Too much normality

1. Going sideways

After years of particularly challenging helter-skelter rides on the stock exchanges, the last couple of months have evidenced a remarkable lack of direction, which gives rise to at least as much lack of orientation as the previous hectic conditions. Of course, no one wants the daily drops of three or four percent or more back on the exchanges, and generally speaking no one really misses the Icarus-like flights of the new economy markets. As long as – and precisely as a result of these experiences – investors are still grateful for the maintenance of their capital, there will be no pressure to enhance the so-called performance of investments by means of the rash taking of risks. In the long term, however, capital can, and should, not fail to generate returns. Which is why, after these first directionless six months, it is time to consider this phenomenon.

Only a few stock exchanges stand out in 2004

Region	Index	Return *
Switzerland	SMI	+2.2%
UK	FTSE 100	-1.6%
Eurozone	Eurostoxx 50	+0.8%
USA	S&P 500	+1.2%
Japan	Topix	+12.4%
Hong Kong	Hang Seng	-2.8%

* in local currency

Source: analysis

Actually, 2004 got off to a fairly hopeful start. The *stock markets* began the first few months with the dynamism of the previous year, benefiting from positive corporate reporting and a generally friendly global political situation. However, the elan of these first few months proved unsustainable. At the corporate level, the view increasingly prevailed that the sharp rise in profits would not be repeatable – strong basic effects were in play. Given the losses, or the very low profits of the previous years, the profitability improvements obviously looked good. But further improvements would inevitably be more meagre. And this again increasingly raised the question of the justification for valuation levels. Scepticism here can clearly be felt on the markets. A more *subdued political atmosphere* as well, as the attacks in Madrid and the lack of discipline of the American occupation troops in Iraq provided the world with an unpleasant return to reality. Less immediately obvious, but probably by far the most important, is the anxious question as to how long the extremely accommodating supply of money to the world by the central banks will continue. What would happen if interest rates really start to rise?

It is worryingly calm not only on the stock markets, but also on the *currency markets*. Here too, there was still a lot of movement in the first months of 2004, and the currency forecasts were more divergent than they had been for a long time. Some people expected to see the US dollar at one franc, others regarded the euro as thoroughly over-valued and yet others forecast a dramatic rise for the yen. In the mean time the situation has settled down; many currency experts have adjusted their forecasts to a less courageous “neutral”.

More stable currency markets?

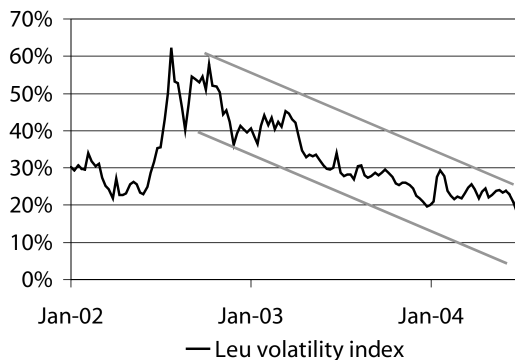
Source: analysis

For every currency, there are about as many grounds for a rise as there are potential reasons for a fall. For the US dollar, for instance, clearly stronger and broadly based economic growth contrasts with the ever more threatening balance of payments deficit. The euro enjoys a significant advantage in terms of real interest rates, but

there is practically no economic growth. These are difficult conditions for currency forecasting.

Boredom and lack of direction may be tiresome for normal investors and their advisers, but they are not really threatening. For those who earn their living from sharp shifts and developing trends, though, things look different. *Hedge funds*, advocated by many players in the asset management business as an absolute must for any portfolio – not least, of course, on account of the generous commissions involved – have generally produced *pretty unimpressive results* this year. When one of the biggest European fund-of-funds generates a negative return of (minus) 4 percent in the first six months of this year, this is simply not enough for a conglomerate of instruments that is supposed to compensate the leveraged acceptance of (un)systematic risk with higher returns.

