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Neglecting the "F" factor

bergsicht

CHAPTER 1

Cheering the villain?

There has been a lot of talk recently about an impending reversal of interest rate policy. With equity prices having enjoyed an untroubled and fairly constant upward trajectory on most of the world's trading floors for more than seven months now, a sense of unease has been casting a pall over the financial markets over the last few days and weeks. While it is ostensibly external events – such as the street battles in Istanbul or yet another of Japanese prime minister Abe's notoriously vacuous speeches – that have caused prices to plummet, these episodes clearly conceal a deeper and more widespread concern among market participants that the age of cheap money – *de facto* free cash – might be drawing to a close. Yields on long-term bonds are looking up in places; here and there, inflation is turning out a little higher than anticipated or hoped. And, as ever when the price of money is involved, the financial markets have lapsed into antagonistic mode, with any negative economic news (such as higher unemployment figures in the USA) being greeted with an enthusiastic round of applause; such announcements imply a continuation of current monetary policy, after all. They are also music to the ears of the bond markets (which vaguely follows, as ongoing loose monetary policy means bond prices are not – yet – threatened). Then, there are the equity markets; such announcements are of course welcome news here too, as continuation of the *status quo* preserves the circumstances in which shares are relatively more attractive than bonds. For now, at least.

When bad news – and deteriorating employment figures are anything but glad tidings – evinces such a positive reaction on the markets, it is time to pause and take stock; such a contradiction cannot possibly last. Inevitably, a time will come when positive news is greeted positively on the equity markets and gloomy prospects are reflected in lower prices. In other words, a time when real-world conditions triumph over artificially orchestrated distortions. Those entrusted with managing wealth face a major secular challenge: a paradigm shift is looming on the horizon and its consequences will be radical and far-reaching. Rock-bottom interest rate policies, excessive sovereign (and in some cases, household) debt, undercapitalised banks, absurdly inflated executive pay, distorted risk premia, bloated central bank balance sheets – sooner or later, people will realise that the emperor has no clothes. The question is not *whether* the paradigm shift will come, nor even – for those that have the time – when it will materialise; we should instead be asking ourselves *what precautions* we should be taking, and the purpose of this commentary is to do just that. Our exploration will involve establishing a few fundamental principles, and a few basics on real economic conditions are first on the list. We shall then outline two or three key aspects of monetary and fiscal policy, before seeking to address the crucial question of why a policy of ultra-cheap money might be unsustainable, i.e. why it engenders well-below-average growth and is thus bound to run out of steam.

We conclude with some thoughts on how best to negotiate the advent of this paradigm shift, with its attendant anxieties and uncertainties.

CHAPTER 2

Deflationary forces at work

Let's briefly rewind to the period before 1989. *Mundus est omnis divisus in partes tres*: there was the highly industrialised West, bursting with economic vitality; there was the Communist-aligned East, circling the drain towards oblivion; and there were the developing countries and emerging markets, professing allegiance to neither *bloc* but often inclining politically towards the East in order to exert some influence on the wealthy West. Due to global trade embargoes – and despite (or perhaps because of?) development aid – they were all as poor as church mice, with no real hope of any improvement. The vast expanse of China, a somnolent giant, was just awakening from its artificially induced coma.

And then everything changed. We witnessed a miracle of global history, the bloodless implosion of the Soviet Union and its allies in the Warsaw Pact and Comecon, the "Council for Mutual Economic Assistance". The world began to shape itself anew, with land and labour – two essential production factors, besides capital – multiplying on a planet that had now melded into a single economic system. With unparalleled speed, production of many goods streamed from the West to these newly interpolated corners of the world, much as floodwater flows to fill a new reservoir, and a new division of labour between the various regions of the world was established in next to no time – production of low value-added goods in the New East, assembly of high value-added (and know-how-intensive) finished goods in the Old West, where the constituent economies were becoming increasingly service-based.

