Optimism alone is not enough

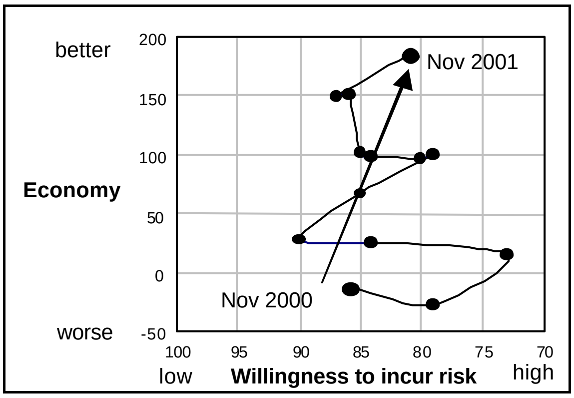
1. Chanting in the catacombs

People are incredibly adaptable! Barely two months ago, the world realized how vulnerable it had become. Only a month and a half ago, the markets were in the doldrums. And only a month ago, some people had serious doubts about an American military success in Afghanistan. Today, they are inclined to see the Afghanistan problem and everything else in a somewhat friendlier light. Tangible facts are mixed up with wishful thinking and psychological repression. Presumably, this reflects one of mankind's particular genetically based capabilities. How else could people have survived millennia of mutual slaughter, treachery, expropriation and expulsion? Apparently, hope can blossom on any level, and already trees are planted, houses are built and children are born again. This is a good thing.

This type of adaptability to new risks can be of a rather peculiar nature. Who would have been understood, say, three months ago, if at the time of an airplane crash, he would have exclaimed: "For heaven's sake, I hope it's only an accident!" An accident, as tragic as it may be for the people involved, since September 11 it has been measured against the much worse alternative of a renewed terrorist attack. The same phenomenon could also be observed in conjunction with the assessment of the second line of terrorism in the USA, the anthrax cases. Soon enough, the relative advantages and disadvantages of anthrax spores emerged. To wit, they are easy to produce and, above all, very durable and thus easy to store, but they have no multiplication mechanism and do not spread out by themselves. Hence, anthrax has been literally written off as the relatively lesser evil, although somebody had tried to contaminate half of the Capitol!

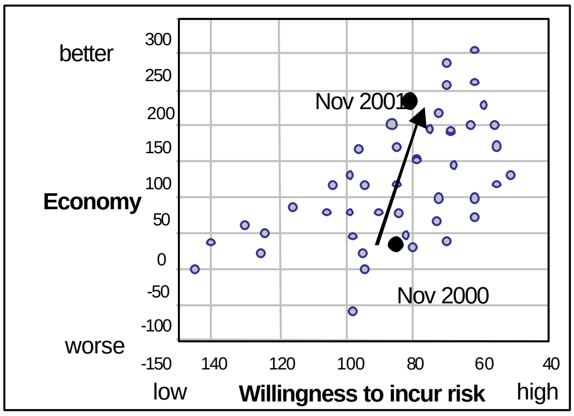
This comparative optimism not only pervades these new facts of the real world but also involves its monetary realm, although the economic data and corporate earnings news have deteriorated further. Today, adverse news seem to encounter *pronounced indifference*. At any rate, they no longer succeed in precipitating the stock market slides experienced prior to September 11. Thus, on the day the mighty collapse of the globally operating American energy trader Enron became reality, both the Dow Jones and Nasdaq closed with leisurely gains of 1.2% and 2.4%, respectively. Surely, the losses of the past 1.5 years have not engendered a real party mood. The equity markets have not attained real breadth as yet, but there is a distinct improvement in sentiment. This is born out by the facts.

With the aim of determining whether the times we live in are "good" or "bad," our bank has been working for some time with an economic indicator which is not based on emotions and polls but on market data. Market data do not constitute opinions expressed (without consequences) by some purchasing managers but are actual prices paid for very concrete financial instruments. The assessment whether economic prospects are generally perceived by the market participants as rather positive or negative arises from the difference between short-term and long-term interest rates (term spread). Higher long-term rates may indicate anticipated faster economic growth (unless the interest rate differential masks inflationary expectations and hence a risk premium for future inflation). The assessment of the investors' "mood" is derived from the appetite for risk as measured by the interest rate differential between low-risk and high-risk bond investments (credit spread). The course of this indicator since November 2000 suggests a substantial improvement in both the economic outlook and sentiment.