Stock exchanges increasingly calm



Source: analysis

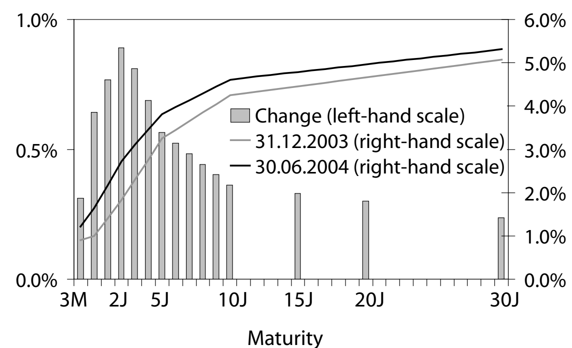
It looks as if the hedge fund boom was more or less correlated with the sharp rise in volatility on the stock markets in the 1990s and at the beginning of this century. If this indicator – the fluctuation of stock prices – were to persist at a significantly lower level for a longer period of time, this would most probably result in a high mortality rate for the sector, with only the most skilful hedge fund managers surviving. A consideration that should be kept in mind when assessing the revenue situation of asset management banks. Those that have become highly dependent on the high commissions in the hedge fund sector will find themselves in difficulties under these circumstances.

A general lack of excitement, then, or perhaps something completely different? Is there such a thing on the markets as the "calm before the storm", and if so, where shall we be driven by this storm? Will it open up a new abyss, such as we encountered in 2001 and 2002, or will it blow us into the sort of conditions we believed we were experiencing in 1999 and early 2000, when people seriously talked of the Dow Jones reaching 36,000?

2. The remarkably calm long end

We are well advised to turn to the most efficient area of the financial markets – *interest rates* – for our analysis. Since March of this year – at least here, one might say – there has been some movement on interest rates. US dollar rates rose by about one percent, and there was also pressure for higher rates in Swiss francs. So there has been something like a change in the interest rate trend. The central banks – first the American and then the Swiss – have meanwhile reinforced the trend by raising money market interest rates, or alternatively, have yielded to the dictates of the market.

Plenty of movement in the middle, not much at the long end



Source: analysis

So there is something going on on the financial markets, after all. Or perhaps not, or at least only to a much lesser extent than might have been supposed, or desired? A closer look at the interest rate structure curve shows that, for both the US dollar and the Swiss franc, there has been most change around maturities of two to three years, whereas the long end has remained relatively unaffected. This is remarkable. For if anxieties about future rates of inflation had been present in the system, then the changes at the long end of the curve would have had to be very different. Those who can still recall the conditions of 1994 will know what is meant here. Then, there were serious worries about inflation, with an appropriately massive reaction from the bond market, and the Fed had to raise money market rates from 3 percent to over 6 percent within a very brief period of time.

The current interest rate shift is quite different, and much less concern-based. There are no, or virtually no, expectations of inflation within the system, despite the fact that the US economy is

growing at a real four to five percent, and although short-term real interest rates are at about –2 percent and the rate of inflation has risen from 1.9 percent last year to its current level of around 3 percent. A number of economists are complaining vociferously about the enormous flood of liquidity with which the Fed has deluged the economy over the past years. But if they were right, and/or had been listened to, then the long end of the interest rate curve would look different. The lack of action with regard to interest rates, visible in the unexpectedly unspectacular behaviour of long-term rates, raises questions and gives rise to further lack of orientation.

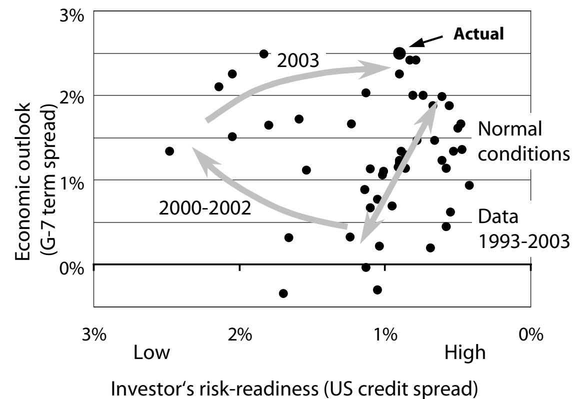
3. Optimum macro-conditions

In the past we have repeatedly measured the attractiveness of the prevailing conditions with two indicators, that provide information on the estimated future performance of the economy. One of these is the *steepness of the interest-rate curve*, i.e. the size of the difference between long-term and money-market rates. If the difference is significant, this implies that debtors assume that long-term (investment) financing will prove attractive, and thus seek long-term capital on a corresponding scale. A significant difference also means that the central bank is prepared to provide the financial system with cheap money, in order to generate a multiplier effect in the economy, through term and risk transformations. This is known as a "generous financial policy". A lesser difference could mean, among other things, that debtors no longer believe in long-term investments on such a scale, or that the central bank wishes to prevent the financial system from achieving its multiplier effect on the originally envisaged scale. This would be a "restrictive financial policy".