In the course of this development, Western consumers benefited from substantially lower prices for everyday goods, with shirts, trousers, blouses, socks (and plenty more besides) all becoming consumables. The boon of cheap products of ever improving quality spread like wildfire through the entire consumer goods sector: cameras, mobile phones, televisions and radios are now pretty much exclusively of "eastern" provenance, and anyone familiar with the consumer goods sector will know that, for years now, there has been an almost limitless supply of manufacturers undercutting each other and driving prices into the bargain basement. Thanks to Western know-how and machinery, it has been possible to massively enhance production in emerging countries, and even highly complex goods such as cars – and, to an ever greater extent, capital goods as well – can now stand comparison with Western merchandise.

"An almost limitless supply of manufacturers undercutting each other" – and with near-equivalent quality standards? Whatever monetary policy stance is chosen, inflation is out of the question under such circumstances! The links between monetary policy and the price of goods have fallen away in the wake of real-world changes over the last 20 years. Frankly, the central banks could have done as they pleased and there still wouldn't have been a cat's chance in hell of consumer goods inflation taking hold. This extraordinary situation unfolding around us is what economists call an "exogenous shock", and the exceptional thing about this particular shock is that is has persisted for some 20 years.

And then there is technological progress, which has continually – and almost simultaneously – contributed additional deflationary pressure. At the turn of the 1990s, only a handful of inquisitive tech freaks possessed a mobile phone, and the internet was still no more than a twinkle in its creator's eye. The PC had only just got through its teething phase and mighty standards such as MS-DOS were still carving out a niche for themselves (the thoughts of only a tiny minority were straying in the direction of "freeware" or "open source" technology). No one was yet dreaming of transmitters and receivers providing continent-spanning, virtually blanket coverage for telephony and data.

We have since become fully accustomed to the technological Great Leap Forward and make use of all these newly created possibilities without a second thought. Such technologies are spawning new opportunities, facilitating new business models and enabling innovative start-ups (some of these will also disappear beneath the waves, of course). Every sector of society, from clubs and associations to unions (yea, even unto the churches), is adapting its "business" model to these new realities. And here too, we are caught in the middle of an exogenous shock, and it too has lasted 20 years. As *information and transaction costs* have fallen or been eliminated, technological progress has equally become a source of deflationary pressure. Intermediaries are being sidelined even as others with lower cost structures come to the fore; suppliers that nobody had even heard of until recently are establishing themselves as market leaders.

In addition to globalisation and the technological Great Leap Forward, a third long-term shock with deflationary consequences should be mentioned: the socialisation of knowledge. State-of-the-art expertise, e'er a pearl of great price jealously guarded by Western universities and companies in a distinctly cartel-like manner, now floods across the entire world like rain upon the mown grass, like showers that water the earth. The billions of young people living in emerging and developing countries that are thirsting for knowledge now have access to learning at an affordable price – and they are jumping at the chance! Manufacturers in emerging markets (who don't give a fig about the intellectual property rights of Western firms) are thus beginning to apply cost pressure to the erstwhile exclusive guardians of know-how in the West.

In short, the proliferation of capacity in land and labour as production factors, the reduction – indeed, partial elimination – of information and transaction costs, and the dismantling of knowledge cartels have tipped the Western world into a state of ongoing

deflation. Around the globe there is surplus capacity (an "output gap") in almost every sector. At the end of the day, however, is this such a ghastly prospect? Is deflation induced by world events or technology a bad thing *per se*? Certainly not; anything but – cheaper goods for all and greater participation of the previously disadvantaged betoken an increase in prosperity across the board. Even for the relative losers – us spoilt Westerners – such a turn of events should not be a negative development. Unless, that is, you happen to be in debt.

CHAPTER 3

Debt – the heart of the problem

If things are getting cheaper, earning (or owning) less in nominal terms should not be problematic; in real terms, you are just as wealthy as ever – indeed, lower prices might even mean you can afford more things. However, lurking within the process of deflation lies the danger that people might refrain from consumption for a certain period of time, as there is a general expectation that, either tomorrow or the day after, everything will get cheaper still. This can result in something like a deflationary spiral, so the argument goes, and the manifest notion of wishing to prevent such a deflationary glissade has given rise to macroeconomic steering models such as that contrived by John Maynard Keynes (1883–1946). Keynes believed sagging demand caused by deflationary developments could best be offset via public works programmes (and the latter's stabilising effects on consumers' incomes and general financial wellbeing). "Maintaining consumption" is the watchword of Keynesianism, and the two levers to bring this about are fiscal activity and monetary generosity, i.e. lower interest rates.