Source: Own presentation

On a longer term comparison (ten-year period, quarterly figures), the economic indicator looks entirely encouraging. The upper right quadrant signifies "good times" – positive economic prospects and investors' willingness to assume the risk of investing in this favorable outlook.



Source: Own presentation

The analyses of the typical course of recessions and the behavior of equity markets in such recessions point in the same direction. None of the nine recessions in the United States since World War II lasted longer than three quarters, and in each of the nine downturns, the stock market indices rose by double-digit percentage points. One might happily conclude that history will repeat itself. But will it actually?

We do not wish to nip anybody's optimism in the bud. We only want to know if and when we will actually succeed in sticking our heads out of the catacombs. If so, what would the world look like? What conditions would have to be met to spare the world and its economy new disappointments and threats of recession, crisis and war, perhaps for an extended period? In other words, this is an intermediate term analysis of the situation. We readily join in the short-term chant in the catacombs. Or rather: we are humming it.

2. An atypical recession

A closer look at the nine US recessions since World War II indicates that they all had the same underlying causes to varying degrees: An expansion of the money supply, i.e. a pronounced monetary stimulus, was followed by a booming economy leading to supply shortages and a production capacity close to the limit, resulting in corresponding rates of inflation of goods and wages. The central bank was compelled to throttle the money supply by introducing drastic measures on the interest rate front, drain liquidity from the economy and make the funding of businesses and private individuals considerably more expensive. This was followed by two or three quarters of negative economic growth, during which monetary policy could be eased and interest rates lowered again until the merry-go-round started anew after a while.

During the recessions, the equity markets moved up consistently. This was tantamount to an anticipation of benign economic fundamentals in the wake of the economic decline. It was actually taken for granted that demand could readily be guided by monetary policy. Based on the experiences of the seventies and early eighties, we know quite well that this embodied a grave error, which inter alia shortly led to disappointments on the market and resulted in enormous economic costs.

How did the 2001/2002 recession come about? Quite certainly *not like the nine previous ones.* There was no overheating of business activity, high rates of inflation, restrictive monetary policy and steep nominal interest rates. Rather, the economy (of the USA) for years expanded practically without inflation at a brisk pace of three to five percent. The Fed supplied the system with adequate liquidity. Interest rates surpassed the six percent mark only for a short period and only minimally. The productivity of the American economy rose every year at an impressive rate, time and again allaying fears of an excessive capacity utilization.

This uniquely long and uniquely fast economic growth without inflation was characterized by an equally unique cornucopia of capital expenditures. Capital spending and investing was the name of the game until the year 2000. The

Americans generated this boom not only for themselves, but literally the whole world took part in it. The future of the world economy was perceived to lie almost exclusively in the United States, where most new patents are registered, showing an extremely high degree of innovative strength. As a result, the capital flows in the direction of America assumed enormous proportions. Reflecting this, the US dollar was strong, an inexplicable phenomenon for many analysts.

Today, there can be no doubt that a burgeoning amount of money must have poured into projects that had no prospects whatsoever. We discussed this phenomenon of seemingly irrational over-investing in previous issues. The collapse was unavoidable, leaving behind a heap of rubble with only few elements capable of survival. Interestingly, though, the collapse of investment spending initially did not cause a dramatic upturn in unemployment or a sharp drop in consumer spending, as should have been the case in a "“classical" recession. The bursting of the bubble of the real economy basically occurred in remarkably moderate fashion.

On the other hand, the investors were sharply penalized. On the Nasdaq and the technology oriented bourses of other countries, billions of dollars were destroyed. Contrary to the fears of many analysts, though, the losses in market value did not spark an appreciable downturn of consumer spending. Wall Street’s share in the economic slump probably did not surpass a one-percent shortfall in GDP growth.

The impact of the bursting of the investment bubble on the economy as a whole, then, was not all that severe, but it also explains the difficulty in accomplishing much through monetary policy. The measures that function (perhaps) in a “classical” recession, namely boosting consumer spending by means of low money market rates, certainly do not work in this atypical kind of recession. Capital expenditures are not particularly interest rate sensitive. This is quite plausible, because an investment is either promising or it is not, regardless of interest rates. If an investment has good prospects, the interest expense must be born – almost regardless of the level of interest rates. If the project is not viable, it is dropped, even if the funds bear practically no interest.

