Complex situation. Simple remedies?

1. Causality or coincidence?

One forecast, at least, is easily made in these confusing times: 2008 will go down in economic history as a very special year. And because this forecast is easily made, it will serve as the opening to many articles that will appear at the end of the year. But anything that goes beyond such trivia is a good deal more difficult to ascertain. For, in addition to a few clearly identifiable developments, the profound crisis into which the financial system has maneuvered itself – and with which the economy as a whole is now increasingly confronted – is characterized by the concurrence of a wide variety of negative factors. To try to create causal links within this concurrence would be hopelessly constructivist. That no-one any longer wants to buy gas-guzzling off-roaders and the American automobile industry is therefore in difficulties; that the big banks still need to worry about the intrinsic value of their assets; that pirates and navies play cat and mouse off the coast of Somalia, while the rise in maritime insurance premiums threatens international trade; a priori, these have only one thing in common: their coincidence in time. Crises have a habit of simultaneously bringing to the surface problems latent in our everyday existence that are perhaps overdue for resolution.

This means that jumping to premature conclusions is a risky business. The philosopher Peter Sloterdijk, for instance, recently proclaimed triumphantly: "Thanks to the crisis, the state is revealed in its true colors. It is once again clear that it plays a decisive role in the markets – not just as a distributor, but as guarantor and purchaser of last resort. It is in reality the only multi-billionaire that really counts. And yet the spirit of the past thirty years has reduced it to playing the fool." (*Neue Zürcher Zeitung*, 29.11.08, p. 47). The genuine skeptic sees things rather differently. The chaotic inconsistency of state intervention – Bear Stearns's bankruptcy no; Lehman's bankruptcy yes, Paulson's bail-out yes at first, but then only heavily diluted, guarantees by European heads of government for their domestic banks ranging from the excessively generous to the obviously unfulfillable – is part of the catastrophe that the global economy is now sliding into. It is not part of any alleged solution – not that there are any signs of one, anyway.

The essence of this crisis is an unprecedented complexity of the most varied threads of problems, that are at best only loosely interconnected. And if we begin by questioning Sloterdijk's (somewhat surprising) euphoria concerning the state, then we must also begin with a warning against false expectations concerning simple remedies that might enable the formulation of investment strategies for the coming months and years. The sheer complexity of the situation makes it virtually impossible to offer mono-dimensional advice.

So, let us restrict ourselves to examining one or two of these threads, assessing their importance and, cautiously, identifying some consequences. All we will say in advance is that the complexity of the situation is clearly reflected in the radical changes to the financial system's data series. Risk premiums for banks, companies, even states, have rocketed to heights unimaginable before the crisis: that is, in what was a supposedly risk-free world. *Risk* has now become a tangible reality, and is at last again being *compensated*. This piece of good news cannot be sufficiently emphasized, no matter what doom and gloom is to be found in what follows. For it is far better (for investors, but also for the financial system and the economy as a whole) if existing risks are compensated than if the supposed non-existence of risk results in a free ticket to a fool's paradise.

2. Economic heart attack

Let us turn first to the state of the global economy. The period from 2003 to 2007 was clearly characterized by simultaneous strong growth in all areas of economic significance, on a scale that had never been seen before. The growth engine powered ahead because information and transaction costs had been radically reduced by the opening up of global politics and by the communication revolution. We are still not sufficiently aware of the enormous significance of this important driver of the global economy. The ease with which goods and services are exchanged around the world today would have been unimaginable just 25 years ago. From trading between enormous commodity merchants and industrial giants right down to the individual consumer, things are selected, ordered and paid for via the Internet as a matter of course. And wonder of wonders; the delivery of 10 million barrels of oil and the timely arrival of a crate with replacement parts for Hyundai XG30, as well as the postal delivery of the pirate copy of the latest Bond film all go smoothly. Everything as expected, just in time.

This ease of international trading; the possibility of having everything always available, everywhere; the ability to compare quality and price easily all round the world: all this has given the world an unparallel surge in growth. Suddenly, no small or medium enterprise could do without its own global strategy. No international company that did not continually review and adapt its production portfolio. Outsourcing, nearsourcing, offshoring, production sites and joint ventures in India, Vietnam and China have become part of the vocabulary of companies all around the world in recent years. "Globalization" as a concept only partly does justice to the nature of this development. It is rather the conjunction of two independent driving forces: the politically motivated opening up of the world and the technological multiplication of means of communication.