Keynes assumed that the public sector would put money aside during the good times – fixing the roof while the sun was shining, as it were – so that it would have sufficient financial leeway when the going got tough. Keynesianism is an archetypal countercyclical macroeconomic system; when the general population is inclined to save, the state should do the opposite. In this respect, the model is idealistic or, if you wish, ideological; it posits a wise state with shrewd, selfless superintendents – a somewhat bold assumption. Keynes' paradigm does not cater for a scenario in which a state plunges into crisis when already up to its ears in debt.

And this is precisely the problem. As debts are nominal variables and have to be paid back in their original amount, the presence of *large debts* at the outset of a crisis will have a *negative anticipatory effect*. The population suspects, or knows for sure, that the public sector has only minimal financial latitude, and that this latitude can be expected to shrink still further – fiscal activity has to be financed and, as tax hikes are practically out of the question in such economically precarious times, treasuries have no choice but to increase public debt. This burden is increasingly perceived as a Sword of Damocles hanging over the heads of the current generation, and possibly generations to come as well. (It is no coincidence that buzz phrases like "fiscal child abuse" are doing the rounds…). The vague presentiment that nation states will sooner or later have to clean up their act inevitably curbs any enthusiasm to strive towards greater prosperity through employment or other undertakings.

We estimate the negative economic effects of significant pre-crisis debt to be greater than any potentially positive consequences of fiscal and monetary Keynesianism. Those claiming that all of the people can be fooled and that no anticipatory fears of expropriation are guiding public sentiment can of course go on demanding more and more fiscal programmes, as the Nobel laureate Paul Krugman does with great verve. Krugman is forgetting (or deliberately ignoring) what we will call the "F" factor, with "F" standing for "freedom". For now, let's take "freedom" to mean being unencumbered by fear of future expropriatory measures. We shall revisit this notion and add a second dimension to the "F" factor in due course.

Let's first explain the concept of "fiscal activity" and its relationship to sovereign debt, as it would be precipitous, indeed quite incorrect, to demonise state undertakings and potential debt as such; only voodoo liberals go that far. Indeed, a coercive, public financing mechanism is the obvious choice for plenty of public goods and projects whose consumption is collective by nature. Furthermore, some public goods and works are so expensive and take so long to realise that financing them via the current account makes no sense at all. A state may cheerfully rack up debts for investments in Herculean infrastructural projects, provided these are prudent enterprises promising benefits for the public in the foreseeable future, and provided that they can be prematurely aborted if this turns out not to be the case.

In other words, there can be no discussion of fiscal activism and debt without a qualitative assessment of *how* the public sector conducts itself; we refer readers to the comprehensive elucidation of this topic by American economists Kenneth Arrow and Mordecai Kurz (K. J. Arrow & M. Kurz) in *Public Investment, the Rate of Return, and Optimal Fiscal Policy* (Johns Hopkins, 1970). We suspect that the principal problem underlying the current economic situation is a function not so much of the indebtedness of Western countries but of the circumstance that vast amounts of money have been spent on projects whose positive effects have already been used up and exhausted, i.e. that these resources have merely been redistributed. Transfer payments are certainly part and parcel of a state's responsibilities, but they are not projects with future impact in the sense described by Arrow & Kurz; they are simply ongoing attempts to cope with a structural problem in society. Redistribution is a consumption-based state activity and, strictly speaking, does not even form part of fiscal activity according to Keynes; by its very nature, it should be an extraordinary occurrence rather than an ongoing process! It is even worse, of course, if such consumption-based, redistributive activity can no longer be covered by a state's current budget and becomes so copious that

there is barely any wiggle room remaining for genuine investment ventures, merely a shortfall for future generations. "Used up and exhausted" accurately describes the budgets of many Western states at present – significant debts on the liabilities side and little or nothing on the assets side of the ledger.

