Stability – but what stability?

1. Calls for a redesign

What does Friedrich August von Hayek have in common with a safe passage across loose scree in the mountains? And what does whatever they have in common have to do with the current financial crisis? What action should these insights cause investors to take? This is roughly the content of this Investment Commentary. It seems to us that what may look like a few catchphrases, or a frantic search for the telling metaphor, in fact takes us to the heart of the credit market problem, and relates to the way the financial system has worked so far.

First things first, however. Let's start with a status review, and ask what has been the course of the crisis so far, what damage has been done, who has been hit, what dangers still lie ahead, and what we may expect by way of long-term consequences. Most of all, of course, we'd like to give the "all clear". The question is whether, with the information available, we are able to do so, and further, what the "all clear" might in fact mean.

So, we have once again to revisit the causes of the crisis. A vigorous search is clearly in progress for ways of ensuring that this sort of thing can never happen again. Mostly we seem to be hearing, prematurely in our view, from those who have some sort of causal connection with the origins of the crisis. A period of silence might be more appropriate here. For minor repairs to the existing architecture of the financial system will not suffice: the evidence that most concepts have failed fundamentally is overwhelming. Without a real understanding of the economic function of capital and its allocation in the interests of the overall economy, there can be no sensible discussion about redesigning the system.

This is the context in which the demands now being made for improvements in the banks' risk management, more stringent equity requirements, limitations on product complexity, the introduction of a transaction tax for derivatives, and such like must be more closely considered. It is obvious enough that these and similar proposals for the redesign of the financial system are highly relevant for investors. Direct valuation corrections (of bank stocks, for instance) would be the consequence in one case; in the other cases a denser regulatory network would have a deleterious impact on the allocation of capital, and would thus reduce the efficiency of the system, and/or the prospective returns.

There does at least seem to be agreement on the overall objective: to make the financial system safer, by using early warning systems to nip in the bud the exaggerations and excesses that seem to be almost obligatory every five to ten years. Or by obliging the key players to be more restrained, monitoring them better, and insisting on greater transparency. In what follows, we shall not be able to avoid questioning these apparently uncontested intentions. Why? Because people have wanted to do all that before, without success. Is the objective perhaps unattainable? Which brings us to Hayek and the hikers. But more of that later.

2. The end in sight?

In a previous review of the situation, in late autumn, we distinguished three possible scenarios for the further course of the credit market crisis, namely:

a) An activist, and largely successful, deployment of monetary and fiscal means, particularly in the USA, to enable banks to gain time in which to generate equity and generally put their balance sheets in order;

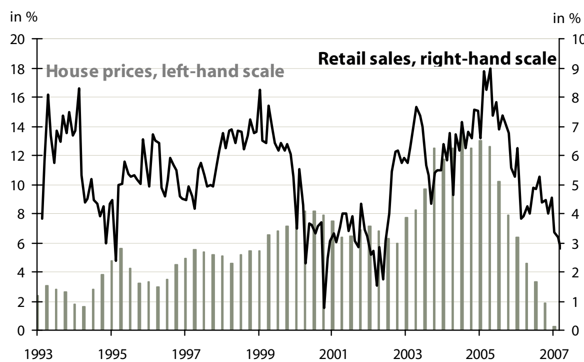
b) The failure of such attempts, which would make it impossible to prevent the insolvency of one or more major banks;

c) An overestimation of the whole issue, in terms of its impact on the American or the global economy, and an underestimation of the banking system's ability to help itself with its own resources.

In the subsequent five months, we have havered between the first and the second scenarios. Scenario three, by contrast can be definitively disregarded. The figures from America reveal a far too clear, and dismal, picture. All the indications are of a contraction, and possibly a lengthy recession.

The figure below provides a fairly comprehensive view of the situation: consumer activity and the real estate market have collapsed over the past quarters. Accordingly, there will be little house building – planning applications have reached the lowest point since 1991 – and an increasing number of house-owners are no longer paying their mortgages. The tendency to default is now spreading to the so-called "prime" segment. The recently posted figures showing an increase in industrial output in the first quarter of 2008 offer little relief, and one of only temporary nature, for the resulting increase in stock levels will have a negative impact on growth in subsequent quarters. It's obvious enough where the problem is: with consumer activity. Americans have had to shift to the unfamiliar "savings" mode.