In other words, the Fed’s aggressive interest rate reductions this year at best managed to prop up consumer spending. They had no material influence on the resumption of investment activity nor are they going to have any. Capital expenditures are guided primarily by real and structural factors and not by monetary ones. This means that surfacing from this atypical recession will not necessarily happen analogously with the desirable end of a classical economic downturn. It will presumably take place much *more slowly* and, at least initially, more sluggishly than a monetary policy induced brushfire.

3. Obscured by terror shock

The atypically flat and not primarily consumer driven recession has been overshadowed by the shock triggered by the events of September 11, whose impact can now gradually be analyzed. The negative consequences of the shock have mainly affected the otherwise relatively unscathed consumer sector. The adverse effect was quite drastic on all areas that require some kind of transportation, notably tourism, but most especially the (high margin) conference tourism. In the United States as well as worldwide, capacity reductions in aviation are in full swing, in the hotel business, the failures and dismissals are probably imminent. This sector is likely to have the biggest problems with regard to unemployment, because the jobs are largely industry specific, and the level of skill places great demands on retraining programs.

Interestingly, the retail trade in the USA is hardly affected by the terror attacks of September 11 and the anthrax letters that followed. On the contrary, Americans seem to find comfort in dropping in at the nearest shopping mall. Wall Mart and similar chains report good to excellent sales. In view of the great insecurity caused by the terror attacks, the savings rate in the USA has increased only moderately, to about four percent. In our last Commentary of early October, we predicted such a constancy in the habits of the Americans, unless a second wave of severe terror attacks should defeat their confidence in the future. Despite occasional horror stories (anthrax, airplane crash in Queens), this attitude has turned out to be correct too date.

Also assuming no further terror shocks in the next couple of months, we stick to the following model for our forecast: The recession in progress has the shape of a *broad valley* resulting from the collapse of investment spending but without strongly affecting consumption. Its *trough* is the terror related decline in consumer spending and a rather rapid return to normalcy. The idea of such a trough, which has steep banks, does not suggest that the edges of the whole valley should also be regarded as steep. This currently presents the greatest danger in the assessment of the statistics by analysts and markets. The recovery in the second or not later than the third quarter of 2002 will turn out to be appreciably more subdued than it would appear to be on the basis of the current normalizing tendency.

For many corporations, then, the lean stretch will be longer than anticipated. In particular, really substantial earnings gains will have to wait a while. Remember, recessions serve to eliminate excess capacity from the economy, and this process has not ended by any means. The months ahead will confront us with further business failures. The example of Enron, the energy trader, shows that bankruptcies can occur in areas which until quite recently have been deemed as stable, financially sound and virtually investment grade.

This has clear-cut consequences for the formulation of the investment policy for the coming months: It is important to select companies which have relatively *secure earnings* and *ample margins*, as well as sufficient equity to endure an extension of the economic trough. Companies which on account of their indebtedness rather resemble options that have a certain expiration date should be avoided in consideration of a slower than generally anticipated recovery. Time should not play any role in this atypical recession! Moreover, corporate earnings expectations should be kept within bounds. The year 2002 might be tough and partially disappointing. Also, it is conceivable that the markets will treat such disappointments rather harshly, especially if expectations are (unduly) high. High price/earnings ratios, therefore, signal caution.

4. Recession à la Nippon?

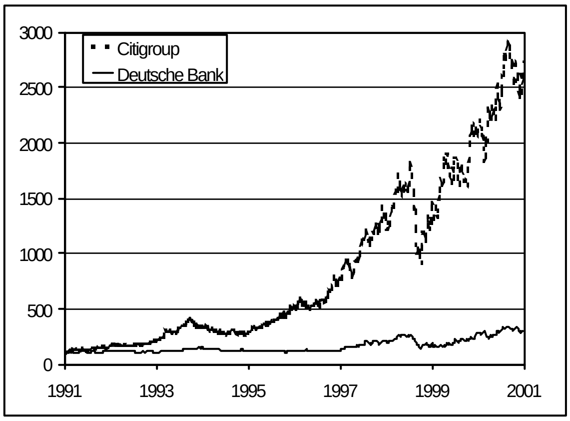
Atypical forms of economic developments are unpopular, because the future course of the economy can not simply be discerned by way of analogous conclusions drawn from past history. Instead, it must be determined by analytical means. It is not surprising that in view of the lack of direct recession "models" from the past, other crises must serve as substitutes. Above all, 1929 and the ensuing period is used frequently for comparison purposes, although the economic framework was entirely different. There was no banking supervision, no derivative markets, etc. Indeed, the American stock market in those days was reigned completely by foreigners, i.e. Europeans, and the economy was largely heavy industry weighted. Today, agile service enterprises dominate the scene. In our opinion, such comparative analysis is not particularly useful. We are trying to understand *today's world*.

