Between a rock and a hard place

1. Odysseus is a better sailor than it appears

In Book 12 of Homer's epic poem, Odysseus, perhaps condemned to years of voyaging around the Mediterranean, or perhaps having set off fairly voluntarily in search of adventure, has to sail through a narrow straight. On one shore, the six-headed and twelve-footed Scylla lies in wait in a cave in the cliff, ready to devour unwary sailors. On the opposite shore, the monster Charybdis waits, ready to suck down whole ships, and then, roaring, spew them out again, half-digested. Not a very attractive prospect. There are distinct similarities here with the condition of the players on the financial markets over the past few months. A condition which we fear, for reasons which we will attempt to provide in this investment commentary, may continue for some time to come. Although, after the experiences of the last three years, which may well be compared to the worst that happened to Odysseus, we might reasonably have hoped for a soft and welcoming beach, with palm trees, the sun shining in a blue sky, and maybe even Penelope herself, to bind up our wounds...

No such luck. On the one side lurks the Scylla of the continuing *complete absence of economic recovery*. If it does not occur in good time, then all the new expectations implied by the rise in share prices since 13 March this year will be disappointed. For, without a reasonable level of economic growth, fairly well balanced across the individual sectors, companies will not be able to return to attractive profit growth, and without profit growth rising share prices are hardly conceivable with such low interest rates. Capital gains on the stock markets must sooner or later be justifiable at the operational level. At a time of profound and justified skepticism, hard evidence will soon be required. Otherwise we will see a renewed exodus of investors

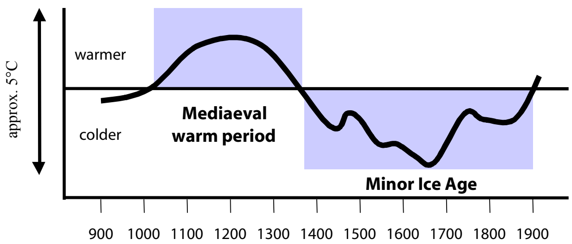
Charybdis is, however, no less dangerous. *Rising interest rates* would greatly endanger many bond-based assets, and transform much comfortable debt into a loss-bringing monster. Financial institutions exploiting the steep interest curve would be confronted with serious problems. For let us be under no illusion: much of the windfall showered on the economy by the expansive actions of the central banks has landed in short-term call deposits in the financial sector, which have, by means of term shifts, i.e. longer-term loans, created a very nice little earner. Of course, as we know from experience, all risks are always totally under control… However, whether an entire sector could cope quite unperturbed with a serious rise in interest rates is an entirely different question. And how all those safety-conscious investors would react if their bonds suddenly turned into cash loss-makers is still another question. After all, when interest rates rise by one percentage point, from 2¼ to 3¼ percent, for example, which is no big deal, a bond portfolio invested on a long-term basis loses 5–7 percent of its value.

It looks as if Scylla and Charybdis are working together. When the economy booms, this may be good for share prices, but interest rates then become a threat. An economy that continues to stagnate, on the other hand – and who would wish for that? – would at least keep interest rates stable, if not induce a further fall, to a really low level. Odysseus was aware of the probable cooperation between Scylla and Charybdis – hence his great anxiety as a sailor in dangerous waters. But what does he realize? All his anxieties seem, at least so far, to have been in vain. For who would have thought it: on the one hand, share prices around the world have risen by 20 percent and more – and that must ultimately have something to do with a positive assessment of the state of the economy – but on the other hand people have also been making money with interest-bearing paper: returns have fallen again, and long-term bond portfolios have again risen sharply in value. The return so far this year on a bond portfolio containing ten-year bonds has been around 5 percent in Euros and almost 5½ percent in US dollars (total return, in local currency). Scylla remains quiet and obliging, Charybdis the same, strangely enough, and Odysseus sails on his way. But he feels more and more queasy with every nautical mile he sails.

2. Historic conditions

It is a commonplace that interest rates worldwide have fallen to a historically low level. On closer inspection, however, this is a somewhat undifferentiated conclusion. The word "historically" is in any event problematical, as it not only suggests an objective judgement based on statistics, but also defines the extraordinary nature of the current situation, together with the implicit expectation that a return to more normal conditions must be imminent. The discussions about the current interest rate situation are much characterized by such thoughts and it is necessary to be continually on guard against indulging in them. The warmest early summer period, the coldest January for a hundred years, the wettest autumn: we are all familiar with our obsession with sensational news. It leads us to read historical significance into what is no more than an unusual concentration of statistically entirely unrelated events, and indeed to regard complete trend reversals – a new ice age or global warming, with all their apocalyptic consequences – as givens.

