Debt reduction: difficult and risky

1. Clearing up

Back in the days when it was thought desirable, and rewarding, for young Swiss managers to qualify as military staff officers in Switzerland's army, we learnt some never-to-be forgotten lessons. For example, when, in the early hours of the morning, after working through the night, in the midst of a chaos of half-finished operation plans, manuals, draft orders and mislaid writing utensils, the instructor suddenly bawled "Stand still! Clear up this mess!" And lo and behold – once everything surplus to requirements had been binned, pencils sharpened, manuals and regulations retrieved from under poster-sized plans, and some sort of military aesthetic re-established – the sudden release of amazing productivity and utterly unexpected energy meant that what had previously seemed utterly hopeless and pointless could be achieved rapidly and successfully.

The aim of this sort of no-punches-pulled management training was to inculcate a sense of priorities in the middle of mess and muddle. Crises also leave mess and muddle behind them, but in this case, it is not artificially created; nor is it to be overcome by a break in the training. It is all too real, and those who have to deal with it may be exposed to short-term incentives, and thus not so very interested in distinguishing the fundamentals of the problem – in our case the recent financial crisis and the ongoing economic crisis – from superficially important trivialities. It is utterly typical that half the world is obsessing about bankers' bonuses and salaries. Some want to limit them, some want to tax them, which seems not unreasonable, given that national treasuries are not only empty but in debt. Still others content themselves with high-profile lamentation in the media, so as to avoid rocking the boat, for bankers are, among other things, often the good friends of politicians. The fact that the issue of management remuneration is merely the symptom of a much more profound cause is ignored in all this – either because people cannot see the wood for the trees, or because they'd rather have a couple of the trees themselves.

In this Investment Commentary, we want once again to get through to the real root of the evil that has plagued us for the last two and a half years, so as to be able to identify the need for action in various areas, while keeping in mind what this means for the management of assets. Their value will depend decisively on how well things are cleared up after the crisis – or not. It seems to us that, on the morning after the crisis, it is too little recognised that "clearing up" means above all "getting rid of". Getting rid of structures that have proved to be dangerous, of ballast that once seemed nominally valuable, of assumptions that are obviously illusory. Despite the acuteness of the financial crisis we have experienced, we are still far from achieving this. But it is essential if the world is to return to a more productive mode. So long as too much appears "absolutely hopeless", there is no room for any real, justified hope.

2. The red thread of debt

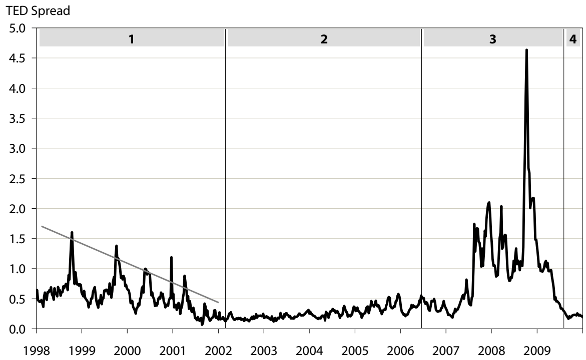
Without wishing to bore our readers, or indeed to look as if we are suffering from withdrawal symptoms for a nostalgic past, those military staff exercises taught another approach that often enables progress to be made – the *"De quoi s'agit-il?"* question. This is the attempt to get to the heart of the problem, and to leave all else to one side. A great deal has been said and written about the financial crisis and its causes. However, the heart of the problem still seems to have escaped the attention of many, which is why we gladly expose ourselves to the charge of repetition.

De quoi s'agissait-il? The unexpected, and originally certainly unintended, consequences of a well-meant idea. That is the heart of the problem, and it is difficult to discuss, on account of its initial positive connotation. The experiences of the 1930s made it all too clear that to prevent the collapse of a bank that has (frequently innocently) become illiquid requires a lender of last resort, which will exchange illiquid assets for cash according to established rules, and thus prevent the sudden collapse of a single bank or a whole chain of interlinked banks. The concept of the lender of last resort is essentially unchallenged, to the extent that it concerns illiquidity only. For a bank, liquidity is only partially controllable by its own efforts; an ultimate source of liquidity makes sense for extreme situations. It was, and is, appropriate for central banks to take on the function of the lender of last resort, for only the central banks are in a position to provide unlimited liquidity.