An agreeable side-effect of this opening-up process have been very low rates of inflation in the Western industrial nations over the past fifteen years. This was the result of a highly effective global "output gap"; that is, a positive difference between so-far unmobilized production capacity and effectively exploited potential. Put rather less theoretically, it was always possible to find someone who would provide goods or services more cheaply.

A disagreeable side-effect of globalization has been (and remains) the oft-mentioned imbalance in task distribution across the regions of the world, and the associated trade deficit of the USA. Imbalances of this nature are virtually unsustainable in the long term. Not even an unquestioned global power can afford to live on tick indefinitely. It also seems that the positive effects of globalization have begun to reach a peak in recent years. Now that absolutely everybody is producing their goods in Shanghai, wages for suitably skilled labor are beginning to rise noticeably there. So, to somehow achieve further cost savings, it becomes necessary to move on to ever more exotic – and perhaps ephemeral – areas. If our analysis is correct, the increasing difficulty of finding positive globalization effects has most recently been reflected in a slowing down in the growth of the profitability of manufacturing industry.

And of course, as seems unavoidable with any quantum leap in global development, euphoria about the new possibilities is conducive to carelessness and improvidence. Carelessness about the risks inherent in all international exchange despite, or perhaps because of globalization. For the whole process only functions if the communication works, if there are no political or military obstacles to the exchange of goods, and if international payment transactions happen smoothly. Put the other way round, globalization has its Achilles' heel – and not just one, but several. Accepting exposure to ever more extreme logistics risks can only be described as improvidence. Woe betide when some essential component does not arrive on time. The concept of a "reserve supply" has increasingly tended to disappear from our vocabulary.

Globalization, the perhaps somewhat overripe fruit of the last fifteen years' endeavor, has now been wounded in the Achilles' heel of its financial system. Its oxygen supply, in the form of capital and credit, has been cut off, creating widespread anxiety among both producers and consumers. Factories until recently running flat out suddenly find themselves confronted with empty order books – practically without advance warning. This contraction began in the textile machinery and automotive sectors, but is now spreading to more resilient sectors. Orders already placed are being cancelled, international financing no longer works, shipping lines on the high seas are having to work with freight rates that no longer even cover the fuel costs. The collapse of shipping companies is a matter of time.

What has been happening in the economy over recent months resembles a heart attack suffered by someone of a sanguine disposition: one minute he's cheerful, casual, optimistic, entrepreneurial and well-nourished; the next, he's flat on the floor, motionless, pale and corpse-like. What do we do now?

3. Counter-Reformation in progress

One of the most important consequences of the fall of the Berlin Wall in 1989 was the way the significance of the territorial was reduced by the forces of open global access. It was suddenly possible to travel anywhere in the world, to experience foreign cultures much more easily, to settle almost anywhere one wished, and, above all, to produce and trade goods worldwide. As a result, the home base declined in importance, relatively and absolutely. The territorially defined organization – the state – came under pressure from the sudden comparability of conditions, and the ability of citizens and businesses to move elsewhere if they felt like it and find thoroughly acceptable alternatives. This is probably what Sloterdijk meant when he talked of the state being reduced to "playing the fool". Conversely, one could also say that for the first time in history, thanks to globalization, the individual was no longer condemned to play the fool, but could at last emancipate himself from his territorial organization.

Whatever: it was obvious enough that sooner or later the territorially defined organization would strike back. It was forces from cultures diametrically opposed to globalization, because it threatened to rob them of their male domination over women, that helped the Western states to a revival of their military and police power. Without the terror strikes of 2001 and the associated actions, there would have been no Afghan War, possibly no invasion of Iraq, none of the rigorous and tiresome security checks at airports, no secret service computers snooping around private data, no "Patriot Act". Without intending to, international terrorism has strengthened both the state as such, and the cooperation between states. In doing so, it has made good progress towards its goal of pushing back globalization.