Historically warm – historically cold

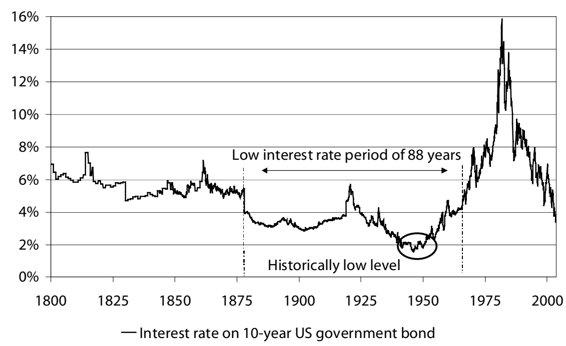


Source: www.biokurs.de; own presentation

In fact, it is simply a matter of the period selected. Over the last thousand years, for example, the climate has already once been historically warm, and once historically cold, as the above diagram shows. There are indeed cycles that can only be detected in retrospect, but it is also evident that the significance of individual, in themselves apparently extraordinary events is relativized in the context of a long number series.

This also applies to interest rates. There have been periods of low interest rates in the past – and what is particularly remarkable is that some of them lasted a very long time. To conclude from the current low level that this "historic" event will soon come to an end would thus be a dangerous pseudo-analytic short-circuit. Nor can it simply be asserted that attractive economic growth and low interest rates are mutually self-exclusive – not even that! The theoretically entirely logical cooperation of Scylla and Charybdis must first be demonstrated in practice. Or was the US economy stagnating during the 1950s?

Low interest rates: not for the first time!



Source: GlobalFinData; own presentation

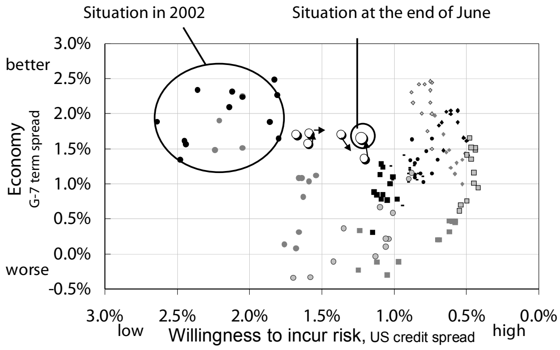
Furthermore, it is necessary to be careful about *what* interest rates are being referred to. There are rates for short-term loans, and for long-term credit. And there are rates for top-class debtors, from whom the repayment of the money lent can be expected with a high level of probability, and there are rates for more dubious counterparties. Both distinctions are as trivial as they are significant. If the long-term rates are significantly higher than the short-term ones, this is known as a positive interest-rate curve, and such a curve can mean two things. Either the higher long-term rates reflect a greater demand for long-term real investments, for example because companies wish to invest in large and expensive plants, or the higher long-term rates contain some inflationary expectations, that make lenders regard it as advisable to demand sufficiently high rates so that they will in the future earn something in real terms, after deduction of the expected inflation. Both cases imply high economic growth, though of differing sustainability. Large, expensive plants will only be installed on the assumption that it will become profitable over the coming years. And inflationary expectations are anyway synonymous with a state of hectic economic activity.

The second distinction – differing rates according to the quality of the counterparty – is a very important barometer for measuring the state of the economy, and indeed of society in general. If there are only minor differences in rates for debtors of varying quality, then it may be concluded that there is a generally high level of confidence in the future readiness and ability of debtors to repay.

This general confidence first, naturally, concerns economic issues, but ultimately also the reliability of the institutions and the customs prevailing in the society in question. Conversely, a higher credit spread indicates a deep lack of trust and profound pessimism. For the high risk premium for inferior debtors implies the assumption of a high probability that debts cannot or will not be repaid in future.

When we review the current situation, it appears uncomfortably diffuse. We have already, on various occasions, published the diagram with the term spreads and credit spreads in the Commentary, and readers may recall the extraordinary (really, this time!) situation in 2002: a high term spread, indicating high future growth, combined with an abnormally high credit spread, as an expression of market players' profound mistrust of future developments. The good news in the following updated diagram is that we have returned to regions of greater normality. The term spread has reduced slightly, the interest rate curve has thus become somewhat less steep, and the difference between rates for top-class and second-class debt risk has also been reduced, which indicates that there is somewhat greater confidence in the future ability of debtors to repay, as the crisis-based assumptions of 2002 begin to be somewhat relativized.