However, over time the well-meant idea got out of hand. Systemic collapse resulting from bank insolvencies was increasingly stylised as the horror vision par excellence, and the distinction between illiquidity and bankruptcy due to over-indebtedness became blurred. By the end of the twentieth century, the concept of bridging liquidity shortages had mutated into the notion of "too big to fail": system-relevant banks were not to be allowed to fail; even thinking about such a situation was frowned upon, because this might itself have a destabilising effect. This suited the group of system-relevant banks just fine, for such an unlimited insurance of last resort resulted in record low risk premiums when borrowing money.

As we have shown on previous occasions, during Alan Greenspan's lengthy term of office as head of the Fed, this situation was accentuated in that not only did the assumption that system-relevant institutes had to be saved at any price increasingly become a premium-relevant factor on the financial markets, but the general impression was created that any internal or external disturbance in the system would be addressed by means of monetary policy measures. This has been described as the "Greenspan put" or a "zero-accident" monetary policy, as clearly shown in the figure below by the development of the premium in inter-bank business during Phase 1, from 1998 to 2002. Once just about everyone believed in the continuation of this monetary policy, during Phase 2 the big financial conglomerates increasingly expanded their on-balance-sheet business, which was more and more characterised by proprietary trading with very cheap money. In the financial crisis (Phase 3), the previously implicit state guarantee became a largely explicit one. In effect, the monetary policy measures in the wake of the financial crisis since mid-2007 represent a continuation of Greenspan's policy by the new head of the Fed, Ben Bernanke, with the exception that a serious accident occurred in 2008, with the collapse of Lehman Brothers. We have serious doubts as to whether "after the crisis" (Phase 4) will look like "before the crisis" (Phase 2). The financial crisis has shown the limits of a "zero-accident" monetary policy; we shall long remember it.

A distortionary central bank policy



Note: TED Spread: 3-month US Libor – 3-month US Treasury Bill
Source: Bloomberg; analysis

In economic terms, the provision of a long-term implicit (and since the financial crisis, to a degree explicit) state guarantee for big and very big financial conglomerates represents one of the greatest conceivable actions of redistribution by a large number of guarantors (the unknown number of taxpayers and "owners" of the central banks) to the benefit of a particular economic sector. An indirect subsidy of this sort is bound to create serious distortion. This was accentuated in the USA in the regulatory arena, in that the big banks succeeded in convincing the Administration (President Clinton) and Congress to scrap the Glass-Steagall Act. From 1999 onwards, this meant that the floodgates were open for these banks to expand their activities to include investment banking. The very low premiums for refinancing made it possible to radically increase the proportion of proprietary trading – on-balance-sheet business at the banks' risk.

The close connections between the big financial conglomerates and the supervisory authorities also paid off in that, with Basel II, the equity rules were formulated precisely so that supposedly low-risk business could be loaded onto the balance sheet in virtually unrestricted amounts without this triggering appropriate measures on the equity side. Where this no longer satiated the hunger of the ever-accelerating juggernaut in New York, London and elsewhere, resort was had to off-balance-sheet vehicles, so-called SPVs (special purpose vehicles), or the selling of securitised tranches of the balance sheet (CDOs, ABS) to financial market players, and mainly to other banks, to go on their balance sheets. This was all extremely profitable, not necessarily for these institutes' shareholders, but undoubtedly so for their managements, who came in for a thoroughly disproportionate share of the bonanza through their salaries and bonuses.