It looks like recession



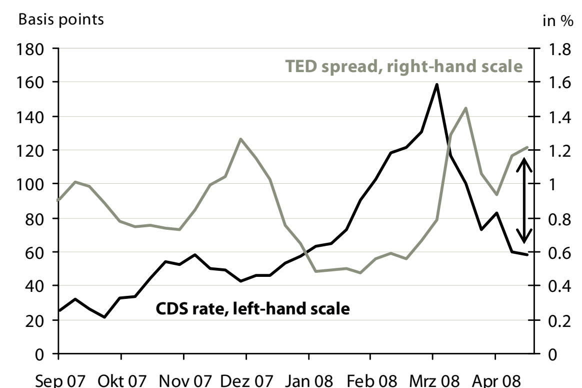
Source: Bloomberg

Note: Annual change in US house prices and US retail sales

So, scenario three is irrelevant, but we need to stay with scenarios one and two. At the moment, it looks as if things have calmed down a bit. Volatility on the stock exchanges, for instance, has fallen somewhat. Risk premiums in the big banks' own credit business, in terms of Credit Default Swaps (CDS; equivalent to the securitized shift of doubtful debt off the balance sheet to third parties, against payment of a premium), have fallen significantly. And industrial borrowers again have access to money on somewhat more moderate terms, even if 7 percent above Libor (for a single-B debtor) is still quite a lot. The market calmed down when the Fed, with the help of the stable JPMorganChase, bailed out the hard-hit Bear Stearns investment bank, and signaled its readiness, for the foreseeable future, to accept lower-quality "securities" against liquidity injections.

Interestingly though, this degree of relaxation does not yet seem to have improved the banks' confidence in each other. The TED Spread, the difference between the "risk-free" rate for treasury bonds and Libor, the interbank loan rate, remains unchanged at a high level. And we probably also need to take account of the fact that Libor is anyway reported too low. For – as was recently pointed out by the *Wall Street Journal* – the banks involved do not want to admit that they are all using higher rates, in order not to lose face. However much we might be inclined to definitively dismiss scenario 2, highly unattractive as it is, this would be unwise. For when those who best know their own balance sheets, and are best able to estimate their colleagues' situations (after all, until very recently they had provided each other with cover for all these positions) are so highly mistrustful of each other, it is not going to be easy for us, as somewhat more distant observers, simply to return to "business as usual".

The "all clear": yes or no?



Source: Bloomberg

Note: TED Spread: 3-mth EUR Libor • 3 mth T-bill

3. It's not just the volume

Estimates of the real scale of damage caused by the credit market crisis vary widely. The International Monetary Fund recently mentioned a figure of 1,000 billion dollars; the OECD's estimate was about half that. A measure of skepticism is advisable here. Firstly, precisely these organizations failed to deliver any such aggregations *before* the crisis – that is, when they might have been of some use. Secondly, such estimates are not devoid of self-interest. The IMF sniffs the possibility of exploiting the crisis to reposition itself as an indispensible institution within the financial system, and the OECD, as the extended arm of the finance and economic ministries of its member countries, has no wish to see damage done to the global economy that generates their tax revenue.

Ultimately, the total volume of the problem positions is not that important. For the "problem" is very much to be understood in dynamic terms, firstly over time – what is today a problem may tomorrow, or at some future date, again be valu-

able – and secondly because of the dependency on other factors, such as the question of how bad the recession in the USA will really be. What is more important is the degree of concentration of the actual or potential problem positions, and the immediate threats that such concentrations can actually represent. In plain English, we are talking about banks' balance sheets and, further downstream, similar structures in the hedge fund and private equity sectors. It is not the volume as such that is dangerous, but its combination with a high level of debt.