More normal conditions – but no trend



Source: analysis

Clear signals? Absolutely not! That's the bad news. Despite a "historically" low level, and despite a recovery from "historic" depths, the current interest-rate situation permits a profoundly pessimistic perspective on the future, with few, or no conclusions about future developments. It is clear that the very low money market rates reflect the generous money policy of the central banks. Thus, it may be that the positive interest rate curve implies future economic growth, and perhaps the reduction in the credit spread indicates that there is somewhat more confidence in the future of the economy and society. But then again, perhaps not. For perhaps, on account of the three-year-long flight from stocks by investors, conditions on the interest-rate side of the capital markets have got so completely out of kilter that it is no longer possible to make any kind of reliable comment. The flood of liquidity may have temporarily overwhelmed any kind of normality with regard to fixed-interest investments, whether long- or short-term, high or low-risk.

The fact that specific statements and forecasts are difficult does not, however, mean that certain risks should not be considered. Even if the available data do not indicate an immediate and sharp rise in interest rates, the consequences of such a rise, should it materialize, must certainly not be lightly dismissed. Long-term bond portfolios have done amazingly well so far, and balance sheets based on falling interest rates have profited wonderfully from term shifts. But it only needs a hint of expected inflation to get into the system, and there would be a rude awakening – immediate, unforeseen, and in many places extremely expensive.

3. Interest rates and Schumpeter

Criticism of the activities of the central banks is a long-established tradition. At the time of the erratic money policy of the US Fed in the 1970s and early 1980s, the Shadow Open Market Committee led by the Swiss money theorist Karl Brunner (1916-1989) was not only highly regarded, but was also both respected and feared for its often highly acerbic statements – an important corrective for monetary authorities far too closely involved with the political sector. In other countries the role of observer and critic was reserved for a few outstanding economists. In the 1990s, as the danger of inflation receded, and as in most civilized countries people with a sound education in economics took over the top positions at the central banks, criticism of monetary policy became less significant. This makes it even more remarkable that now, voices are again being heard that not only represent the first indications of renewed criticism of the central banks, but indeed are taking the bull directly by the horns, and attacking the godfather of all practical financial policy, Alan Greenspan himself.

He is accused of tempering his actions exclusively to the current state of Wall Street, which is near and dear to him. Wall Street is said to always get the interest rates it wants, and this results in a kind of ultimate risk insurance for the stock markets, and indeed for the financial sector as a whole, provided by the Fed. Such an approach is, however, dangerous in the long term, firstly because it encourages the illusion that the economy and the financial and currency markets can be fine-tuned. But ultimately, the instruments available to a central bank are too weak to stem fundamental upheavals. The result of this policy of effectively bailing out the financial markets is an excessive risk appetite on the part of the market players. Secondly, with its far too accommodating financial policy, the Fed provides the system with such a high level of liquidity that there is far too great an incentive to incur debt. The level of consumption and real estate activity in the USA is far too high, and people are living on credit, as is reflected in the USA's high balance of payments deficit. Third, low interest rates mean that the private sector can finance itself too cheaply. This results in unused or unusable capacity being retained for far too long, which ends in too low investment activity.

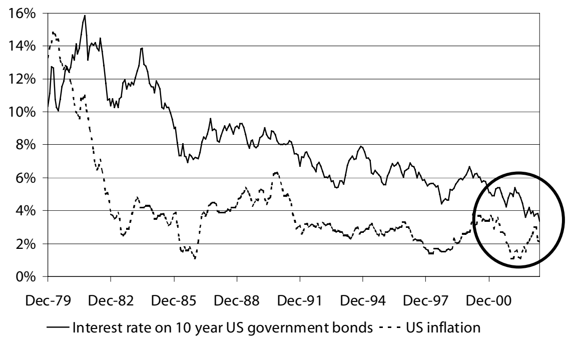
Interesting issues. Economics of Austrian provenance describes, among other things, the processes involved in birth, life and death within the economy. Death, letting die, is of crucial importance. If this does not happen, because politicians try to retain existing structures, or because other mechanisms, such as bankruptcy legislation that is over-friendly to debtors (Chapter 11!), interfere with the disposal process, the result is anaemic economic growth. The hypothesis is that structures can also be maintained inappropriately through over-generous financing. Low interest rates are equivalent to high liquidity, which is made available by the banking system. If (!) the system were simply to make the liquidity available tel quel to the economy, then the accusation of structural maintenance through monetary support would indeed be justified.