It should be noted that redistribution does not necessarily have to flow from rich to poor; a good portion of Western nations' current debt pile may be attributable to the bailout of the banking system following the 2008/9 financial crisis – a move that benefited a system that is now likewise exposed to deflationary pressure. The nominal debt remains on the states' books. Apart from the fact that these bailout manoeuvres have (at great cost to the public purse) kept the system stable and maintained overcapacity, such programmes have had no appreciable effect on the assets side even as they have dumped substantial obligations on the liabilities side; all this is naturally weighing on people's minds.

CHAPTER 4

Low interest rates – an aphrodisiac?

You might well counter that any such frown should be turned upside down, given the many interest rate cuts that have been instigated, benefiting consumers and homeowners in particular and, more generally, taking the sting out of deflationary pressure. Indeed, even high sovereign debt need be no problem, as the liabilities are easily financeable, given such rock-bottom interest rates. What is more, the results speak for themselves: consumption has never completely collapsed in the USA and in some areas has bounced back impressively – even the real estate market, which took a mauling in the financial crisis, has re-stabilised itself. This much is true; statistically, however, it is *also* the case that 7.6% of Americans remain unemployed despite record monetary stimulus (in actual fact, this figure is likely to be well north of 10%). In Europe, which has been pursuing a similar monetary policy, unemployment in resilient countries like Germany stands at 6.8%; in the ailing countries on continent's southern periphery, the figure is well over 20%. Young people's job prospects are grim. The annual growth rate across the Atlantic is barely 2%; in previous post-recession upswings, growth has typically been some 3% higher. Europe has been shrinking in real terms for a year – few would characterise such a performance as an exuberant boom. Responsiveness of economic growth to interest rates is astonishingly low and the aphrodisiac just refuses to kick in.

Astonishing? Hardly. The intellectual focus of many economists on consumption is quite simply misplaced; consumption alone is insufficient to generate an upturn, especially when the investments induced by bolstered or boosted consumption are made not in your own back yard, but at the other end of the world. Who stands to gain if Americans now buy an average of six pairs of jeans per year, rather than two? There may be modified rapture in Bloomingdale's, but joy will be unconfined at the factory in China. Who wins out when a Frenchman buys a Hyundai? The car dealer and importer will have a smile on their face, but the widest grin is reserved for the manufacturer in Korea. Which is by no means intended as a plea for protectionism – it is certainly right that the Koreans should build cars rather than the French if they have a comparative advantage over them. What we mean is that, in the absence of real incentives to invest, there can be no authentic upturn, however low interest rates may go. While fiscal and monetary policy have their uses, they cannot effect an upturn in isolation – the missing link is a readiness to invest (upon one's own responsibility and at one's own risk) and thus to expand the capital stock.

Consumption is for the present, and its brief candle is soon out; investment is for the future, and signals expectation, hope. Consumption can be turned on at the touch of a button, as it were, much as pigs are fed in a pigsty; driven by hunger and gluttony, they grunt and squeak at the trough before sinking into a contented sleep. Investment, by contrast, is not available on tap. It is tied up with the regulatory obstacles that exist in the real world and in particular, it is a matter of *trust in the future* – trust that the investment will pay off, if successful, and that the investor will not be denied that success. It is this element of trust that is conspicuous by its absence on both sides of the Atlantic. This lack of trust is due to perilously high sovereign debt, the implicit knowledge that nation states are powerless to implement genuine, fiscally rational investments, and the ever more brazen propensity of politicians to help themselves to people's property, under one legal pretext or another.

CHAPTER 5

The neglected saver

There is consumption and there is saving. According to economic textbooks and national accounts, saving is delayed consumption; the economic reality is that we are all simultaneously consumers and savers – the decisive factor is *how much* we save or consume. In extreme cases, when we go into debt for consumption, our saving rate is negative. There is normally an at least implicit balance between consumption and saving in any family budget.