Thus, UBS, to take what is for various reasons an obvious example, has a level of debt of around 50 in nominal terms, that is, measured against a balance sheet unadjusted for any risk factors. On the one side, assets of almost 2,300 billion Swiss francs; on the other equity of 42.5 billion or 1.9 percent of assets (status at end 2007). That is not much, or rather, the leverage is enormous. Now, until recently it was possible to argue that a nominal view of a bank's balance sheet made little sense. For assets that will almost certainly not only retain their value, because they are highly creditworthy, but can also be traded at any time, as this creditworthiness will always be acknowledged in the market, should not be regarded in the same light as assets of dubious quality. For this reason, so runs the argument, it is appropriate to have gradations of required equity, according to the nature of the assets. The constant disposability of assets and liabilities in the market makes it possible to react at any time to shifts in valuation, so that the equity itself must in all probability never be touched.

The credit market crisis of the past months has brought this biased perspective on risk in banks' balance sheets to a premature and painful end, and with it the principle of fair value. Financial vehicles regarded as absolutely safe experienced (lower) revaluations virtually overnight, and their tradability disappeared extremely rapidly. The banks affected were suddenly trapped by their enormous balance sheets. Recapitalizations were the result, sometimes accompanied by striking changes in ownership. In view of the threatened recession in the USA, it is still unclear to what extent further tectonic shifts, in the "prime" mortgage sector for example, will adversely affect further bank assets, and necessitate more write-offs or recapitalizations.

So, for the time being, it is the nominal positions that matter, the more so as the ratings on which the risk-oriented perspective is based are only of limited value. While the valuations of tried and tested companies have remained largely unchallenged, there is now widespread skepticism regarding the ratings of financial vehicles. The nominal perspective is a sobering one: with a balance sheet leverage of 50, under certain conditions it only needs an insignificant shift in the value of assets and liabilities for the bomb to detonate. These "certain conditions" have proved to be far less improbable than might have been assumed on the basis of normal statistical distribution. The mathematician Benoit Mandelbrot made this point long ago, and with considerable urgency (*Fraktale und Finanzen; Märkte zwischen Risiko, Rendite und Ruin*, Munich 2005); his warnings have remained unheard.

An "all clear" for the credit market crisis will be justified not only when the affected banks have successfully carried out their emergency recapitalizations (by way of first aid), but also when we see that their immensely bloated balance sheets have really been slimmed down, and debt levels also significantly reduced. Nominally. And not just for a few banks, but by way of a general adjustment process, right across the financial system. The considerable increase in the cost of finance over recent months will no doubt contribute to this process of adjustment. For it is a poor deal to have to pay more on the right-hand side of the balance sheet in order to manage shaky or unattractive positions on the asset side.

4. Root cause research

Scenario 2, unblushingly referred to in financial jargon as "Black Swan" or "Harmagedon", may have become somewhat less likely, but it cannot be entirely dismissed for the months ahead. And we must also be aware of the direct and indirect damage that the crisis will leave in its wake. The direct damage includes the watering-down effect that the shareholders of some banks have already experienced, and some others may yet experience. It's around 40 percent at UBS for those who do not participate in the recapitalization. Bear Stearns' shareholders suffered virtually total loss. Previous owners are being replaced by new, often powerful, big shareholders, from different cultures, whose intentions are still unknown. And of course the enterprises themselves have suffered direct damage, in purely economic terms, but beyond this in the immaterial area of their reputation and their brand.

The indirect damage is probably more serious. For one thing, it is hard to imagine that a real recession would have threatened without the grossly exaggerated flow of funds in the direction of dubious American real estate investments. This is too high a price to pay for an entirely endogenous problem, created by the financial system

itself. It is not acceptable that precisely those whose function it is within our economic system to ensure the efficient allocation of its lifeblood – capital – themselves put the whole system at serious risk at regular and far too frequent intervals. This is really not how capitalism is supposed to work!