The concept of *creative destruction*, as formulated by the Austrian economist Joseph Schumpeter in the 1930s, is admittedly fascinating. The new, the innovative, the really productive can only be created when the old and useless can die off. But as to how this dying off should be brought about – here, with the best will in the world, we dare not prognosticate. Are the advocates of a far more restrictive monetary policy so sure that the higher real interest rates this would involve would not unleash a complete collapse into a genuine depression? Would not much essentially valuable capacity be destroyed in such a dying-off? Might it not be that the process would be so socially unacceptable that ultimately social cohesion would be endangered? Chemotherapy or homeopathy: this is basically the choice. Indeed, on serious consideration, what do the social sciences, and in particular economics, have to offer on this most important issue?

4. A large-scale, real-life experiment

Unlike the natural sciences, economics is not experimental by nature. It is not concerned with chemical substances, atomic particles, or laboratory animals, but always with individuals and societies. It is not possible to test the "correctness" of a financial policy, before unleashing it on humanity. However, the coming years may offer us an involuntary opportunity to take part in a large-scale experiment in economics and monetary theory – both as observers and also as utterly involved parties. The criticism of the central banks' policy described above was mainly directed at the US Fed. In fact, as a result of this financial policy, and for other reasons, the USA enjoys extremely low real interest rates, that naturally have a stimulating effect.

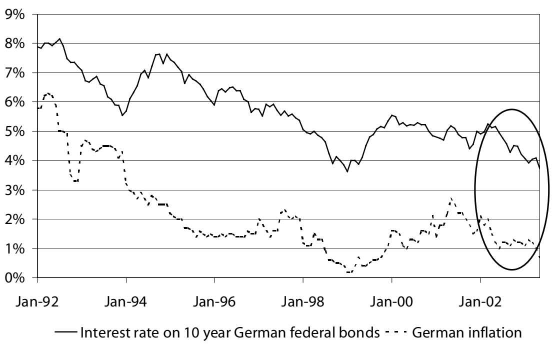
Low real interest rates in the USA ...



Source: Bloomberg; own presentation

The situation is quite different in Europe, as shown below in the case of the economically most important country, the Federal Republic of Germany. On grounds of coherence within the newly created currency area, the European Central Bank (ECB) has so far been unable to follow anything remotely like as accommodating a course as the US Fed. In some EU countries, namely the previously more marginal ones, the economy is experiencing such a boom that the ECB has repeatedly been frightened off reducing interest rates. The result, among other things, is that Germany is confronted with real interest rates that are a good three times higher than those in the USA. And this with an economic growth rate of around zero, a treasury that has been so plundered that there is no more latitude for fiscal measures, a labor market that makes wage adjustments almost impossible, and a pension system that is already burdening generations yet unborn with high taxes.

... and high rates in Germany



Source: Bloomberg; own presentation

When the membership of the European currency area is increased in the near future by more, again rather marginal candidates, the situation is likely to become still more accentuated. With its high-wage and high-price economy, Germany effectively has no means of "defending" itself in the mutual adjustment process. The results will be further high unemployment, economic ruin for many companies, particularly SMEs, and a general exodus of all those not yet dependent on state subsidies. That is, the continuation of what we have seen so far, but maybe still more so. The system is starving itself to death.

Alternatively? The alternative would be a new start in Schumpeter's sense. But then creative destruction would not affect private enterprise alone – this is already dying off, or has moved its production out of Germany – but also, and above all, the exceedingly dense network of state institutions. Then, what the political sector could never under any circumstances do for itself would be forced on it by the disastrous real-life situation. The question of the social acceptability of such a kill-or-cure remedy is, however, anything but trivial, particularly with respect to Germany and its historical experience.

5. What potential?

Let us assume that the experiment is successful. Germany, and also the countries closely linked with it – France, Italy and the Benelux countries – manage to achieve reforms deserving of the name, and can thus create space for new growth oriented towards higher productivity and higher profits for businesses. That they can do away with the worst ossification, in the labor market; that they do everything to attract global funds with free and open capital markets. In other words, that they are structurally fully competitive with the USA and the emerging Far Eastern countries. What potential would such a Europe have?

