased a little again and are mostly above the long-term average. This situation is unlikely to change much while economic uncertainty persists and shapes investor behaviour. Like the public sector, the yield for private borrowers with a good credit rating is very low.

The strong currencies are fighting their own strength
At the end of 2011, the most important currency relations were quoted close to purchasing power parity values. The notable exception is the Australian dollar which is considerably overvalued due to the relatively high interest rates in Australia. Given the marked economic uncertainty, practically all countries would prefer a weak currency. The exception would be China, which can be expected to maintain its policy of steadily up valuating the renminbi. The structural weakness of the US dollar combined with practically unchanged low interest rates imply that the US currency will generally be under downward pressure. Positive impetus can only be expected from improved economic perspectives.

We assume in all probability that there will not be any euro collapse. There is no legal and organisational framework for a split and it is almost impossible to estimate the costs for countries to leave and for those remaining. But it can be assumed that the amount needed to stabilise the currency zone would be much lower. The political process for saving the euro must, however, be expected to remain slow, so that the European Central Bank will have to increasingly intervene in the bond market. The actual convergence of European and US monetary policy would calm market players and thus strengthen the euro.
With these parameters, traditionally strong currencies such as the Japanese yen and the Swiss franc will continue to be under upward pressure in 2012. Japan will therefore continue to try and manage its currency by occasionally intervening in the foreign exchange market. By defining a lower limit of 1.20 to the euro, the Swiss National Bank (SNB) introduced a new policy. If developments in the Eurozone should be positive, the target could be increased to 1.25 or 1.30, and in a best-case scenario this exchange rate policy would become obsolete. If the trend should be negative, this could lead to purchases of countless billions of euros by the SNB.

Equity markets caught up in the swirling vortex of the economic storm
According to Bloomberg the consensus estimates for earnings in 2012 of all important market indices are positive. The quite considerable risk aversion of investors means that equity markets are valued very interestingly in a historic comparison. The S&P 500 index boasts a risk premium of around 6% (earnings yield compared to yield in the capital market), which is high in absolute terms and has never been reached in the last 20 years.



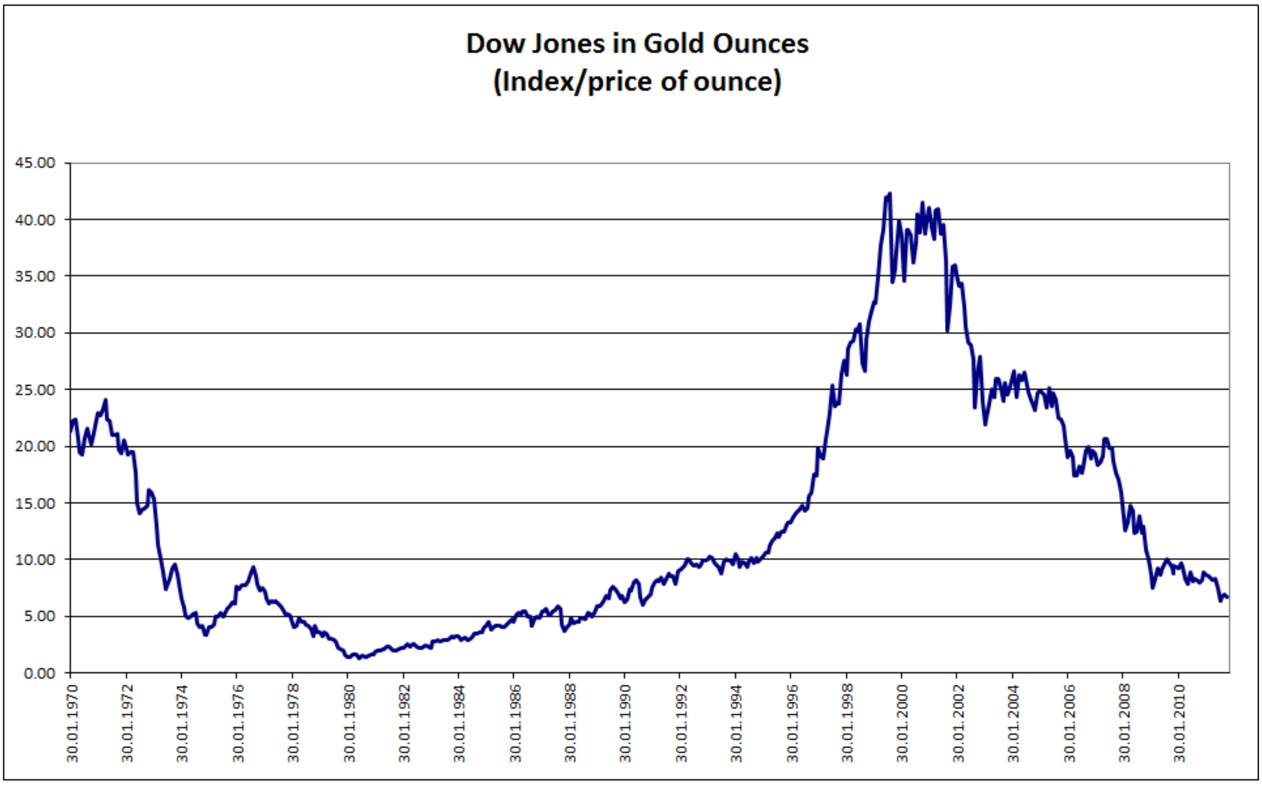
The "normalisation process" of the risk premium over the course of the 11-year bear market has presumably reached a phase of exaggeration. The uncertain macroeconomic environment will have a decisive effect on the US and thus most other equity markets in spite of impressive earnings trends. The darkening of the European economy in the first half of the year is likely to again emphasise concerns about its global impact and send equity markets south.