"Saving for a rainy day" is of course good advice; but it doesn't tell the whole story. Not every truism hits the nail precisely on the head – saving is more than merely putting money aside. It would be closer to the mark to say that savers are the little brothers of investors. Saving, unlike consumption, is not about the present, it is about the future. Saving is only worthwhile if you can expect to get at least a

small return on what you have saved and that you will not be deprived of your nest egg. Saving (and investing) is connected with the presence of the "F" factor: greater *freedom* of action in the future. More specifically, it has to do with the second dimension of freedom, the freedom to *do* something. Save now and you can go on holiday later. Save now and your children will be able to go to college one day. Save now and you will be able to afford a little home of your own without panicking about mortgage rates or being dependent on first-time buyer schemes. Save now and one day you will be an investor. Save now and one day your children and grandchildren will be investors.

The saver's "F" factor has been increasingly forgotten in recent years. Since 1981, interest rates have been declining in the currencies of the world's major industrialised nations. This initially came about under Federal Reserve Governor Volcker on the back of successful efforts to combat high inflation, and as a result of deregulation of the financial sector under President Reagan. Since Alan Greenspan took office in 1987, the Fed has been pursuing a policy of actively lowering interest rates. We are not blind to the real-world circumstances that rendered the pursuit of loose monetary policy possible, perhaps even sensible and necessary; but here too, there is no such thing as a free lunch. The tab for the monetary policy pursued over the last 25 years has been picked up by savers, and they are still paying to this day. Any return they may have received has consistently diminished, and they are currently receiving nothing at all. Savers have been *systematically discouraged* from saving over the last two-and-a-half decades. The "F" factor – short for the freedom and fun derived from making provisions and taking personal responsibility for one's affairs – has been violated. In the West, expansion of the capital stock has been left playing second fiddle to a monetary policy – and a general approach to life, or so it seems to us – based on the short-sighted fetishization of consumption.

Interest rate cuts have been the default response to one real-world crisis after another, whether in 1998 (Asia/Russia crises), 2001 (9/11), 2002-3 (dotcom bubble) or 2008-9 (real estate and banking crisis); time and again, lowering the cost of borrowing was seen as a panacea. Here too, there is no suggestion that this was necessarily wrong; we are merely stating that there was/is a price to be paid for such a response, as a policy of low interest rates represents a gigantic redistribution of wealth from savers to borrowers. If the central banks continue to pursue "financial repression", i.e. a policy of real negative interest rates (the *ne plus ultra* of low interest rates), savers will witness not only an ongoing decline in returns but also a decline in the real value of the money they have put aside.

This price that will have to be paid for current monetary policy is particularly evident if one looks at the predicament of pension funds, not just in Switzerland but also further afield; many of these are catastrophically under-funded. The result is in-fighting (still mostly behind closed doors) between employers and employees over who should cover the shortfall.

The precarious position of many public pension schemes is particularly concerning. It is only a matter of time before governments fall back on taxpayers in their (long overdue) efforts to restore order on this front, thereby narrowing scope for genuine fiscal investment projects still further.

CHAPTER 6

Feeding the pigs is quite the fashion

We may have used the phrase "expansion of the capital stock" rather casually earlier; it is closely related to the fact that it is proving very difficult indeed to generate any real economic momentum in Japan, the

USA and Europe – despite every effort of fiscal and monetary policy. It is linked to the crucial economic questions of how wealth is actually created, how it is multiplied and how it is best distributed within society. By "capital stock", we mean the sum total of the assets within an economy, i.e. private and public real estate, cars, trains, dams, laptops, office chairs, lathes – basically everything required to get the wheels of production turning, day in, day out. Poor countries have low capital stock, rich countries high; anything that is used up or exhausted – or stands idle – is not part of this giant stock of assets. Capital stock, labour and productivity are mutually dependent.

