“Favour stocks over bonds!”

In an interview with ‘Finanz und Wirtschaft’, Switzerland’s leading financial paper, Dr. Martin Jetzer, Bellecapital’s Chief Investment Strategist communicates his views on markets and the outlook for 2011.

Q: *Mr. Jetzer, equity investors suffered a setback this week with Ireland and Korea casting a cloud over markets. Can we still expect an end-year-rally?*

A: Yes, the rally is already under way. Despite Ireland and Korea the upward trend is unlikely to come to a standstill. As long as bailout packages are granted and ongoing growth is predicted stock markets will applaud, especially since the worldwide glut of money silenced all those who, until very recently, had cautioned investors against a double dip scenario, an exit strategy and a hard landing in China. Many investors checking their portfolios are realising that they have plenty of fixed income investments but not enough stocks. Favour stocks over bonds!

Q: *But Europe’s debt crisis is an ongoing issue. Is another domino dice about to fall?*

A: As investors we remain extremely cautious over Europe. The Irish banks are not the only ones facing structural problems, nor is Greece the only country struggling under the burden of unbearably high sovereign debts. One thing is clear: The stringent fiscal austerity measures implemented by the governments of all EU economies will slow economic activity and with it lower the tax revenues so desperately needed. It is a vicious cycle that is likely to claim other victims...

Q: *What are you referring to and where do you locate the source of the problem?*

A: The European debt crisis is a crisis of the welfare state. Not only the banks underestimated the risks they took, so did politicians. In 2012 at the latest, we will come to realise that all the financial aid granted is insufficient and that the European banks are far more stressed than the most recent stress test has shown. I am not at all convinced that sovereign defaults can be prevented. Indeed, one of the big European countries could be the next domino. Not only Portugal but also Spain is at risk. Investors should insist on getting a high risk premium even from the best EU debtor, including Germany. Top-rated debt instruments can be riskier than the bonds of a country being supported by a bailout package.

Q: *How much at risk is the Euro, if not now how about later?*

A: Tightening the belt is the word of the hour as evidenced by cuts in social welfare spending, tax raises and the widening of the tax basis. There is much more ahead. Still, I doubt that countries such as Greece or Ireland will ever be in the position to repay their debt. No wonder that credit spreads have risen sharply. However, foreign exchange markets remained calm – a good sign and not at all surprising. Contrary to the national budgets of many countries the Euro is professionally managed by the European Central Bank. As an investor I am much less worried about the European monetary system than about the exchange rate. The Euro is part of the solution, not the problem. Medium-term it is likely to depreciate against most major currencies with exception of the yen.

Q: *With Europe and its challenges in mind - what are your measures of precaution in the investment strategy?*

A: The single currency notwithstanding investors are being forced by circumstances to distinguish carefully between countries at risk and those few who may even benefit from the turmoil. Capital markets have become hypersensitive to country-specific differences in fundamentals and risks. Not only stock picking helps limit risk, country picking as well. We readily invest in Germany, Scandinavia and Switzerland but only with much hesitation elsewhere in Europe. However, we are staying away from banks, including German banks. The banking crisis is far from over. Last but not least, investors should hold a large amount of cash not least because, due to deflationary pressure, the purchasing power of cash has been unusually stable.

Q: *Globally, there is talk about competitive devaluation leading to a currency war. What impact does this have on the Swiss franc and the Swiss economy?*

A: I only partially agree with the scenario of competitive devaluation. An exchange rate can not so easily be manipulated in a free market. If so, there are inevitable unpleasant side effects. China is a case in point. Dollar purchases to prevent China's currency from rising boost inflation. Eventually, this depresses the country's competitiveness even more than a currency revaluation.

As for Switzerland, thanks to the high external value of the Swiss franc we are actually better off and not worse! Despite export dependence and a strong Swiss franc Switzerland has done exceptionally well since the 2007 boom. Today's exchange rate level may require some adjustments but from an economic point of view it will hardly cause a deceleration of growth. Other factors are more important.

Q: *What do you expect to be the biggest risk for investors in 2011?*

A: The worst would be a crash of government bonds. It could be triggered by an unexpected tightening of the US monetary policy in response to the economy gathering strength and rising inflation concerns. Another possibility: Beijing might decide taking action against an overheating of the economy, its real estate bubble and accelerating inflation by ending their dollar purchases and letting the RNB appreciate as the Swiss National Bank did in the early 1970's with the Swiss franc for the same reasons. China's demand for US Treasuries would slow dramatically and probably boost US bond yields.

Q: *How should an investor narrow that risk?*

A: Ideally by holding lots of cash and favouring stocks over bonds. And if an investor holds bonds he should go for short-term paper rather than long-term durations.

Q: *Times of economic upheaval also offer opportunities. Can you name some of them?*

A: This week brought good news with surprisingly robust economic data from the USA and Germany as well as good results from US technology companies. This is where our focus has now been for two years. I would still recommend investing on weakness in US stocks with an emphasis on the technology sector. The capital goods cycle is in its early stage and backlog demand is substantial. Germany is economically on the upswing – also in 2011 – and not despite but because of the impact of the debt crisis. German companies paying out attractive dividends are among the most interesting in Europe. We recommend combining cyclical stocks with defensive stocks. The latter offer a higher return than debt securities with-out adding significantly more risk to the portfolio. High dividend yields can be found in European telecom and pharma stocks, e.g. Swisscom and Roche in Switzerland.

***Q:** What performance can equity investors expect in the New Year?*

A: 2011 should, in my judgement, provide healthy though unspectacular performance to the tune of 5 to 7% for globally diversified portfolios. Moderately rising interest rates shouldn't have a negative impact on stock markets in an early phase of the economic and interest rate cycles, particularly because interest rates are likely to remain historically low for quite some time. A bond market crash is a risk but not part of our scenario.

***Q:** What is your strategy for the stock picking and what are your favourites?*

A: We do not aim to identify the "best" companies but to create a diversified portfolio of well managed successful firms that promise to increase their market share in their respective industries. The combination is key to long-term success not the selection. Switzerland offers a wide range of globally positioned leading companies but unfortunately only a few domestic companies to invest in. We can neither invest in Coop nor in Migros, the big Swiss retailers. Our favourites are Nestlé, Novartis, Zurich Financial Services, ABB, Swatch Group, Galencia, Mobilezone, Sulzer and BKW.

***Q:** And abroad?*

A: As mentioned, in Europe we go for high yielding stocks including Telefónica, Vodafone and Royal Dutch, or stocks of companies likely to profit from the upcoming global infrastructure boom such as Siemens, Nokia and Schneider. In North America we are invested in the big gold mining ETFs and in mining stocks such as Silver Wheaton but our emphasis is on technology, amongst others Microsoft, Qualcomm and after the sharp correction Cisco. Asia is attractive with Hutchinson, Samsung or China Mobile and our biggest position in Vietnam – Vinaland, a closed-end fund. In Japan we have only recently begun to look out for lost jewels, so far our candidates are Canon, Nomura, Komatsu and Kyocera.

***Q:** Are there other investments which should be added to a portfolio, e.g. precious metals, commodities?*

A: Careful with commodities! Some have become very expensive such as copper and sugar. We do not speculate in commodities preferring to invest in commodity stocks such as BHP. As for gold, also a commodity, it is increasingly viewed and traded as a hard currency. Gold and, in much smaller quantities, silver belong into every portfolio together with shares of gold miners which are generally better values than the yellow metal.

(FuW No.93/November 27, 2010)