The economic background should lighten during the rest of the year, which will give the equity markets the opportunity to realise their attractive valuation potential. This process will trigger a rather strong sector rotation so that cyclical stocks will end up being the relative winners.

Whether this will introduce a new and longer upward market trend as predicted by certain market technicians remains to be seen in view of the manifold problems plaguing the global economy (climate, migration, population growth, resource scarcity, etc.).

Investment strategy – caution instead of recklessness
It is very obvious that it did not pay for investors to be risk tolerant in the past year, quite the opposite, in fact. It should be feared that the risk aversion of international investors will continue for some time still. It is therefore advisable to structure the investment portfolio with caution. Preserving the value of the portfolio should sometimes be more important than pursuing return targets. The risk of such an investment strategy is that the investor cannot fully participate in any unexpected rise in the value of equities and commodity investments, but this is quite acceptable under the assumed circumstances. If the risk assessment should change fundamentally, the component of real assets should be increased. The following individual arguments apply:

- Although the money market does not bring any income, the value of an investment can be maintained with this asset class, specifically also for funds that at a suitable point in time should be transferred to more risky investments. Money market investments should as a matter of principle be held in local currency to achieve the objectives. This specifically means that the interest rate advantages enjoyed by other currencies should be ignored. The credit ratings of the banks where the funds are invested should also constantly be monitored.
- High-quality bonds offer modest interest income and overvalued government bonds carry the risk of price losses once risk aversion eases a little. Attractive returns can only be earned with bonds with a lower effective or presumed credit rating. High yield bonds (not including junk bonds) should do well if US government bonds should come under pressure. Bonds issued by European governments with a considerable spread to German government bonds would have upward potential if the Eurozone crisis should de-escalate. Spain's debt position is considerably better than those of the US, the UK or France, but the market is demanding substantially higher interest rates. A reduction in the risk premium for Portugal and Italy is also expected, but the high refinancing requirements in the first half of 2012 are poised over these markets like the sword of Damocles. In any case, managing the bond portfolio will be a challenge. This specifically also includes monitoring the credit ratings.
- In terms of valuation equities are considerably more attractive than bonds, but they are less popular in uncertain times. As this situation could persist for a while still it is a good idea to hold a lower than average component of equities in the portfolio. Equities with good dividend returns, a solid business model and geographically diverse sales area should take centre stage. Given the recessionary trend in Europe, caution should be exercised as regards companies focusing solely on Europe. The same applies to bank stocks, as increased capital adequacy requirements and a flood of new regulations are putting pressure on the banks' margins. As a general rule, a buy and hold strategy is unlikely to be very successful in this environment.
- Commodities are generally sensitive to economic cycles. Energy carriers and industrial metals are therefore unlikely to be interesting from a cyclical viewpoint, but doubtless harbour some long-term potential. The dramatic increase in agricultural prices came to a standstill in spring 2011 and the price bubble has since lost a lot of air. As a result, investments in soft commodities could gradually become more interesting again. Precious metals, in particular gold, are known to enjoy strong but also changeable investor interest. This safe harbour in times of crisis is then also susceptible to bubbles. In relative terms the value of the Dow Jones index more or less equals the value of 6 fine ounces of gold (see graph below).



When the equity markets were at their zenith around the turn of the century, the index value equalled more than 40 fine ounces. If the global risk scenario should improve, the gold price is likely to come under pressure for as long as there is no threat of inflation. The gold component of the portfolio should therefore gradually be reduced to the minimum.

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Wyss & Partner
Asset Management and Investment Counseling AG