The capital stock has to be paid for. It may be – as was the case during the Wilhelmine period of industrial expansion and the early 20th century – that a few private individuals do the financing (and go on to pocket the rewards and achieve dubious notoriety in society as corporate tycoons), but a considerably more equitable and socially acceptable route is that the capital stock is expanded by the general public of savers and those making provision for retirement. However, in order for this to happen, the right incentives must be in place; an economic and monetary policy designed to maintain the capital stock should not simply leave savers out in the cold. If there is no upside to saving, if money is no longer kept scarce and is unable to command a price, the incentives are unquestionably wrong. If saving means you are in danger of being cheated of the fruits of your labour, as you face the threat – either direct or indirect – of expropriation through financial repression, you are sooner or later going to give up on doing your bit to expand the capital stock.

It seems to us that the last twenty or thirty years have seen the *zeitgeist* pivoting away from production towards consumption in many societies – and this appears to have occurred in lockstep with the general trend towards lower interest rates. Many of the phenomena that we find disquieting can only be explained through this secular shift in attitudes. It is striking, for example, that virtually no political grouping in Switzerland takes a serious interest in improving conditions for industrial production any longer; the debate largely revolves around how the *existing cake* should be divvied up. Political allegiance is actually of little import here – it all comes down to what majorities can be drummed up to advance redistributive measures. The supposedly rightful legal underpinning for these kinds of moves – not to mention any moral justification – is in any case easily acquired in a media landscape shaped by such a *zeitgeist*.

There is of course a certain logic to all this. Savers who emancipate themselves – give themselves more independence from the system via the "F" factor – are seen as politically suspect. Those thinking along redistributive lines will automatically lean towards wanting to satisfy the consumer, and hence towards dispensing pigswill at the push of a button.

The change in the *zeitgeist* we have described was brought home to us in a particularly memorable way at this year's German Evangelical Church Assembly (1–5 May 2013). According to the organisers, the event saw more than 100,000 of the faithful (and other interested parties) come together in Hamburg under the motto "as much as we need". At first sight, "as much as we need" suggests frugality. Listen a little more carefully, though, and you will soon notice that "need" is also equated with "be entitled to". Much mention was made of buzz phrases like "minimum wage" and "subsistence income", but some topics were conspicuous by their absence: diligence, punctuality, reliability, hard work and productivity – let alone the necessary prerequisite for all this, expansion of the capital stock. It is incredible how far German Protestantism has strayed from Max Weber's melding of Calvinism and capitalism! And it is equally incredible how closely and studiously our neighbours to the north cleave to social models once thought vanquished (models that reserved any accumulation of the capital stock for the collective – a VW Beetle for every little National Socialist, a Trabi for every little East German socialist, as much as we need...