Even more popular these days is the comparison with Japan. Because of the very low American money market rates after the September attacks, it is argued that the Fed will soon have "spent all its ammunition," and that there was a danger that, if the US economy still does not bounce back, there were no further stimulants. (This is a somewhat distorted view. To wit, if the medicine does not work today, why on earth should it work better later on?) The comparison of the present situation with that of Japan ten years ago overlooks the huge differences in the economic framework of the two economic blocks. On the one hand, there is a domestically oriented, state capitalist system without a meaningful incentive structure designed to encourage private initiative, let alone entrepreneurial activity. On the other hand, the American system is highly responsive and capable of regenerating quickly with a great deal of self-starting initiative and a virtually breathtaking capability of creating new businesses. The Japanese financial market possesses limited transparency, while America has the world's sole system of funding organized along genuinely capitalist lines. In sum, any comparison is bound to fail owing to the huge structural differences between Japan and America.

But above all, the Japanese banks were already in trouble at the beginning of the 1991 recession, and they still are. Yet, they play a central role in a recession. Based on the Japanese banks' financial condition, there is little or no scope for additional credit extension, and the corporations will not get out of the crisis due to lack of funding. The American banking system in general is completely intact and healthy. In the early nineties, this was not the case. The Savings & Loan debacle, combined with the aftermath of the international debt crisis of the eighties, at the time even pushed a proud institution such as Citibank close to the brink.

If one should insist on making a comparison with Japan, *Germany* would serve as a much more suitable candidate precisely because of the situation of the banking system. There is no doubt that Europe, to a quite similar extent as America but for different reasons, is also sliding into a recession. In Europe, there is no pressing need to clear up the remainder of a technology investment boom, but the old and well known structural problems are at the root of the trouble once again. Europe has scant regenerative power, has been operating far less productively than the USA for a long time, and is holding on to labor market models that nip any structural change in the bud. The European Central Bank is incapable of conducting a monetary policy that is guided by the heavyweights of the Continent.

In a period of flat or declining economic growth, Germany's banking system could turn out to be the country's Achilles heel. This is because a very large proportion of the medium-sized businesses depends almost completely on the banking system for its funding, reflecting the great lack of an efficient capital market. In the past couple of years, however, this banking system has excelled in committing relatively minor but also major *flops*. First, the DG Bank, one of Germany's ten largest institutions, in early 2001 sustained a DEM 2 billion loss. After it combined with GZ Bank, also a cooperative institution, to become DZ Bank, the situation appeared to be salvaged at first. But now there is talk about a new DM one billion hole. Bankgesellschaft Berlin, another large German institution partially government owned, has been ailing for several years. Because of it, a government change took place in Berlin this summer, with the taxpayer having to absorb billions. A short while ago, fate caught up with one of the country's most aristocratic private banks. Unlike Swiss private banks, the German houses engage in the lending business - in the case of SchmidtBank, too permissively so. Reflecting the need for additional write-offs on Consors, its Internet affiliate, the bank is now facing ruin. The German banking system thwarted bankruptcy in order to at least suggest stability one more time.



Source: Bloomberg, own presentation

It goes without saying, however, that the problem lies not only in the failure of individual banking institutions or some maybe a bit reckless new banks. For the most part, the problem is also structural. *The German banks simply do not earn enough*, and when they try to reorganize, they do it in an awkward manner. The mergers of Deutsche Bank with Dresdner Bank and Dresdner Bank with Commerzbank essentially fell through because of senior management's self-interest. Such conduct is miles removed from shareholder value orientation. The above chart shows the comparative stock price performance of Citigroup and Deutsche Bank. In the ten best years of the 20th century, Deutsche Bank returned the investor almost nothing. With Citigroup, however, investors earned 36% annually, on average!

Admittedly, the stock price performance is not necessarily a direct mirror image of the quality of the enterprise. However, a performance that is ten times better in the minds of a consensus of stock market participants looks sufficiently unequivocal to us. Frankfurt is in need of some adjustment. Against this backdrop, emerging from the catacombs of the European recession will probably be much more difficult than in the USA.