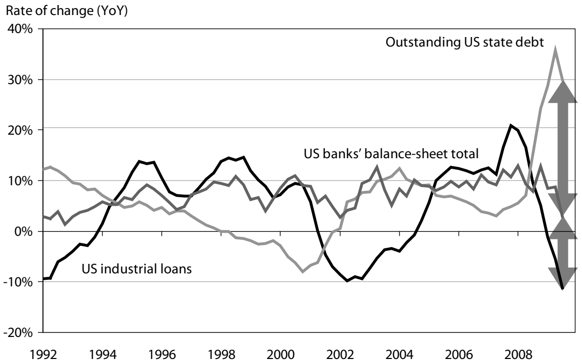
De quoi s'agit-il? What was, and is, the problem? On account of their structure and their activities, banks are in a position to create money. To the extent that the money they create is made available to businesses in the form of credit, so as to make them more productive, this is an essential function of banking. And to the extent that the debt thus incurred is kept within reasonable limits through equity requirements, or that, in the absence of any implicit or explicit state guarantee, borrowing would eventually become so expensive that natural limits would set themselves, a state of equilibrium would have to occur. This was, however, obviously not the case in the run-up to the crisis. Debt as such, both absolutely and relatively to other metrics such as GDP growth, was simply too great. An ever-growing number of firm commitments was confronted with fewer and fewer projects of a productive nature. Debt acts like an agreeably flavoured poison: nice to take, but potentially lethal.

3. Where has the debt "disappeared"?

A look at the balance sheets of a few important financial conglomerates reveals that the financial crisis has led to a reduction in risk positions. This has been partly due, no doubt, to the hefty losses, which have an impact on the equity position, but also to the significantly greater mutual scepticism that prevails in the world of banking since the collapse of Lehman Brothers. And of course the supervisory authorities are now – ex post facto, but better late than never – somewhat less accommodating than they once were. Nevertheless: if risk premiums remain so low, there is a danger that the whole business might start all over again. Once again, this crucial part of the financial system would not have been put in order. That would be disastrous.

And if we look at the rate of change in the banks' balance sheet totals and their credit activity, we also find that, in the wake of the financial crisis, the latter has fallen more sharply than the former. Credit activity involves the provision of funds to private individuals – via credit cards, mortgages and personal loans – and the financing of businesses and commercial construction. This credit activity has, on the basis of representative American data, virtually come to a standstill. The difference, we must conclude, has gone to the state as debtor. The figure below clearly shows this development, and the exorbitant new debt in the public sector.

Crowding out: money flows to the state



Note: The figure shows the annual change in the three indicators. The balance-sheet total includes American branches of foreign banks.
Source: Federal Reserve Board; analysis

In other words, trading with sub-prime securities has effectively been replaced by proprietary trading with government bonds. Short-term borrowing stands against rather longer-term financing based on supposedly risk-free state debt. There is no doubt that the banking system can be cleaned up in this fashion, provided that enough time is available. The repayment of TARP (Troubled Asset Relief Program) loans to the American Treasury has already demonstrated the beneficial impact of this carry-trade (cheap short-term financing of rather longer-term state securities) on the back of the dollar yield curve. To this extent, there is some clearing up going on. However, the place of the mortgagee has now been taken indirectly by the taxpayer; somehow, one has an uneasy feeling that not all that much has changed.

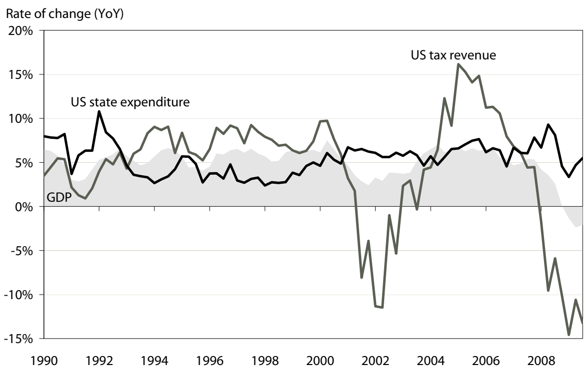
Furthermore, the rest of the new state debt is to a large extent covered by the central banks and quasi-state institutions. This self-referential circular system for the creation and maintenance of a vast debt mountain has distinct analogies with the state of the financial system before the crisis. Whether it is a matter of excessive debt being accumulated in a (state-guaranteed) banking system for the purpose of proprietary trading, or of debt circulating from one entity to another within the state, the two processes have one thing in common: the debt is unlikely to be devoted to any productive purpose. Debt is also, and particularly, an agreeably flavoured poison for the state. Thus, no sooner had previously distressed American banks repaid their loans than voices were raised in the US Congress in favour of a new stimulation package, rather than any reduction of debt.