The second indicator, the *"credit spread"*, relates to the confidence which creditors have concerning the probability of their loans being repaid. The credit spread is calculated from the difference between top-quality debtors and those with a somewhat lower rating. If the credit spread is low, this means that creditors do literally credit it, and that creditworthiness is of virtually no significance. If the credit spread increases, then shaky debtors have to pay more for their credits – creditors require a higher return for the higher risk.

The combination of the two indicators, "term spread" and "credit spread", reflects something resembling belief in the future, or the confidence with which the system as a whole has in the economy as a whole. The figure below shows how dramatically poor these indicators remained during the 2000–2003 crisis on the financial markets. Confidence in the ability to repay loans, in particular, on occasion hit a historical low. The interest rate curve, on the other hand, always remained fairly steep, due to the aggressively relaxed financial policy of the central banks.

Difficult to imagine better times



Source: Datastream, analysis

The latest data now present *an extremely attractive picture*. The interest-rate curve is steep, creditors' confidence is high, and both indicators are situated in the optimum quadrant. But if the indicators do have any relevance for assessing the future, as would appear to be indicated by economic logic, this raises the question: Why is there not more confident anticipation on the financial markets? A high probability of the repayment of funds flowing into long-term investments: what could be better than that? Serious demand for such funds – what better signal could there be of entrepreneurs' and investors' confidence in the future? Nota bene; the analysis is not based only on more or less questionable surveys: rather both "term spread" and "credit spread" are prices paid on the market.

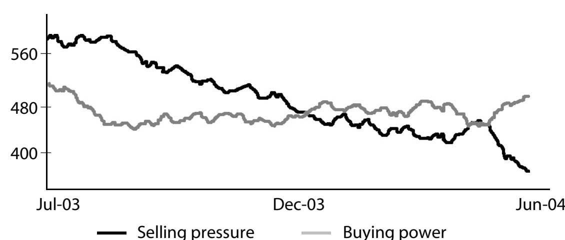
But still, this analysis too gives rise to a sneaking suspicion that all is not well. That, for example, the interest rate curve is as steep as it is only because financial policy remains very generous, and thus exerts downwards pressure on money-market interest rates, while there is neither much demand for, nor much supply of long-term funds, particularly for investment in the real economy. Or, put differently, that pricing has been falsified by structural particularities in the wake of the collapse of 2000– 2003.

4. Buyers' and sellers' strike?

That there is a lack of unrestrained enthusiasm on the financial markets is also evidenced by

another pair of indicators, that have been getting closer for some time, and are now almost convergent: the relationship of sales and purchases to overall stock exchange volumes. Throughout most of the 1990s, "Buying power" naturally had the upper hand as far as stocks were concerned. Everyone wanted a bigger piece of the action, and few were inclined to realize their gains. The reverse was the case in the following years. Then, stocks only found new buyers after serious falls in price, and sales were firmly on top ("Selling pressure").

Serious lack of interest in transactions



Source: Lowry's report

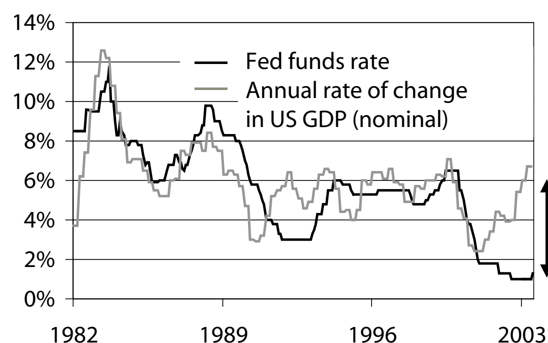
And now? Not many want to sell, but then not many want to buy either. Interesting. First, with regard to selling: there is only really an incentive to realize an investment if there is also a satisfactory alternative. This is certainly not offered by the bond market, for no one really wants to invest in an environment of rising interest rates, regardless of the prevailing indifference over interest rates. The money market? No chance of real earnings there. Hedge funds? Only if one knew the right ones. Foreign currencies? The trends are too difficult to identify, given the latent risks. And the interest rate differences between the currencies are, with the possible exception of the English pound, just too low.