Two far more serious consequences arise from this: one, the already mentioned denser regulatory network; the other, a further expansion of the money supply, the result of the central banks' rescue operations, which are themselves by no means neutral in monetary policy terms, and thus by no means harmless. This is already making itself felt in the fall in the value of the dollar and the drastic rise in the price of oil and other commodities. Inflation threatens on every side. A phenomenon unknown for the last 20 years, and one which very few know how to cope with, it lives on as the scourge of the previous generation. So, in the medium and long term, there can be no talk of any "all clear" for the credit market crisis. We will suffer from its fallout for a long time to come.

Good enough reason not just to revert to business as usual, and put up uncomplainingly with further strokes of fate. In our view, the causes of the credit market crisis are fairly clear by now, so it should not be that difficult to think about alternatives to the previous system. The key issue was the level of debt that built up within the financial system, and *the level of debt in the financial system was, is, and remains a matter of the price of money*. Full stop.

So who was really responsible? The small players within the system, whose resources, both financial and physical, were soon exhausted? Absolutely not. Rather, the really big players, who for a very long time could take up money practically for free, and without physical limitations. Or semi-state institutions like the German IKB, whose direct or indirect state guarantee was well known. As long as, and because, business was so good, equity requirements were eased or circumvented by outsourcing bits of the balance sheet into "vehicles". Risk management was limited to the – relatively uninteresting – case of normal Gaussian distribution; data series so selected that, with regard to the supervisory authorities, they could be manipulated for the unholy purpose of "growing the business". The structures of companies were changed so that all their parts could serve the single purpose of getting as much onto the balance sheet as possible, at the lowest possible price.

We have made urgent reference in past Investment Commentaries to the catastrophic role played by the implicit state guarantees enjoyed since at least 1998 (Asian crisis, LTCM) mainly by very large institutions. The crisis of 2007/2008 is a direct consequence of the instrumentalization of this state guarantee, which has resulted in an unhappy concatenation of investment banks with unlimited production, and with an unlimited urge for still more commission revenue (and still higher bonuses), and banking conglomerates with virtually unlimited appetites for both products and risk.

But why American mortgages, of all things? The reason lies in the level of securitization, more advanced in this region and this sector than anywhere else, and thus in the deceptive (with the benefit of hindsight) certainty of operating in a limitlessly liquid market. What might (perhaps) have made sense as a diversification strategy for a single bank turned out to be a collective disaster. Once it becomes collective, speculation renders the statistical law of large numbers null and void; the dimension of risk based on it becomes tautologically empty of meaning. So, ultimately, half the world of banking bet that real estate prices would continue to rise. No account was taken of other factors, like the ability to pay interest or to amortize the loan. This all became possible, as already mentioned, because virtually unlimited funds were available on extremely attractive terms to finance all this speculation. To fail to take advantage of this free ride would have been regarded as unworldly and incompetent.

The "me too" attitude – the accumulation of supposedly low-risk or risk-free deals, the collective carry trade – has been clearly described as a phenomenon intrinsic to the financial markets by the Stanford economist Mordecai Kurz (*Endogenous Economic Fluctuations: Studies in the Theory of Rational Beliefs*, Stanford 1997). Put simply, as long as many people believe in a particular approach, it is rational to believe in it oneself, because one can make money with it. However, the end of every carry trade is a major or minor collapse, and generates what can reasonably be described as risk: unavoidable loss, whose timing is impossible to forecast. This risk will always be present: the only question is how great it should be. In the present case it has undoubtedly been too great.

5. Monetary policy or structural problem?

In an attempt in some way to retrospectively personify the blame for the collective error, the previous head of the Fed, Alan Greenspan has come under increasing fire in recent weeks. His low

interest rate policy from 2001 onwards should be seen as the real cause of the flood of liquidity, and thus of the reckless inflation of the big banks' balance sheets. This view seems to us to fall short of providing an adequate explanation.

There is no doubt that under Greenspan dollar interest rates were on occasion dramatically reduced in difficult times – in 1998 and 2001 – but it cannot be claimed that this monetary policy was not consistent with economic developments. Or that it was in itself inflationary. Rather, it must be admitted that a virtually ideal macroeconomic climate existed from the end of 2002 onwards, enabling broadly based global growth. In the wake of the collapse of the dot.com bubble and the shock of the terror strikes, this was by no means inevitable. Most businesses, with the exception of the financial sector, have been able to use the period since the end of 2002 to put their balance sheets in order and to prepare their financing for contingencies – what things would be like at present if the business sector were not so healthy hardly bears thinking about.