So in trying to ascertain the real big picture, and see where clearing up is required, we strike gold, as it were, with the total amount of debt. "Too much leverage" is the cry: too much overall debt, and this debt mostly in the wrong place or for the wrong purpose. For if "a lot of" debt could be justified anywhere in the world, then in those countries whose state, industrial or private infrastructures need to catch up with the rest. If surplus capital has to be available anywhere in the world, then it should be in the developed countries, in which future productivity improvements will be more modest than in the emerging markets – in mature countries then, that will anyway soon be dependent on capital income for demographic reasons. Precisely the opposite is the case: the Western debt mountain is financed by its own banks, its own central banks and the "rich" emerging markets. A remarkable state of disorder, that characterises our world in the wake of the financial crisis. Time to clear up.

4. The decisive question of financing

The increase in debt (described in these pages as a "tsunami", and we stand by the appropriateness of the description) on the part of the Western states since the outbreak of the financial crisis in mid-2007 is serious. The figures are impressive enough in purely nominal terms, but become really frightening when set in relation to GDP, and when the new debt inevitable in the years ahead is taken into account. The figure below, again using representative date from the USA – much the same is true, with a grain of salt, for the UK, Germany, France or Italy – demonstrates that debt is not only a problem deriving from the "episode" of the financial crisis, but is clearly of structural nature. For one thing, tax revenue over the period under observation proves to be considerably more volatile than the correlated economic growth, and for another, with the exception of the "golden 1990s", the growth of state expenditure was systematically higher than economic growth. The American figures do not include any of the expenditure on economic stimulus programmes in the wake of the financial crisis.

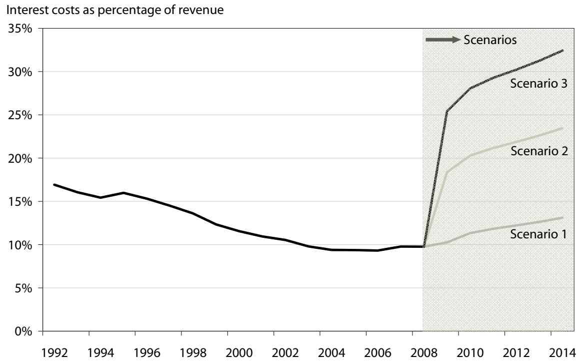
Tax revenue: not really controllable!



Note: The figure shows the annual change in the three indicators.
Source: Bureau of Economic Analysis; analysis

Any aggressive policy aimed at achieving higher taxation faces serious economic and political constraints. Expenditure is difficult to reduce, in view of all the promises, commitments, and support measures now in progress. It thus follows that the financing of the necessarily expanding deficit is of the greatest importance. The US Treasury currently needs about 200 billion dollars a year in cash for interest payments. If we assume a constant level of revenue of around 27 percent of GDP – given the economic crisis and its impact on taxpayers, this long-term average may be a rather optimistic assumption – then only if the interest rate on all US state debt remains at the current record low level of 3.3 percent on average does this cash expenditure remain manageable (Scenario 1 in the figure below). If financing costs merely rise to the long-term average of 5.7 percent, according to our calculations this would result in interest payments amounting to 25 percent of all state revenue by 2014 (Scenario 2). Should state revenue fall to the historically low level of 1949 (some 20 percent of GDP), then interest payments would consume no less than 35 percent of state revenue (Scenario 3)! A doubling of the share is not an impossible scenario, with a corresponding reduction in the room for manoeuvre in fiscal programmes.

Every third dollar for interest?