At the same time, we are witnessing attempts to mitigate the state's loss of influence by means of cooperation – motivated not only by security considerations – between states at higher level. Key words here are "a level playing field", harmonization, the attack on destructive tax-based competition, system security, fair trade, environmental protection, and the like. Subjects, then, that from an objective perspective may well be in need of attention at international level, but essentially serve as a pretext for following one's own agenda. Supranational organizations and bodies have gained in importance from the difficulties – not least financial – encountered by states in recent years. What was unattainable by means of domestic politics has been gained by technocratic means at a higher level. This explains the remarkable affinity of lower-level players for the higher levels, so particularly obvious within the EU.

In this context it should be noted how genuinely important problems, only capable of solution internationally, have been misused, inasmuch as entirely unconnected topics have been allowed to ride on their backs. There is no doubt that there was need for action on terrorism after 9/11; without batting an eyelid, however, the Americans slipped their disastrous war on drugs into the agenda, as did the Germans their struggle against tax evasion. The same thing is now happening in connection with the consequential damage from the financial crisis: once again, the main focus is on the "tax havens", as if they had any causal relationship with the financial crisis.

This means that in the dramatic course of events in 2008, with the complete or virtual collapse of big banks and insurance companies, the comeback of the state seems to have been successful, also at the lower, internal level. The existential problems of the big players essential to the system have enabled the states to appear as the ultimate source of salvation. As states take on debt and risk – however this is done – their ability to exert influence over the banks clearly increases. Salaries and bonuses are to be limited, and credit policy dictated by the state to meet the needs of the real economy. The banks are being obliged, more or less by decree, to behave more accommodatingly towards each other; in some countries they are even being press-ganged into accepting state support. Never before in economic history have so many financial institutions been wholly or partially nationalized in such a short space of time. No matter whether this was necessary or not; all that interests us here is the facts. The last three months resemble an October Revolution for the financial system.

Or, another metaphor: after the Reformation of globalization, a rigorous Counter-Reformation is now under way. If we are not much mistaken, the first inquisitors are already at work, and the wood is being stacked at the foot of the first stakes.

4. The limits of debt?

This Counter-Reformation is based on territorial structures that are in a fragile condition internally. Here too, the parallels with church history are not entirely absurd. In terms of the classic tasks that may reasonably be allocated to the state – internal and external security, the maintenance and further development of the rule of law, the provision of an appropriate infrastructure as a platform for personal and business activities, the production of individual public goods such as education and research – the performance of public institutions has clearly and measurably declined over the last decades. At the same time, additional tasks have been piled on, and these too need to be performed by structures that are far from cost-efficient: a wide range of cultural activities, "production" in the healthcare sector, the management of redistribution between the various client groups in the social state, energy supply, and so on and so forth.

Even before the financial crisis – that is, without taking account of the additional financial liabilities now incurred – there was hardly a single Western state in a position to harmonize its tasks, its expenditures, its commitments and its current and future income. What we first set out for our readers some years ago has recently been confirmed with new figures by the "Stiftung Marktwirtschaft" and its "Frankfurter Institut". The sum of current expenditure, based on explicit national debt and the cash value of commitments for future benefits, far exceeds what can be financed on the basis of currently applicable tax rates. Depending on the country, the total explicit and implicit national debt amounts to between three and six times annual GDP. It is evident that, in the absence of any "real" solution, such as massive immigration, states will only be able to get out of this trap by increasing taxation in the future and/or reducing benefits (e.g. by means of depreciation). Both measures are of more or less confiscatory character.

The already overripe and fairly toxic fruit of recent years – a loss of credibility through the reduction in performance of the classic functions of the state, coupled with the incurring of unrealistic commitments and irrationally high debt – appears now to be reaching its culmination in state measures to maintain the stability of the financial system.

Let us first review the impact of support on the budgets of the most affected states. What would be the additional national debt in the event of a partial default on the part of the assets acquired from the banks, if the guarantees issued were called upon, and if the capital injections were written off? The table below is based on the assumption of a 30 percent default rate.

Potential additional debt

	Government aid		Potential loss	
	Absolute (USD bn)	Per capita (USD)	In % of GDP	Increase in debt
UK	941	15'547	10.1%	23.0%
D	668	8'077	6.0%	9.3%
CH	59	7'864	4.1%	8.7%
F	455	7'433	5.3%	8.2%
US	2'298	7'665	5.0%	7.6%

Note: Figures as of 24.10.08.