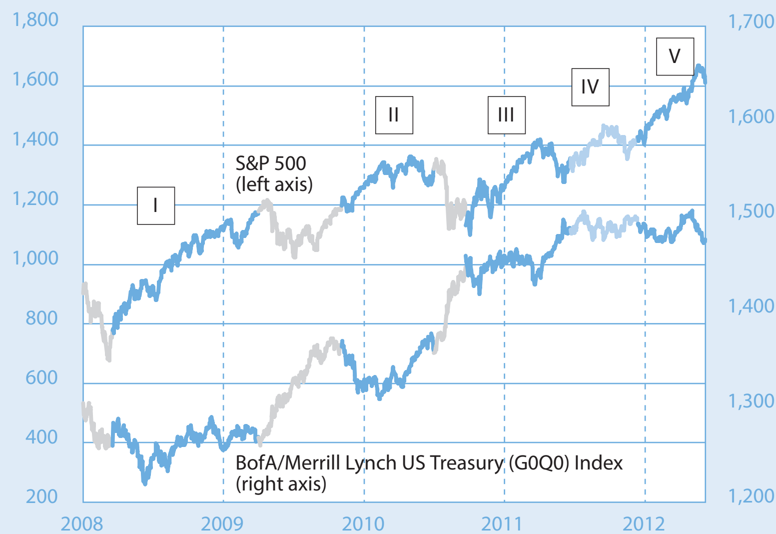
CHAPTER 7

Dealing with distortions

Let's now take a step back from the airy heights of debate about the *zeitgeist* and ideological inclinations and return to the rather more practical questions facing savers, whatever the means at their disposal. The situation is (alas!) relatively simple: money has no price. Financial investments generate no return. And given that the currency may be slowly and ineluctably depreciating as well, monetary value is being eroded just as slowly and ineluctably in real terms. The same applies to investments in fixed-income securities: low – extremely low – yield, with no compensation in the offing for the interest rate risk that has been shouldered or for the issuer's credit risk. Bonds have become horribly asymmetrical: yields are negligible and prices can rise no further. If the paradigm shift we have sketched out sets in unannounced, expect a bloodbath.

And what about investments in stocks? Our preference for financial instruments that represent equity capital is well known, and it is based on the knowledge that, as a rule, companies (and hence securitised title in them) have historically withstood heavy weather better than any other instrument. Cash can be debased, devalued or abolished. Bank accounts can be wholly or partially expropriated, or blocked. A currency can come under external pressure. Bondholders may face (partial) expropriation, i.e. be forced to accept a haircut, as in the recent Greece drama. Ownership of gold can be made illegal and the bank vaults in which it is stored can be confiscated. It would not be the first time for any of this. The real substance of equities – a share in ownership of the means of production – is what preserves the intrinsic value of a stock, even when thing turn nasty. The powers-that-be usually shy away from legally sanctioned destruction of the means of production

QE manoeuvres set the mood music



Source: Bloomberg. The grey lines represent periods without monetary policy intervention. The Roman numerals refer to the four QE programmes plus Operation Twist.

(which would invariably also involve the elimination of jobs), even in times of grave crisis.

This notwithstanding, there are several question marks hanging over current equity valuations. Even in normal circumstances (i.e. where there are positive returns on financial investments and bonds), there is a substitution effect between equity investments and fixed-income securities, and the magnitude of the substitution observed and/or its development over time is even used by certain analysts as an indicator of relative price expectations (the so-called "Fed model", which compares the stock market's earnings yield to the yield on government bonds). It is nigh on impossible to estimate with any accuracy how high the additional demand for equities might be when the stock market's earnings yield has reached zero and bond market yields have practically hit the floor, but something akin to a "flight to equities" certainly takes place – a distortion that results in companies' share prices rising way above their intrinsic value.

The chart above shows the parallel development of bond and equity prices over the last five years as a function of monetary policy interventions (confirming the thesis of the "Fed model" that the equity and bond markets are in equilibrium over the long term). The relative decline in demand for bonds resulting from the substitution effect mentioned above was offset by the Fed's "quantitative easing" (QE). It is no secret that approximately half of the total volume of newly issued Treasury Bills will, for the foreseeable future, be bought up by the Fed. Or, to put it another way: under equilibrium conditions, QE is indirectly flowing into the equity market. Cheap money is clearly leading to a distortion (overvaluation) of both the bond and equity markets. Downward corrections are a foregone conclusion, and those who are conspicuously overweight equities but have fixed obligations for a particular point in time would do well to buy themselves some peace of mind – hedging instruments are currently relatively inexpensive.

This aside, we must nonetheless make the following sobering assertion: given that any positive growth generated by the prevailing pseudo-Keynesianism (which neglects the "F" factor) will be too little too late, there is every chance that the ill-starred policy will continue. Indeed, it is quite possible that the financial markets, much like a drug addict, will continue to be swayed more by the sweet, sweet poison of a further hit of liquidity than the gloomy prospects created over the long term by any continuation of current monetary and fiscal policy. But surely sitting this one out and prudently parking one's assets in money market funds or bank accounts (which themselves are not "safe" in any real sense) cannot be the right answer either – so what other options are there?