It could be argued that Greenspan was simply lucky, inasmuch as his expansionist monetary policy just happened to hit a time when inflationary forces had no chance. This was because enormous productivity increases resulted in a sort of global "output gap", as capacity expanded in virtually all sectors of the economy, with naturally deflationary consequences. Luck or skill – it doesn't really matter for our purposes; in our context all that matters is that Greenspan's low interest rates do not represent some aberration in monetary policy, so there can be no question of blame attached to monetary policy, however much some unfortunate bank bosses would have it so.

Low interest rates as the result of an excessively accommodating monetary policy do not really explain the financial sector's "easy money". For the banking system does not normally finance itself mainly through the central banks (which involves providing security), but by means of the public, i.e. via the capital markets. What really matters is thus not just the (very short-term) central bank rates, but much more what the market demands to finance the banks over all durations. The price will vary depending on the quality of the debtor, and there will have to be a visible and effective risk premium. We have already explained why this became less and less the case. In the financial system, and here we must include Alan Greenspan, along with many others, as co-responsible, a "zero-accident" strategy was pursued. And proof was provided often enough of the commitment to this zero-accident policy, resulting in the excessively low, almost non-existent risk premiums.

In other words, the causality resembles a vicious circle: accidents in the financial system were to be avoided at any price, and because that was possible for a very long time, the result was a price situation that more than ever made it possible for the banks to build up hazardous positions. The real impact of the zero-accident strategy was a massive redistribution to the benefit of the banking system: the bigger (and thus more indispensable) the players, the more they profited from the system. Herein lie the much-lauded synergies and economies of scale of the banking conglomerates. "Zero accident" is synonymous with "zero cost" for money; the cost is carried, for there is no such thing as a free lunch, by the general public. The cost hits come directly, as in the case of the takeovers of Northern Rock, IKB and Bear Stearns, or, even worse, indirectly, through the excessively frequent and ultimately superfluous financial crises, low or even negative real interest rates for savers, and possibly inflation or even stagflation. In other words, the distortionary structure of the financial system is a classic problem in political economics: by means of asymmetric incentive systems, a specific sector creates for itself one-sided benefits at the expense of the broader public – one of the most extreme forms of subsidy of all, which, among other things, allowed the big banks to operate on a far greater scale than would have been possible if they had had to pay the real price for the risks incurred.

"Zero accident": well meant (perhaps), but with disastrous consequences – a vicious circle indeed. That it did more damage in a period of low-interest-rate monetary policy than it would otherwise have done is no reason to look for the systemic error in monetary policy. There is no way round a discussion about structure. The free implicit state guarantee offered to the financial system is easily able to explain most of the distortionate effects, such as excessive bonuses and managerial salaries, disproportionately luxurious offices and all the rest. They are hardly to be found in other sectors of the economy outside the financial system. The difference between the real economy and the financial system is thus not, as often claimed, primarily a moral one, but a structural one.

6. No alternative?

Now, we shall of course hear the objection that there is no real alternative to the zero accident approach to the financial system. For the smooth functioning of the system is far too important to

waste any time thinking about models more open to incidents and accidents. IKB, Northern Rock, Bear Stearns and before them LTCM, indeed the entire "moral hazard" issue, are the price to be paid for an uninterrupted supply of capital for the whole global economy. All that is needed is the right regulation to keep a check on the negative side-effects, and it may be admitted that, in the light of the current crisis, this requires further consideration. But there can be no interference with the basic principle of accident avoidance.

This position is widely held. Supervisory authorities, finance ministries, central banks all share this opinion, and practically the whole world of banking also thinks like this. Without at all wishing to insinuate any incorrectness, people do tend to think in terms of their own advantage. And the interests in this case seem to be fairly well aligned. Authorities tend to favor structures that enhance the importance of their own operations, and the zero-accident structure fits very well with this interest. And it is obvious enough that the big players in the financial system will be in no great hurry to give up their gratis guarantees. There is a great deal of money at stake, and a great deal of power. The financial system as it currently functions is managed by an at least implicit cartel of opinion. So it is no surprise that there is no call for alternatives to "zero accident".