5. Delicate unfinished business

Our medium-term forecast is altogether rather subdued. This not only reflects the earlier described peculiarities of the American recession and certain specific structural drawbacks that have concerned us for Europe for years. It is due mainly to the new world situation after the September attacks. Budding optimism or not – the world is involved in a deadly conflict, which in no way is less serious than defeating Nazi

Germany in World War II or the Soviet empire during the Cold War. The events of September 2001 have demonstrated that relatively small but superbly organized and exceedingly determined groups are capable of hurting the world in such a way that it can no longer function. The use of live human beings as weapon platforms was one of the alternatives from the arsenal of the terrorists. Weapons of mass destruction of the A, B or C variety are the logical extension.

The progress in the war in Afghanistan should by no means lead to the conclusion that the matter is settled. Even with the removal of Usama Bin Ladin and a large part of the Al Kaida network, the world will face just the beginning of a big and difficult job. First, there are other and possibly even more dangerous groups in the realm of terror. Current focus is primarily on Iraq and Somalia. Moreover, much more powerful Iran has not as yet proved its innocence with respect to international terrorism.

Additionally, the idea that the problem can be localized – Afghanistan, Iraq, Somalia, Columbia, etc. – is the wrong way of conceptually approaching the heavy new threat to the world. Our strategic thinking is influenced much too strongly by previous conflicts. Localizability was an issue in World War II and perhaps the Cold War. International terror is ubiquitous. Put in another way, the military destruction of certain bases of terror may be a necessary measure but it is not sufficient. The objective should consist of preventing generally and everywhere that individuals or groups can seriously threaten the civilized world. They have proven that they are capable of doing it with the September 11 attack.

The chances that we, i.e. the civilized world, will accomplish this are not very good. The problem lies in the *asymmetry* of power and the vulnerability of attackers and victims. This will have to be at the core of the strategy discussions held in the near future. The biggest conflicts involving war and power politics to date, such as World War I or II, and essentially also the Cold War, took place on the basis of the principle of more or less symmetrical conditions on both sides of the parties to the conflict. Both sides possessed a certain threat potential and a certain measure of own vulnerability. The course of events was basically determined by the ability of the parties to raise their threat potential and minimize their vulnerability. World War II ended because Nazi Germany had completely exhausted its threat potential, could no longer defend itself against air raids and thus became completely vulnerable. In Japan, the first nuclear weapons had to be dropped to cause vulnerability. In the Cold War, the balance of terror, threat potential and vulnerability of both parties were evenly balanced. The demise of one of the parties to the conflict resulted from self-destruction and not for war related but social and for economic reasons.

Terrorists possess an extremely significant threat potential but, in the end, are almost completely *invulnerable*. The opposition certainly has a certain threat potential, but it is also extremely vulnerable. This is the calculus of the war against terror. The invulnerability of the terrorists is rooted in their indifference, indeed willingness, to perish for their cause. The enormous vulnerability of the civilized world lies in its highly complex systems, its openness and its tolerance, but also in its unwillingness to suffer for its cause.

6. The problem of extreme action

If one thinks the calculus of the war against terror through, the war can be won by the civilized world only if the threat potential is reduced *to zero* as rapidly as possible and thereafter in a sustained manner. The American President Bush has probably recognized this instinctively. The European intelligentsia describes his rhetoric as "Texan" and "cowboy-like," but it hits the core of the matter. Every half-measure, every bit of tolerance creates a dangerous situation that is unbearable for the civilized world because of the asymmetry of the relative vulnerability. It goes without saying that this must also especially concern the investors and the parties interested in continued economic progress, as the insecurity associated with international terror has a paralyzing impact on business activity, the economy, the exchange of goods, services and capital. Permanently higher transaction costs, indeed the physical impossibility of engaging in international exchange and trade, would dash all stock market dreams and precipitate a worldwide recession that would dwarf the current slowdown.

The question is only if the civilized world is actually prepared to go to war on this basis, and what are the means leading to success without questioning our very system. The fight against terror apparently has a paradoxical component for the civilized world. The civilized world is civilized because it grants its citizens their own responsibility and freedom. It is civilized because it does not control everything and anything but seeks to consciously give matters their free run. Its sociopolitical and economic strength lies just in this willingness to make room for spontaneous developments and permit old and ailing things to be displaced by new and better ones. The civilized world is civilized because new developments can occur only when an adequate private sphere protects the maverick from the establishment and its protective mechanisms.