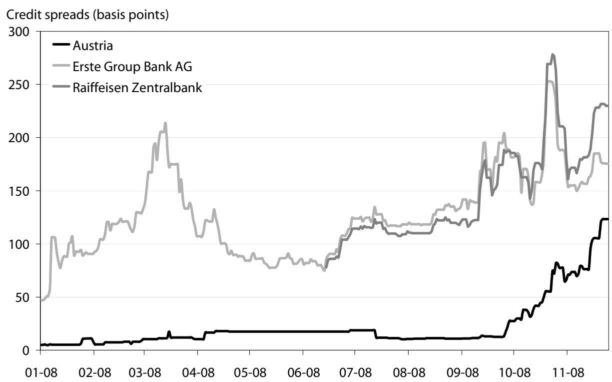
Source: Bank of England, Eurostat, IMF, OECD

There are no empirically confirmed figures on the sustainability of explicit or implicit national debt. Zimbabwe, Argentina, Ecuador or Iceland will hardly serve as examples, given their widely differing situations and economic structures. It is also surely the case that variations in the level of general nervousness have a significant impact on the perception of the sustainability of state debt. Currently – that is, under the impact of the near-collapse of the financial system – nerves are raw, and the players on the international financial markets no longer have any faith in states' unlimited capacity for debt. A couple of examples here, that must provide food for thought. The metric for states' capacity for debt is the current Credit Default Swaps (CDS); that is, the "insurance premiums" for outstanding loans to a state in the event of default.

The example of Denmark shows how problematic an excessively generous guarantee by a state for its banking system can be. Danske Bank is by far the most important bank in the country, with a market share of over 50 percent. With a virtually unlimited guarantee, the state of Denmark has now landed itself with exactly the same risk premium for its national debt as Danske Bank is also charged: just on 120 basis points. Conversely, market players now reckon that there is an equal probability that the bank and the state will go broke. Six of one and half a dozen of the other: higher risk premiums mean higher financing costs for national debt. The Danish taxpayer already has a share of the loss.

So far, Austria has largely avoided the attention of observers of the crisis. But since various Eastern European countries, such as Hungary or the Ukraine, have come under both financial and currency-related pressure, risk premiums are also rising for Austrian banks, which are heavily exposed in Eastern Europe. A CDS premium of 100 basis points represents a calculatory probability of around 11 percent that the Austrian state will become insolvent over the next five years, allowing a residual value of 40 percent for the bankruptcy dividend. Is an 11 percent probability of failure a lot or a little for an institution that is supposed to be able to function in the future as "guarantor and purchaser of last resort" (Sloterdijk)?

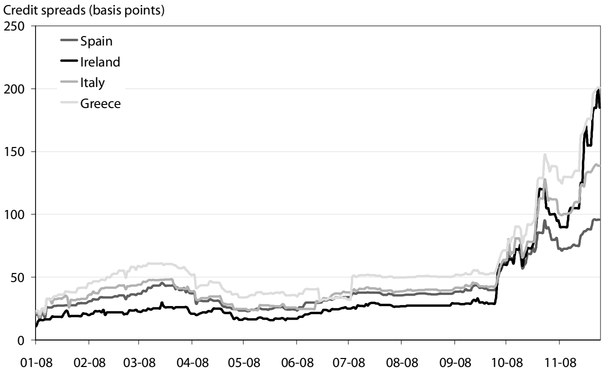
Austria as the next problem?



Source: Bloomberg

There remain the notoriously wobbly members of the "Garlic Group" of countries in the Eurozone, Greece, Italy and Spain, now joined by Ireland, since it issued a comprehensive state guarantee for its banks. What is particularly interesting for these countries is that, according to the *Financial Times* (1.12.2008, p. 15) using the capital market to finance their budgets in 2009 is likely to cost between 7 percent (Spain) and 20 percent (Greece) of GDP. In absolute numbers, this will amount to EUR 220 billion for Italy (13.6 percent of Italian GDP).