Alternatives do exist, though, and it is to be wished, in the wake of the credit market crisis, that they become the subject of more serious discussion. After our first attempt at this, in July last year (Investment Commentary No. 250), our attention was drawn to a paper going precisely in this direction, and which had already been presented in 2004 at a conference of supervisory authorities in Chicago. Under the title "Protect functions, not institutions", the author, Eva Hüpkes, Head of Regulation at the Federal Banking Commission, advocated a protective function for bank supervisory authorities that was limited to system-relevant tasks (*Financial Regulator*, Vol. 9 Nr. 3). This is remarkable.

To take the view that institutions – Bear Stearns, etc. – may indeed fail is implicitly to accept that accidents will happen. Accidents in the sense that ultimately creditors will suffer. The key point is that it is the *creditors who determine the price of money*, on the basis of the probability of default. If the probability of default is artificially practically zero, as a result of the implicit guarantee, then the price of money is too low. If creditors find that they must in future always expect to suffer losses from financial debtors, then they must increase the price of money. And this higher price, at which players in the financial system must then finance their deals, would decisively reduce the leeway for carry trades, for complex financial instruments, and for highly leveraged hedge funds. Accepting the possibility of minor accidents would significantly reduce the risk of mega-meltdowns, such as the credit market crisis has bestowed upon us.

The question naturally arises of whether such a "functional" approach would be at all likely to be successful. Hard to say. The boundary between "system-relevant" and "not worth protecting" is delicate and would, if it could not be clearly communicated in advance, result in continuous disputes between the banks and the supervisory authorities. It might be simpler to revert to a rather cruder distinction between investment banking and commercial banking, as prescribed in the USA's Glass Steagall Act, which was abolished in 1999. It might indeed be necessary to revert, obviously only for the system-relevant aspects of banking, to a "narrow banking" concept (that requires a strict match of maturities on both sides of the balance sheet), as advocated by Milton Friedman 50 years ago.

It is obvious enough that no insights into alternative structural concepts will be gained if no discussion takes place. Over-hasty proposals of repairs to the existing system will effectively stifle such a discussion. In our view there is no point whatever in continuing with the zero-accident approach. For there is no reason to suppose that the financial system in particular should be immune to the accidents that occur continuously in all other sectors of the economy.

7. Static vs. dynamic perspectives

This brings us to the heart of the discussion about what stability really is, and what it might mean as an objective. If we understand the vast literature on this subject more or less correctly, there is a preponderance of static concepts. That is to say, stability is often defined as the non-occurrence of the consequences of internal and external shocks, and consequently, as the general avoidance of such shocks. Applied to the financial system, this means the avoidance of bank insolvencies; applied to the economy, the avoidance of recessions. The Fed in America has indeed explicitly defined such a politico-economic objective.

Is this something that a central bank or a supervisory authority has any hope of being able to do? Friedrich August von Hayek never tired of pointing out that the achievement of such an absolute objective presupposed a comprehensive understanding of all the circumstances, but that such an

understanding was unachievable for even the most powerful authority. Who, for example, would have been able just 20 years ago to forecast the relevance of the Internet and the associated productivity improvements? Certainly not some authority. Who could have – who did – forecast such a mess over mortgages three or four years ago? Who can today say with sufficient certainty whether the price of oil in two years time will be nearer 200 dollars a barrel or nearer 20 dollars? But when we don't know that, and much else besides, and when furthermore, the skills to manage the key system parameters are largely lacking, how can we ensure stability in the sense of the absolute avoidance of shocks?