We have done some calculations, among other things to be able to forecast the expected returns for the various regional stock markets around the world. Such a forecast is necessary to be able to offer investors recommendations on the allocation of a globally diversified portfolio. The model we used is based on the following assumptions:

	Historical average		Current value		Value in 7 years (assumption)	
P/E	**13.6**	15.7	**16.7**	21.8	**15.0**	16.0 (terminal value)
Profit margin	**5.7%**	5.8%	**5.0%**	5.8%	**5.7%**	5.8% (terminal value)
Real turnover growth	**1.9%**	2.0%	**0.8%**	2.0%	**1.8%**	2.5%
Dividend yield	**3.8%**	3.4%	**3.6%**	1.7%	**3.5%**	2.5% (terminal value)

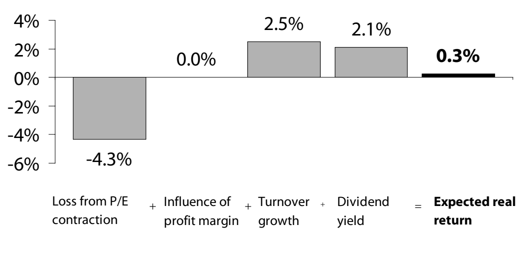
Europe in bold, USA not bold

Source: Bloomberg; own presentation

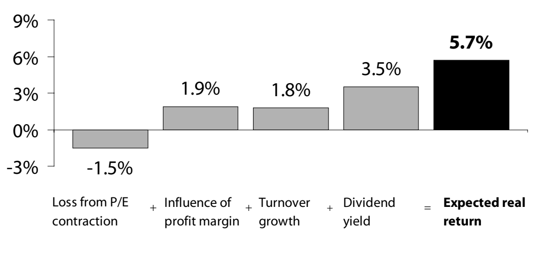
The P/E ratio for shares is a direct reflection of the hopes that the financial market players have of their future development. This is one of the reasons that the P/E ratio depends on the social and political conditions obtaining in various regions of the world. Our model is based on an increasing alignment of P/E ratios in the USA and Europe, always on the assumption that the Schumpeter-type experiment forced on Europe by high real interest rates is successful. Similarly, the other indicators, profit margin, turnover growth and dividends, also converge. These indicators are also highly dependent on the prevailing conditions: dividends for example on the type and extent of taxation.

The results generated with the model are astounding. While with the somewhat conservative assumptions for the USA we have a modest annual return on shares of just 0.3 percent, the expectation for Europe is no less than 5.7 percent. This result reflects the poor opinion that market players have at the moment of the current situation in Europe, and also gives some indication of their estimate of the probability that this will change for the better. Europe is, in stock analysts' terms comparatively undervalued.

Expected returns on the US stock market ...



... and on the European stock markets



Source: analysis

There is a good deal of "if and but" attached to Europe's high potential. And it may look really rather theoretical in this purely numeric form. Below are a couple of examples of what this potential might mean.

6. Real structural change

First, we need to define what is meant by "structures" and "structural change". We are most familiar – if not, indeed, over-familiar – with state structures. These are all the legal and other conditions that surround and confront us as citizens and as economic beings: obligations of material or financial nature, laws, subsidies and so on. Economic structures are somewhat less easy to recognize. We may be aware of the various existing enterprises, their cooperation through associations, their significance within sectors, their market shares and suchlike. More difficult are the unwritten rules, the tacitly observed customs, the real supply and demand mechanisms – but it is they that are often more decisive than the superficially visible structures, when it comes to success or failure, profit or loss.

When, for example, we discuss structural change in the air travel business, and excess capacity in this area, then we mean precisely changes in passenger behavior that are only indirectly recognizable: the readiness to pay more for a certain degree of comfort, or suddenly not to; the way security requirements change over time, and so on. And when we discuss the ability of business to accommodate structural change, then we mean the determination and ability of businesses to change quantitative capacities (number of aircraft, personnel, etc.) and qualitative skills (additional, reduced or different service offerings).