Tensions in the Eurozone



Source: Bloomberg

Are we facing a domino-like series of national bankruptcies, on the lines of the Spanish 'Flu epidemic? Will the euro come under further pressure, and even collapse? As advisers, we have often been confronted with these and similar questions in recent times. Without in any way wishing to dramatize the situation, such scenarios are not wholly impossible or inconceivable. How would the European Union react, for instance, if Greece were confronted with the disastrous bankruptcy of its shipping lines? How would a bail-out work within the Eurozone? Would there be an attempt to solve the financial problems of individual countries by means of a Eurobond? How would the burden be shared? Have such situations been thought through, and possibly even rehearsed?

A question that is easier to answer is whether there is still room for maneuver in the financial system for further state support, or for economic incentive programs. The answer is no. The capital market is now drying up for states as well, and the anticipation of an unavoidable wave of tax increases is already enough to trigger depression.

5. Past the worst?

To the financial system: the collapse of the American investment bank Lehman Brothers on 15 September 2008 came as such a shock to the system that this single event is now being regarded as the catalyst for the accentuation of the crisis. Which is obviously not the case. Its bankruptcy was simply the consequence of the specific and difficult liquidity situation of the bank concerned, within a financial system that was generally in an extremely fragile condition. The problem with Lehman's bankruptcy was not that it happened, but how it happened: under conditions of complete unpreparedness. It is no great surprise that shareholders and unsecured creditors catch a packet when a bank goes broke. But the fact that such a bankruptcy could seriously threaten property rights, or even render them null and void, indicates a dramatic regulatory failure. Neither the Securities and Exchange Commission (SEC), the responsible regulatory authority, nor the Fed had ever seriously thought through the end of a bank, never mind rehearsing for it.

Which gives rise to an interpolation. In these pages, we have often enough complained about the perception, or rather illusion, that the bankruptcy – that is, the compulsory winding up – of a market player is not possible within the financial system, on the grounds of system security. We have made it plain that we see in this misperception the root of all evil; that is, the risk premiums – far too low for far too long – for those players always deemed "too big to fail". Part of this illusionary perception is the absence of any familiar process for a real emergency. Because an emergency was not allowed to happen, the very idea was banished from people's thoughts. The bankruptcy of a bank is no doubt regulated satisfactorily in legal terms, but this is certainly not true of its practical implications, anywhere in the world. The lack of preparation for an emergency represents the biggest, inexcusable, failure on the part of the supervisory authorities. Instead of making banks' daily business a misery through the nit-picking interpretation of rules and regulations, they would have been better employed in carrying out dry runs for the collapse of a bank – in exactly the same way as, during the Cold War, the Swiss Army practiced for an invasion by the Red Army. Absolutely as a matter of course, and with complete seriousness, in the devout hope that it would never be necessary to put the lessons learned into practice for real. Such exercises should have revealed the dividing line between "system-relevant" and "non-essential" within the banks; a dividing line that is now badly needed, so that the state must not ultimately take on the whole risk. It is a reflection of the euphemistic spirit of our times – in which the elderly are banished from society into care homes – that people are also unwilling to face up to the not improbable end of things in the economy in general, and the financial system in particular. However much the financial crisis may appear to be about the economy, it is ultimately also a crisis of the zeitgeist. Euphemism has reached its limit. End of interpolation.

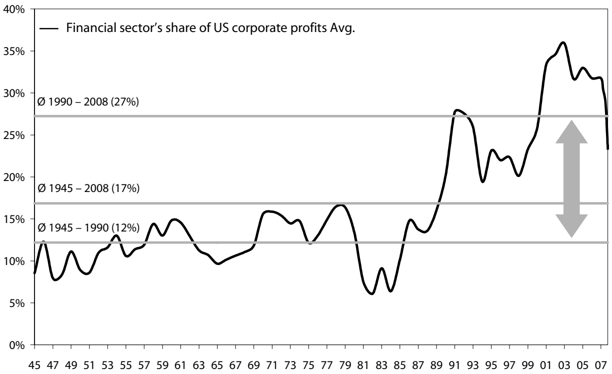
The bankruptcy of Lehman gave new dramatic impulse to the course of the crisis. The smoldering solvency crisis – the awareness of the dubious value of banks' assets and their undoubtedly inadequate equity base – was almost immediately transformed into an acute liquidity crisis. No bank trusted the others; instead, they all hoarded whatever liquidity they had, in the safe havens of state, or semi-state institutions. Only with a great deal of effort and much persuasion has it been possible in recent weeks to somewhat resolve this unhappy situation in interbank trading. In the meantime, the liquidity-poor (big) banks had, so to speak, to be artificially fed with emergency supplies. All in all, this has proved more or less possible, even if the slightest shock has repeatedly resulted in a further radical deterioration of the situation. The extremely volatile CDS premiums – far above the long-time average – tell a clear story: the patient is still alive, but his condition is extremely unstable, and the intensive care unit overstressed.