And so on. There is obviously *a lack of alternatives* that would justify the transaction costs. So people prefer to leave things as they are: the result is a remarkable stalemate. But the big question is: is it a stalemate between too little hope and too little fear, or is it perhaps an indecisiveness that derives from very great fears and very great hopes? For there are several ways in which a harmless average can be achieved. You can stand with both feet in lukewarm water, and feel more or less all right. Or you can have one foot in an ice bucket and the other in a pan of boiling water. The average temperature will also be lukewarm and "normal". But this normality is unsustainable and anything other than harmless.

5. The big financial policy challenge

To make things clear right away: we incline to the second interpretation – to the view that the problems confronting the global economy, indeed the world as a whole with regard to security, and the financial markets in particular, are too serious and too complex to be dismissed as merely "lukewarm water". Or, put differently and more forcefully, freezing ice buckets and boiling pans do indeed exist simultaneously. This remarkable stalemate prevails because it is far from clear in which direction things are going.

Could hardly be more generous ...



Source: analysis

Here is one example of this. We showed above that players in the most efficient sector of the financial market, the bond market, are relatively *calm* about the financial policy situation and any possible *inflationary threat* resulting from it. That this is remarkable, indeed utterly extraordinary, can be seen by comparing the development of the US economy with the changes in interest rates over recent years. The two curves practically never moved far apart – which indeed reflects the logic of financial policy: the money supply must correspond to the needs of the economy. The higher growth is, the higher the interest rates, and vice versa. However, for the last three years, economic development and interest rates have been growing further and further apart, and given this state of affairs, it can hardly be said that the Fed's latest move on interest rates, at one-quarter percent, was particularly courageous. And nor is it, for that very reason, likely to have been the last one this year.

With such a drastic divergence between financial policy and economic development, all inflation indicators should, under normal circumstances be on red alert. But the fact is, they aren't. Why? Because at the same time, and to a fairly unique extent, strong deflationary forces are still at work, which balance out, or at least render less acute, the financial policy discussion. The boiling

pan of overly generous money supply does indeed exist, but on the other hand so does the deflationary ice bucket, which immediately extinguishes the flames of higher inflation.

Two things have *a deflationary effect*: first, the unrestrained efforts to achieve higher productivity, and secondly the pressure of globalization, which, particularly on the labour market, but also to a certain extent on the market for goods, renders fairly hopeless any attempt to raise prices. In the USA, *productivity has risen* by an average of 4.5 percent over the last three years. This has meant that no significantly greater burden has been put on the capacities of the US economy, despite the high growth rate, and that the labour market is still marked by an above-average level of unemployment. This makes it virtually impossible for serious inflation to occur. And when it is required to justify the very cautious interest-rate policy, the Fed does indeed refer to the continuing existence of the so-called "output gap", the difference between effectively deployed and theoretically available capacities.

These deflationary forces are obviously able to compensate for even such dramatic price rises as those we have seen on the commodity markets over the past months. Americans are now paying some 30 percent more at the pump for their gasoline than they were a year ago. But still, there are no signs of raised expectations of inflation. The image of the scalded and the frozen feet also seems to apply here.

One thing is clear, however: this type of financial policy cannot be sustained indefinitely, anymore than Alan Greenspan can remain the Governor of the Fed for ever. Excessive liquidity must be dealt with one way or another, and this can only be done by means of higher interest rates. As the US economy is fairly sensitive to interest rates – remember the sharp rise in mortgage debt over the past years, or the well-known level of credit-card debt – it is easy enough to understand that, despite all the apparently positive indicators, there is a lack of unrestrained enthusiasm on the financial markets.

It is also the case that the deflationary pressure really only affects the secondary or goods-oriented sector of the economy in the western industrial nations. In the tertiary sector, by contrast, inflationary conditions do indeed prevail. Consider, for example the price rises for healthcare services. The current economic indicators are strongly focused on the production of goods, which is less and less true of western society itself. Given these circumstances, the outcome of the conflict between "inflation" and "deflation" will have to remain open for some time to come.