To pretend to be able to do something that is ultimately impossible results in dangerous distortion, as has been demonstrated by the zero-accident strategy in the financial system. We cannot avoid the impression that the current wave of wishful thinking about recovery, as propagated for example by the Bank of England, and the very generous monetary policy practiced by the Fed since the outbreak of the credit market crisis should be seen precisely in this context of the unachievable absolute objective of shock avoidance. The *Economist* quite rightly remarked a couple of weeks ago that without a recession, the Americans would never have been motivated to shift from consumption to saving. Following our logic, the result of an inflationary monetary policy by the Fed that aimed to avoid recession would be that the avoidance of what must be reckoned to be a more minor recession-type accident would end up in a far more serious inflation-type accident.

Hayek distinguished between the following of abstract rules – in the case of a central bank, perhaps the maintenance of the value of money – and interventions with a specific purpose: "nomos" versus "thesis". The abstract rule requires no comprehensive understanding of the whole complexity of the situation, but nor does it lead to concrete and predictable results. Accidents – recessions – can happen. But if nobody relies on the fact that they cannot happen they will be comparatively less serious than if there is an illusionary guarantee of "zero accidents". It's not only the Fed or the financial system; in the Western world as a whole the excess of illusionary guarantees is beginning to have negative consequences. There are too many bodies that instead of following abstract rules stumble from one concrete measure to the next, and soon end up producing nothing but negative side-effects. The "presumption" (Hayek) of illusionary guarantees will ultimately outstrip any financial performance. The financial system has now reached that point; this is undoubtedly even more the case with the now unaffordable structures of the welfare state, itself conceived to prevent the occurrence of any social accidents,

We suspect that we may have reached a turning point, inasmuch as we now see the great hopes of the Western world coming to nothing. Our proud and mighty banks have to recapitalize with Asian and Arab money, a significant part of our industrial production has been lost, and what for the moment seems to remain for the West is the brand names of products that have long been manufactured elsewhere in the world. The place of the Western system, oriented on static security and the absolute avoidance of pain, is increasingly being usurped by people and intellectual approaches that take a significantly more dynamic perspective.

8. Stocks: risky, dynamic and – safe!

How can it be that, in the wake of one of the most dangerous crises of all time in the financial system, and in view of the most unwelcome weakening of the US economy, the stock markets as a whole have reacted relatively moderately – with the exception of the bank and insurance stocks directly affected? The Swiss Market Index (SMI) has fallen by just 11 percent since July 2007, and by just 7½ percent since the beginning of 2008. In America, we are down 1½ percent since mid-2007, and down 3½ percent since the beginning of the year (in US dollars). In their assessment of the crises, are the markets simply more optimistic than the Cassandra of St Gallen, or are there perhaps other forces at work?

We suspect that the latter is the case. Recent months have shown that parking money in the banks or the financial system can turn out to be a dangerous exercise. Scenario 2, the "Black Swan", in which the situation might arise that "too big to fail" becomes "too big to rescue", and that big financial service providers might encounter serious financial embarrassment, was (and to a certain degree still is) real. More probable than improbable, and extremely dangerous. But what would be the right "currency" in such a situation?

It is entirely logical that investors have included in their calculations the holding of solid material assets as an absolutely appropriate instrument for managing the crisis. Companies outside the financial sector are, as already mentioned, generally very robustly financed, have low levels of debt, are posting good revenue figures, and are comparatively undervalued. These companies are, each for itself, managed by people who apply all

their intelligence and creativity to achieving the best for their company and for themselves.

In other words, stocks are the dynamic alternative to an investment in the financial system based on the illusion of a static freedom from accidents, and to the currencies that incorporate this illusionary concept of freedom from accidents, in particular the US dollar. With stocks, we know that they involve risk; with bank accounts we supposed that they did not. And stocks also provide some protection against inflation, which will undoubtedly be of importance in the longer term. That's the difference.

So, what has all this got to do with making one's way safely across the scree? Those who have found themselves on one of the numberless scree slopes in the Swiss mountains know that standing still is more dangerous than trying to keep ahead of the shifting stones by moving faster. The momentum of the economy is far stronger than that of all the mountains in the world. Relying on static concepts is not the answer. Which is why we retain our preference for stocks. They will survive.

KH, 5.5.2008