It should be noted that the efforts to overcome the solvency problem – that is, to move the banks away from their uncomfortable proximity to bankruptcy – has at least got off to a serious start. Assets amounting to almost 1,000 billion dollars have been written off worldwide, and 874 billion dollars of new capital raised. The American banks have borne the lion's share of the write-offs (670 billion), while the Europeans are well ahead on recapitalization in relation to their posted losses, with some 300 billion dollars. The British have taken the most aggressive approach; until further notice, the state is now the majority shareholder of the Royal Bank of Scotland, with a 58 percent holding. The Americans' slower progress with recapitalization is doubtless due to the unclear signals regarding their bail-out plan.

Resolution of the equity situation is an important precondition for being able to deal relatively calmly with the other tasks required in a situation of threatening insolvency: the realization of assets and the reduction of what has become surplus capacity. While the first of these currently seems fairly impossible – there just are no buyers for such intransparent goods – the banks have now made a start at redimensioning their structures. So far, the loss of some 200,000 jobs worldwide has been announced, with 50,000 at Citigroup alone; and the two big Swiss banks will each be shedding between 8,000 and 9,000.

It is difficult to determine how far the restructuring process has progressed. On the basis of the observation that the institutions concerned, and indeed the financial sector as a whole, practically doubled in size between 2003 and 2007, while the rest of the economy grew by a low single-digit percentage during this period, we suspect overcapacity of 30 to 50 percent.

Overcapacity, thanks to Greenspan's cheap money



Note: Domestic corporate profits; financial sector excludes Fed banks.

Source: Bureau of Economic Analysis (BEA)

In this case, the loss of 200,000 jobs would be a significant start to a process that has a good deal further to go. For example, the two main causes of the crisis, Fannie Mae and Freddie Mac, have yet to shed a single job. This does not bode well, for both institutions are now fully state controlled. If all the other institutions that have recently become wholly or partially state-controlled display a similar lack of determination to restructure we shall in ten years' time again find ourselves confronted with a financial crisis.

6. Things are likely to remain precarious

Let us attempt to draw some conclusions from these problematic aspects. In economic terms, 2009 is likely to be a seriously bad year, with shocking unemployment figures, plant closures, bankruptcies and disruptions in the global exchange of goods and services.

In political terms, what we have called the "Counter-Reformation" will take on expansive and euphoric forms. The recovery of ground by the state may manifest itself, among other things, in a return to protectionism (Sarkozy!), in a more aggressive approach by the fiscal authorities to their taxpayers, and in a massive wave of regulation. States will also attempt, by means of anticyclical investment, to counter the economic downturn. In such situations the use of public funds generally results in construction work that is widely visible, but brings only marginal economic benefit.

The financial sector, caught up in the downturn from an early stage, will continue to restructure itself energetically in the coming year, unless prevented from doing so by further state intervention. In and around the major financial centers, the lack of a highly solvent clientele will result in a steep fall in the price of real estate. In ancillary sectors, such as the art trade, things will return to normal. “Works of art” such as Damien Hirst’s shark in formaldehyde are already attracting only a fraction of the absurd sums previously paid for them. Hirst has recently cut the staff at his “factory”.

How rapidly the global economy will recover from these simultaneous shocks will depend on four matters.

Firstly, on the skill of the supervisory authorities and central banks in carrying out whatever further restructuring becomes necessary without additional burdens on, or contamination of, the public sector. Every debt crisis ends with the transformation of debt into property, as we explained in the previous Investment Commentary (No. 259, 13.10.08). The transformation ordered by the authorities of the banks’ long-term liabilities into equity corresponds to insolvency proceedings in which both the system-relevant bank structures and also the state finances are protected. The losers here are some creditors, whose claims are anyway reduced in the light of the higher risk premiums.