It is precisely this private sphere where the fight against terror unfortunately must begin! Not in Afghanistan or Iraq but also in Zurich, Frankfurt, London and Washington. The necessity of cutting down terrorism's threat potential to zero, if possible, is bound to lead to a completely tight monitoring of the whole world. This is an unpleasant prospect. The fight against terror by the Free World will eventually result in a global police state of the first order, with the Free World doing away with itself.

Fantasies of the paranoid commentator from St. Gall? – In America, the reintroduction of torture is discussed in all seriousness. In England, the centuries old rule of Habeas Corpus, the prohibition of unlawful imprisonment, was thrown out in the case of suspicion of terrorism. In Afghanistan, in complete disregard of international law, the extradition or annihilation of a suspect is enforced without conclusive proof. The Western world is forging an alliance with governments with questionable legitimacy. With all the understanding, indeed empathy, for the need for defensive reflexes, it must be seen that the paradox is already in full bloom. One wants to save the "rule of law" and can not do that without violating its very principles.

7. Setting priorities

The subject of protecting the Free World against further deadly terrorist attacks without eventually succumbing to an *unbearable state terror* should be placed most urgently on the agendas of international conferences and symposia. The issue is absolutely vital, and it is already concrete. To wit, if under the title of combating terrorism one government department after the other begins to expand its own sphere of interest, the matter is already partially rotten. Why?

Issues abound. The fight against pornography, the fight against drugs, the fight against cigarette smuggling, the fight against vitamin cartels and other monopolies, the fight against tax evasion and capital flight. These are certainly important problems, but they just do not have the quality of a deadly *threat to the system as a whole.* There is a great danger that, in the course of a wide interpretation of the order to gather information and prosecute, far too much actually irrelevant information must be digested. Even worse, as the offenses become increasingly insignificant, the system will progressively turn on its own citizens. The German Federal Republic nowadays uses police state methods to prosecute tax offenses, using the facilities of the Bundesnachrichtendienst (BND). Meanwhile, since it is not possible to do everything at once, the same BND fails to uncover the most important Al Kaida cells outside of the U.S. in Hamburg and Frankfurt.

In the fight against terrorism, the activities of government and supra-government authorities will have to be *restricted* to very narrowly defined priorities. As a correlation to this extremely narrow restriction to focus strictly on a sole target, they will have to be furnished with the most effective possible means to carry out their monopoly of force to be successful at all. Their mandate will be a *target for destruction* in the military sense. All of the other matters that are "also in the public interest," even if they involve criminally relevant affairs, should be kept absolutely outside of this mandate.

Thus, it is important to establish priorities to govern the actions of our society and its instrumentalities. The civilized world has progressively shed this capability in recent years. Establishing priorities means deciding what is important and what less important. It has a lot to do with *values*. Our pluralistic society operates largely in a void without values. The behavior of our political authorities bears the hallmarks of media oriented pragmatism. Self-interest is actually the sole criterion. Decency, faith in principles and loyalty are catchwords that one likes to use if they have a desired effect, but which are readily betrayed if need be. It's not much better in business. Where are the role models who perform their task with determination but modesty? The scene is dominated by slick operators, wise guys and bonus hungry managers. They excel in glossy magazines.

These politicians and business leaders are the product of a society which has largely lost its value orientation. The prosperity that one enjoys is simply taken for granted. Not unlike the belief that electric energy simply comes out of a plug, the role of a free market oriented society based on the rule of law and adherence to property rights, is completely misjudged and even treated with contempt. This happens although there has never been an other order that has produced more prosperity and greater respect for human rights. The Western intelligentsia and the media it pervades are actually fascinated by authoritarian regimes, and even extreme Islamic fundamentalism enjoys latent sympathy in our society. Those who pay careful attention to cultural development have long been struck by allusions to fascist role models. At the same time, acts of violence that seem utterly stupid and devoid of motives are committed over and over, with enjoyment of excess being the sole aim and the innocent victim being the ideal victim. Society takes note of this with apparent indifference.

"Views on the civil war" is the title of an analysis of the prevailing *nihilism* by the German writer Hans Magnus Enzensberger. It goes substantially beyond the above wrap-up. The piece is worth reading carefully before arriving at the Western civilization' concepts against terrorism. In our temporary view, we will not get around a change in paradigm, which finally recognizes liberty, responsibility and the rule of law as foremost criteria again. This is the only way that the civilized world will find the road back to priority formation. Besides, it would be altogether less vulnerable vis-à-vis all sorts of totalitarian ideas, if only one would believe a little more in what has made it strong.

KH, December 3, 2001