Note: Debt and GDP forecasts from the IMF.
Source: Bureau of Economic Analysis, International Monetary Fund; analysis

At this point it must be mentioned that the cash payment of interest by no means represents the whole of the problem. Around one-third of American state debt is not externally financed, but held by quasi-state institutions ("intragovernmental holdings") such as the various social security organisations, bank deposit insurance (FDIC), motorway construction funds, the fund for the disposal of nuclear waste (!). Government bonds, that pay no interest, are practically the only assets held by all these organisations. They are a kind of "zero bond", whose intrinsic value depends on the understanding that future taxpayers are able and willing to meet their obligations. In economic terms, it is, however, wrong not to regard the total US Treasury debt to quasi-state institutions as sensitive to interest rates, and not to include it in the relationship of debt servicing expenditure to state revenue. From this perspective, America's fiscal room for manoeuvre is even more limited than it appears explicitly.

"Limited room for manoeuvre": this, then, is the concept that will characterise America in the years ahead. It will apply on the fiscal side – that is, with regard to any and every possible or impossible commitment entered into by the current US government before it was elected. In reality, the mere maintenance of the existing transfer payments is barely possible. This is bitter, in a country with over 16 million unemployed and 36 million who have to still their hunger by means of food stamps.

But the room for manoeuvre on the financing side is even more limited. For one thing, there is the already-mentioned problem of sensitivity to interest rates, and for another, the perhaps more decisive issue of the creditworthiness of the USA as a debtor in general. For the "internal financing" of one-third of the debt via interest-free loans from quasi-state entities might be regarded as the systematic erosion of the assets of trusting taxpayers, or as hidden taxation in the form of a forced investment in a hollow shell. The perception of the sustainability of a Ponzi scheme – for there is no doubt that is what we have here – is not a linear process. The realisation of the non-existence of assets can occur abruptly, and would have incalculable domestic political consequences. There is also a similar problem with the external financing of debt. All those holding US Treasury paper do indeed have great interest in the maintenance of the status quo – that is, that there is no change in the value of the US dollar or the creditworthiness of the USA. Realistically though, this cannot be a permanent state of affairs. And should serious doubts arise, then it is the first creditor to lose trust who proves to have been the smartest…

There is a glimmer of hope in that president Obama appears to be able and willing to learn. Thus despite being awarded the Nobel peace prize (far too soon), he has, without much ado, authorised a massive (and once again, sadly, extremely expensive) increase in the number of troops in Afghanistan. As the Parsifal of the Western World comes face to face with reality, his eyes must surely be opened to the Achilles' heel on the nation's financial club-foot. There is no way round the need for a more parsimonious budget, combined with a renewed enthusiasm for supply rather than demand.

As we said above, creating order is essentially about setting the right priorities. For the USA, but not the USA alone when we think of the many highly indebted European countries with similar problems, this would mean focusing entirely on the maintenance, or rather recovery, of credibility. That would include making the capital market as attractive as possible, but so far all the American administration's plans are going in precisely the opposite direction. Failure on the financing issue would be disastrous; in the medium term it would result in a substantial increase in real interest rates for the US dollar and the euro.

5. From a headlong flight to a strategy

The sobering-up process in the wake of the financial crisis applies not only to the USA or the EU with its efforts to achieve greater financial discipline among the member states, but also to Switzerland, which has, as we know, suffered two serious setbacks in the past year, in the form of successful exercises in blackmail. A lengthy period of all too unopposed positioning of Switzerland and its financial centre came to an abrupt end in the face of the concerted and ravenous hunger of the finance ministers of the over-indebted G20 countries. Political leverage that had grown quietly and unobtrusively thus became, over night, a serious burden. The situation was long characterised by fairly headlong flight, but this seems now to have given way to a strategy. As ignominious as it many seem, withdrawal to a tenable line of defence is well known to be among the more successful operational options, to revert once more to the vocabulary of the military staff.