6. Ambivalent security situation

When the history books of the future write of the first years of the third millennium, two elements will probably dominate: economic turbulence in the wake of the investment boom of the 1990s, and the development of a totally new security situation. We have already dealt with the first element, or the central banks' approach to a solution to it by means of an enormous wave of liquidity. The security aspect cannot be neglected, to the extent that terrorist attacks and wars have very direct impact on the financial markets, but also because security policy always has an eminently fiscal aspect. Throughout world history, challenges to security have always resulted in a growth surge for the state sector. And furthermore, the impact has been not only fiscal, but also often of regulatory and social nature, inasmuch as civil liberties have regularly been limited under the impression, or on the excuse, of security requirements. Thus, in addition to the immediate impact of an attack or a campaign, there are also long-term effects of great relevance for subsequent economic development.

One thing should already be clear enough: the *"peace dividend"* that appeared obtainable with the end of the bipolar threat after 1989 *has* probably *been effectively eliminated* by developments since 2000. It is true that no vast, personnel-intensive armies need any longer to be kept at readiness, either in the East or the West, and it is also no longer necessary to keep enormous armoured, artillery and engineering units supplied with heavy materials and munitions. Nuclear competition has slowed down significantly. On the other hand, the policing of society has come on apace, with the professionalization of the previous (often militia-based) armed forces, and a concentration of firepower and military force in the hands of a small number of specialists. Attempts by the police and the secret services to control the Internet, e-mail and mobile phone communication, and financial transactions are forging ahead. The organs of justice appear to be competing vigorously with one another in their efforts to provide their colleagues in third-party countries with every form of ministerial and legal assistance. In other words, at the beginning of the third millennium, citizens find themselves confronted with a newly developing *"nomenklatura" of security staff*. Given the security challenges we face, no objections can of course be raised to their existence. We must however, devoid of all illusions, be aware of the

fact that this new nomenklatura will behave exactly as its predecessors did: it will expand. The replacement of militia-based armies will not bring only advantages.

The question naturally arises at this point of the gains in security over the past years; that is, since the attacks of 11 September 2001 and the subsequent campaign against international terrorism. The answer is remarkably ambivalent. It is not exactly a mainstream European view that the military situation in the Middle East appears distinctly more stable than it did before Afghanistan and Iraq. But many indicators point in this direction. Firstly, the campaign in Afghanistan initiated by the USA and then taken up by the Europeans not only did away with one of the more repulsive Islamic regimes, but also, and much more importantly, it enabled Pakistan, a supra-regional threat with its nuclear arsenal and its powerful secret service, to be brought under control. India's greater closeness to the West and the relaxation of tension between India and Pakistan are direct consequences of this intervention.

Secondly, by doing away with the weakest link in the chain of Muslim states in the Middle East – that is, by conquering Iraq – the USA succeeded in positioning itself so that it *had freedom of action on three fronts*: to the West, should Syria become an issue; to the East, should Iran become an immediate security risk and, of absolutely decisive importance, to the south, in order to retain control over Saudi Arabia. Saudi Arabia is of the greatest strategic importance in two regards: firstly on account of its oil production and its available oil reserves, and secondly on account of the particular role played by the Saudi regime in connection with the al-Qaeda terror organization.

It is becoming clear that the USA will leave the problem of Iraq's internal security to other powers, after having had to discover that it was neither welcome nor in a position to live up to its own self-declared high ethical standards. But whoever holds power in Falluja or Najaf, Iraq will in future serve as a springboard for the USA, and be garrisoned with forces that can easily intervene, for example to secure the Saudi oilfields, or to bring a revolution in Saudi Arabia under control. Indeed, we believe that such forces are already in place – in the current Iraqi environment, there is really no other point to the presence of the First Cavalry Division (a strike force equipped with anything other than horses).

So far, so good; natural enough, as ever in security issues. However, the USA's undeniable military and strategic success contrasts with serious questions concerning its "progress" in the war against terrorism. Some two and a half years after 11 September 2001, *al-Qaeda* is still *capable of action*, as clearly shown by the strikes in Madrid. It is capable of very precise timing, is obviously able to assess the psychological situation in very varied parts of the world extremely well, and is still in a position to operate undiscovered and virtually unpenetrated by the secret services. All the tremendous efforts, from the "Patriot Act" all the way to the destruction of apparent bases in Afghanistan, have had little impact. Indeed, it almost seems as if, even in al-Qaeda's county of origin, Saudi Arabia, this hydra cannot be defeated.