Secondly, it will depend on how far strong Asian domestic demand can compensate for reduced American consumption. In principle, there are millions of people, particularly in China, ready and waiting to enjoy a higher standard of living. The question will be whether the Chinese government has the courage to permit its citizens the greater freedom essential to a higher level of consumption.

Thirdly, there is the question of whether there will be enough projects that can rouse enthusiasm and excite people, not only in the Far East. In the automobile industry, hybrid-drive and electric vehicles seem to be becoming accepted. The electric sports car built by Tesla, a Californian (!) manufacturer, accelerates from zero to 100 kilometers per hour in 4 seconds. In a few years’ time Formula 1 will be electric-powered. But this sort of thing alone will not suffice to revitalize the economy, of course. In all honesty, we must admit that there are currently few major innovations on the horizon; lots of marginal ones, but nothing really exciting.

The fourth requirement is the rapid normalization of financing in the real economy. This is of course to some extent also dependent on the financial system-retention measures already discussed at length. But going beyond this, what in our view will be decisive is whether, given that the major institutions will remain more of less paralyzed for some time to come, new players in the financial sector will be able to find new ways of financing the real economy. Paradoxical as it may currently seem, we remain convinced that securitization will go further, and that the direct financing of the real economy via the capital market, bypassing the banks, as it were, will be among the most important long-term consequences of the financial crisis. And one that is long overdue.

It is of course very far from certain that all this will happen at the right moment, which is why we believe that the situation remains very precarious. Setbacks, uncertainties, desperate situations will continue. And the question of whether the systemic collapse, whose outlines we have seen clearly in recent months, will actually happen will continue to arise. What would be most likely in that case would be currency disruptions, for currencies are ultimately the reflection of the government and the economy of their countries of origin. The questions raised about the limits of state debt will remain relevant in the year ahead.

7. Spreading the load

With every investment category except cash and government bonds showing losses – some of them heavy – this year, banks and asset managers have become cautions in their recommendations. Understandable enough, there is little enthusiasm for doing further damage. And so, many of them no longer dare to alert their clients to the currently enormously attractive returns on top-class industrial bonds.

This is wrong and regrettable. For if we really think though the scenarios sketched above for the further progress of the crisis, then just such a surplus in the so-far attractive investment category of cash could become a problem. Should the system collapse, no certain forecast would be possible for any currency in the world, not even for the Swiss franc. So, cash cannot be the only answer for investors concerned about systemic collapse.

What, then, are the alternatives to cash? Hedge funds? Forget it. Apart from the very few that have strictly maintained transparency and liquidity, most hedge funds can be confidently consigned to the dustbin of financial history. Bonds? Up to a point. Despite the higher risk premiums, government bonds now generate little or no income but still carry an interest-rate risk and, in the event of systemic collapse, a creditworthiness risk. Some industrial bonds, on the other hand, offer extremely interesting returns (Unilever, BASF, EON and Holcim). Should the economic downturn be more serious than expected, however, such investments would come under increasing pressure. Bonds also need to be carefully diversified across countries and sectors, on account of possible currency turmoil. The utmost attention must be paid to the quality of the balance sheets of the companies concerned, for the coming economic downturn will worsen the financial situation of even the best companies.

Stocks? Yes – despite all the losses. Firstly, as soon as there are even small signs of a way out of the crisis, stocks have by far the greatest potential for recovery. We did not go into this crisis on the back of thoroughly overheated stock prices; on the contrary. Current valuations are attractive, if not indeed sensationally low – unless, of course, the system really does collapse. In that event though – and let this be clearly understood – a well diversified portfolio of real assets, in the form of stocks, will be worth a very great deal. For in all the great catastrophes in human history, it is the ownership of real assets that has survived.

We said at the start of this Investment Commentary that the situation was extraordinarily complex. Fortunately, economics offers the correct answer for situations that leave one at a loss, despite all the analysis. It is diversification. Across all investment categories, all regions of the worlds, all currencies, all economic sectors. Once more with feeling: diversification!

KH, 9.12.2008