Essentially, the Swiss version of cross-border asset management was, and is, exposed to attacks on two axes. One is the extensive criminalisation of tax avoidance combined with a far-reaching definition of tax liability; the other is the attempt to apply internal regulation extra-territorially and in this context, to shift the boundary between the active and passive provision of services to national advantage. This too brings with it the danger of the criminalisation of banks and their employees.

Regular readers of the Investment Commentary have been able to follow the process that has been required to reach the formulation of an easily understandable, universally communicable strategy. Lines of defence require clearly defined key points; otherwise they will not be able to withstand further attacks. Over time it has become clear that four pillars are required, two of which represent non-negotiable basic principles, and the other two of which can be regarded relatively – that is, they are negotiable and may involve trade-offs.

- Pillar 1 concerns financial privacy, which unquestionably belongs among the fundamental rights of the individual, and applies universally, so that it must be applicable equally both for Swiss citizens and for foreigners. Let it be clearly understood that this right to financial privacy does not include any supposed right to avoid domestic tax liabilities. This detachment of the fiscal component of banking secrecy from its fundamental elements represents a counter to all those moralising, holier-than-thou attacks on banking secrecy that often find such an echo in the media.
- Pillar 2 anchors the basic principle that, whatever may happen in the future to Switzerland as a financial centre, no-one, neither former clients nor bank staff may be criminalised – not abroad, and most certainly not at home. The significance of this obligation of loyalty on Switzerland's part cannot be estimated highly enough. That this principle has been infringed with regard to the provision of client data in the dispute between the USA and Switzerland over the UBS is one aspect of what may be defined as headlong flight.
- Pillar 3 concerns flexibility on fiscal matters. Once pillars 1 and 2 are again absolutely applicable then pragmatism may (and must, given the real distribution of power) be the order of the day here. When orderly democratic conditions are in place, there is no reason why a financial centre should protect its clients from meeting their tax obligations. The only thing that is important is that they should be able to do so anonymously, so that their financial privacy is not infringed. Otherwise, cross-border asset management no longer makes any sense.
- Pillar 4 of the strategy stipulates clearly that no fiscal concessions may be made without quid pro quos from abroad. If a country were to agree, via its financial centre, to cross-border taxation, which would be a unique situation in the international context, then there would no longer be any reason for the protectionist exclusion of such a financial centre from the provision of services. To the extent that freedom of service provision abroad can be achieved for Swiss banks, the danger of further criminalisation would naturally be reduced.

The idea of a compensatory tax on the revenue from assets held by foreigners in Swiss banks, which has now become part of official policy, represents a combination of the need for privacy (Pillar 1) and fiscal flexibility (Pillar 3). It is an attempt at the same time to uphold the concept of privacy and also to respect the fiscal requirements of civilized, democratic countries, by means of a withholding tax acknowledged abroad as compensatory. This compensatory tax is a logical development of the taxation on interest agreed between Switzerland and the EU. It is thus difficult to understand why it is claimed that it is "too late" for such a compensatory tax. On the contrary, it is absolutely timely for the revision of the interest taxation agreement scheduled for 2013.

The most important element of this line of defence for the future of cross-border asset management is the fact that the 4-pillar strategy is diametrically opposed to the automatic exchange of information. It is very comforting to note that toward the end of last year clear-headedness on this topic began to prevail both within Swiss banking circles and within the Swiss government. This is clearly expressed in the report on "Strategic thrusts for Swiss financial market policy" of 16 December 2009. And for those souls still wounded by the successful blackmail of the past, it is particularly gratifying that there now seems to be a clear will to assert justified claims to sovereignty vis-à-vis foreign powers in the matter of financial market policy. But what has this recovery of clear-headedness to do with the higher-order problem of deleveraging, of the reduction of excesses in the wake of the financial crisis? A great deal. The leverage in the Swiss banks' previous business model was, as noted, a political one, based on the false assumption of the invulnerability of this small country in a largely international environment. In future, genuine offshore business, with sustainedly untaxed funds, will be the prerogative only of financial centres that have behind them powerful countries like the USA or China.