This should come as no surprise. Shortly after 11 September 2001, we particularly made the point that any concept aimed at "total control" in the war against terror was doomed to failure. This firstly because the attempt at "total control" was bound to end in an infinite mass of mostly irrelevant information, and secondly because the attempt at "total control" would force too many not entirely domesticable elements (from the drugs mafia to insubordinate European governments) in the wrong direction: in the direction of implicit, or even explicit, coexistence or coalition with international terrorism. Right from the start, the American concept was hopelessly flawed in game theory terms. The consequence of this is that the world must now expect new, possibly still more unpleasant surprises from al-Qaeda. The period from now until about the middle of September, that is six weeks before the presidential election, seems to us particularly dangerous. Al-Qaeda must probably continually justify itself to its followers with successes, and the experience of Madrid could tempt its strategists into trying something similar in the USA. Should this happen far enough in advance of the presidential election, then the failure of the Bush administration's "war on terror" would have been definitively demonstrated.

In other words, what we have already determined applies to economic and monetary challenges also turns out to apply to political and security issues. The current, apparently harmless, relatively agreeable situation is not the result of a consistent and sustained solution to problems, but the highly disagreeable average of one frozen and one scalded foot. The excellent strategic military positioning contrasts with abject failure in the fight against terrorism, and this at the price of a dramatic loss of civil liberties.

7. Looking for alternatives and the odd percent

Thus, in our view, at the mid-point of 2004, the world appears not at all so harmlessly lukewarm as the low volatility on the stock markets, the absence of movement in the currency sector, the lack of excitement with regard to interest rates and the relative calm in the global security system might indicate. Rather, just below the surface flow both boiling and ice-cold currents, that are only slightly concealed by a balance of forces that could quickly be overturned.

For investors, this situation is as unsatisfactory as it is sensitive. Unsatisfactory, because it is very difficult to "make money" in such a situation. Sensitive, because one might be tempted to "make money" through the ill-considered acceptance of risks – risks that might become life-threatening should the balance be overturned. Imagine, for example, that fears of inflation suddenly occurred, so that interest rates rose immediately and sharply. What would happen then to the interest-rate-sensitive position in portfolios; which hedge funds would go under; which banks would fail?

Accordingly, in our view, the first appropriate focus is on *avoiding* unnecessary *sources of loss* in asset management. The commissions on instruments and transactions are – like it or not – a decisive element in times of low returns. The main problem for investors resides not in the explicit and visible fees, but in the hidden costs. Complex structures such as intransparent derivative instruments or interlinked funds and investment companies offer an overt invitation to clandestine rip-offs. But times of low returns often reveal such practices to the public gaze.

Secondly, it is important to really *review* the range of acceptable *alternatives* from a risk perspective. For example, the sideways tendency on the stock markets practically demands the deployment of structured products. Very low volatilities enable cheap hedging, and when there is somewhat more movement in individual market segments or stocks, risk appetite can be recompensed with premiums. One is fighting here for fractions of a percent, true enough, but "many a mickle makes a muckle", as the Scottish saying has it.

Thirdly, there is the possibility of seeking other alternatives in the form of reasonably valued investments *outside the mainstream* of the big indexes; investments that in all probability would survive an end to the precarious balance, but are also sufficiently attractive that they can in themselves offer a positive return. One such alternative is our "Active Indexing®" programme, the St. Gallen approach to squaring the circle, so to speak, by means of the simultaneous deployment of broadly supported indexed instruments. With Active Indexing® we use valuation models to identify those countries and industries worldwide that seem relatively undervalued, and then invest on a monthly basis in the most interesting regions and sectors. The advantage of the system – or indeed the squaring of the circle – lies in the fairly high diversification, which reduces risk, combined with concentration on a single theme that must in any case be a priority for investors: not to buy anything that looks expensive. The results of the programme so far are highly encouraging.

This all by way of a bit of advertising in our own interest. But beyond this, something much more fundamental: the doldrums could incline the captain and crew to drop off to sleep. On the contrary, we take the view that we must use this tiresome period to apply all our available energies and intelligence, both to exploit the last little breath of air to make some progress, and also to avoid making any mistakes, should this remarkable balance, this excess of normality, suddenly be overturned.

KH, 5.7.2004