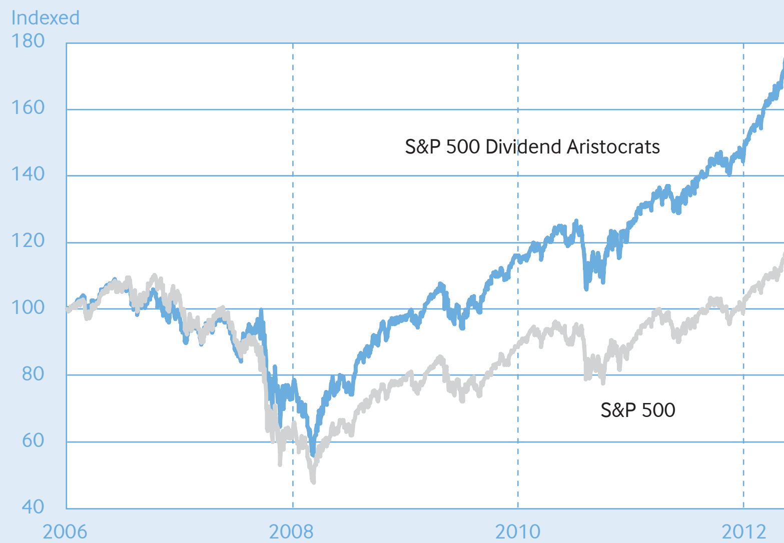
CHAPTER 8

Same old strategy

We return to the good old principle of diversification – which is anyway the only one with any economic justification, as it is not based on superior (or advance) knowledge. The greater the uncertainty associated with any of the following parameters – when exactly the paradigm shift will set in; the desperate acts of (monetary) policymakers drifting into increasingly hot water when the long-promised economic recovery fails to materialise; currency turbulence; anticipated corporate profits; recapitalisation of the banking sector; economic growth in China and the emerging economies – the greater the degree of diversification required.

The fact is, most investment portfolios are woefully under-diversified, so the advice to pursue greater diversification is anything but trivial. We all suffer from a pronounced "home bias", finding Europe (for example), with its 400 million inhabitants, who are being sold a bright future on the back of centralisation and harmonisation, far safer and more attractive than, say, Indonesia, with its 250 million inhabitants, the vast majority of whom are

Dividend stocks in demand



Source: Bloomberg. The S&P Dividend Aristocrats is made up of S&P 500 companies whose dividend payments have increased every year for 25 years.

industriously getting on with expanding the capital stock of their sprawling island homeland. Let's be honest, who among us has invested even 1% of their holdings in Indonesia? The country's share of global GDP is 1.5% and rising.

Current and previous successes should also be considered in any ongoing review to determine whether investments are sufficiently diversified by geography, currency, economic sector and type (fixed-income or ownership interest). So it was sound advice two years ago, for example, to pass over (sovereign) bonds offering no positive yield in favour of equities promising juicy dividend payments. We were naturally not alone in offering this nostrum. And it is precisely the prices of these dividend-rich stocks that have risen disproportionately – an atypical development given that it is generally SMEs that are the bellwethers of better times at the beginning of an upturn. Still, without wishing to give a hostage to fortune, it might not be the worst moment to consider scaling back exposure to dividend stocks; there are plenty of companies around the world into whose shares one could switch – companies where the gap between capitalisation and intrinsic value is far smaller.

One more point should be made – an urgent warning against propaganda. We have talked about distortions and approaches to dealing with the current crisis that are questionable, but which have been – and continue to be – advocated with great conviction; about national finances that are lurching from bad to worse; about interest rates that can fall no further. Everything seems to be reaching its limits, and supposedly only frantic demands for extensions of those limits will help keep the merry-go-round spinning. Such knee-jerk claims are no more and no less than public propaganda – devoid of content, potentially wrong and either wittingly or unwittingly untrue. Anyone reading the papers nowadays or taking their cue from electronic media would do well to keep asking themselves exactly why someone might now be making this or that assertion; unselfish advice has become extremely thin on the ground. Pretty much everything is propaganda these days because pretty much everyone is in trouble.

bergsicht is committed to scepticism. We take nothing at face value and we would put nothing past anyone. We are impressed more by "facts" than by opinions. We believe that this mindset, which questions the veracity of everything, is the best and most sustainable way to add value for savers and investors alike.

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