Swiss, our splendid new Swiss airline, was equipped, by whatever intellectual genius, with 26 short-haul and 26 long-haul aircraft. The mere equivalence itself should have been cause for suspicion. When the structural change in global air traffic – in principle a sharp shift of the demand curve to the left, which means about 30 percent less traffic – became obvious, the company hung on to its chosen model and tried, with marginal cost-oriented offers in the cheap travel sector, to fill the two times 26 aircraft. At the same time, it tried to establish itself in people's heads as the "Premium Business Airline". This is a textbook case of inability to cope with structural change, and we may well look forward to a Schumpeter-style disposal. At the same time, we get an offer from Lufthansa – back to Germany's potential – for business-class flights from Switzerland to Newark in the USA. Business-class only, with a limited number of seats and the comfort level desired for business travel. A step by the German airline in a direction that must determine future strategy: air travel will become disaggregated. There is really no reason why various types of passengers with entirely different requirements –backpackers have all the time in the world but little money; business travellers are the exact opposite – should all share the same terminal with the same comfort, the same delays, the same newspapers and the same lavatories. Nor that they should sit in the same aircraft, or share the same slots (which are allocated by non-economic criteria).

Our times make great demands in terms of the ability to adapt to structural change. In principle, we are confronted with old, obsolescent or already obsolete capacity, as a result of the technological developments of the last five years. Thus, the Internet, somewhat underestimated in the recent past, has in fact had a far greater influence on the advertising market for newspapers and magazines than was long thought to be the case. Properties, second-hand cars and also some jobs are today found by using the powerful search engines of the Internet. This structural change in the demand on the advertising market clearly requires strategic changes too.

In addition to the adaptation, or if necessary elimination, of old, obsolete capacity, the left-overs from the technology boom must also be dealt with, a process of adjustment that is also not without its problems. For although it has slowly become clear which new businesses are capable of surviving and which not, the overwhelmingly equity-based financing of start-ups has meant that the dying-off process is being drawn out over years. Private-equity investments still feature in many asset portfolios at their paid-in nominal value, although they are in fact worth practically nothing. "Creative destruction" turns out to be a many-faceted and multi-dimensional process, and it obviously takes a good deal longer than the economic bubbles that we have become used to.

Real adjustment to structural change: obviously in Germany even the trades unions are taking a hand in this. The IG Metall appears to be trying to destroy itself, and its public-sector sister, Verdi, is well on the way to losing the final remains of its credibility, with its muscle-flexing in the face of an empty treasury. The unions have noticed too late, or not at all, that there has also been a demand shift within the German labor force – in favor of the workplace (and thus the employer) and away from ever shorter working hours. This is interesting and promising. Perhaps it really is true about Europe's potential…

7. Odysseus sails on

Scylla: an economic upturn that occurs too late or not at all, adjustments to structural change that are undertaken half-heartedly or not at all, little or no prospect of reasonably attractive profits on the stock exchanges. Charybdis: surprises on the interest-rate front, stagflation as a result of high liquidity and simultaneous reluctance to invest. So far, Odysseus has remained relatively unscathed on his latest voyage. After the special situation with the Iraq war, the financial markets have calmed down significantly, and even the US currency has made up some ground. It seems as if there is something resembling a balance of anxieties in the markets. For that, after all the losses of the past three years, people are afraid of the stock markets, and are only prepared to operate cautiously is only too understandable. That a suspicious eye is being kept on the interest-rate situation is equally unsurprising. There are threats on every side, but nevertheless – navigare necesse est! There is no way round the need to sail on; there is no way round the need for new investments, new financial products, new strategies. Whether one is a private investor or a pension fund with too little coverage: navigare necesse est.

There is something attractive about the intrinsic contradiction that the danger of the situation ultimately makes it less dangerous, because no-one is inclined to make risky moves. Stability as a result of great instability; sideways motion rather than boom, but also no real danger of collapse: this may well be what the next months will look like. Navigare necesse est; and then, the terra firma of sound, sustainable growth based on bold and thorough adaptations to structural change must soon heave into sight.

The investment policy of our house aims, within the framework of our overall strategy

– which there is certainly no cause to question, given the more stable situation – to operate relatively cautiously, with risk-reducing products. Cautiously also means keeping the greatest share of stock investments close to indexes, and conducting experiments on a limited scale only. With structured MOM products we try, despite a sharp reduction in volatility, to generate returns from the (probable) sideways motion of the stock exchanges. With bonds we have already been cautious for some while, too cautious with the benefit of hindsight – longer maturities would certainly have been worthwhile so far. But is the difference in return between a 4-year and a 10-year bond really worth the great difference in risk? We hold foreign currency as a result of our stock investments, which are globally diversified, and not as a speculation per se.

So Odysseus again threads his way between Scylla and Charybdis. A bit boring, admittedly. No matter – we do not need to be immortalized in Homeric epic.

KH, 7.7.2003