However positive the repositioning of Switzerland in the matter of banking secrecy appears at the beginning of 2010, the need for further action in other crucial areas for Switzerland in the wake of the financial crisis is no less evident. The "too big to fail" problem still awaits a solution. For Switzerland, which ultimately proves to be "too small to save" for the two big banks UBS and Credit Suisse, this is a question of existential importance. The unquestionable lesson from the crisis is that there can be no future for the unrestrained combination of system-relevant functions with high-risk types of business. If we wish to escape a regulatory over-reaction, with prescriptions concerning the size of institutions or their nominal equity requirements, that will result in something like rationing within the system, then functional structural change for the biggest global banks is unavoidable. For systemic and competitive reasons, every effort must be made to ensure that in future only the genuinely system-relevant elements of banking enjoy the essential provision of an implicit or explicit state guarantee. Switzerland needs to reach a solution to this problem during the course of the year. This is a matter of freeing a unique country, with sensationally low levels of debt, from the concealed, and thus particularly toxic, leverage of an implicit guarantee for what is ultimately uncontrollable.

6. Priorities at micro-level

The reduction of generally excessive levels of debt forms the red thread running through the years ahead. In addition to the vast and almost hopeless topic of state debt, and the particular questions that apply to Switzerland and its financial centre, we also need to consider the micro-level of individual enterprises and private investors. Whatever the pattern of economic development – a strong recovery despite all the millstones that the financial crisis has placed round the necks of both business and society; a cautious improvement in the indicators combined with continuing low inflation; further setbacks and the brutal reallocation of functions around the world – one thing seems clear: the key factors in the years ahead will be debt quality, interest rates, currency relations and the legal security of property.

Ultimately all the clearing up that is to be done resolves itself into the question of how the restructuring of states, of whole economic sectors and business models – the financial sector – is to be achieved. Pretty much everything is possible, from gentle renovation based on long-term strategic considerations to short-sighted expropriation by means of confiscatory special taxation, and interest rate and currency issues are almost always involved in the possible decisions. Let us take Greece as an example. If the Greeks do not succeed in making a credible start on restructuring from within, then Europe will have to intervene, which is already the case, to a substantial extent. But if Europe intervenes, it will have to accept a share of responsibility, and in that case, the presumption grows that ultimately Europe, and the ECB, will prevent Greece going broke. Europe's intervention may reduce Greek interest rates, but it will at the same time further weaken the euro. For the problem is not just Greece, but also Italy and Portugal and Spain and Ireland and so on and so on. But if Europe abstains from action, the result might be a general long-lasting increase in interest rates for all countries whose finances are distressed.

Thinking through the USA's options for action produces remarkable circular arguments. Should the recovery of the US economy soon grind to a halt as a result of the discontinuation of stimulation measures, there would then be no pressure for higher interest rates but the (partial) restructuring of the national finances would recede into the far distance. Should the economy recover rapidly, however, with the consequence of higher interest rates, then the state's revenue would also recover, but this increase would very probably be consumed by the higher interest rate on debt. Should further large sums be committed to economic stimulation, that might be the last straw with regard to credibility, which would result in a collapse of the dollar and a radical rise in interest rates, with a crash on the bond market. Should the Obama administration attempt, as it has now announced that it intends to, to impose a special, punitive tax on the banks, then it may endanger its own financing, because a business presence in America would simply become too expensive and too dangerous.

Look at it how you will, the deleveraging process involves high risks, which neither businesses nor individuals can entirely avoid. Exchange-rate losses, falls in the price of fixed-interest investments due to interest rate changes, sudden creditworthiness problems affecting supposedly risk-free borrowers: these can all occur overnight. Given the very low interest rates and, once again, very low risk premiums, many of these risks are of a very asymmetric nature: there's not much upside, but plenty of downside.

In our view, creating order at the micro-level means eliminating unnecessary risks as far as possible. Thus, it makes no sense, for the sake of a couple of basis points of additional return, to take on long-term engagements in fixed-interest investments, in addition to the interest-rate risk inherent in any balance sheet. On the liability side, it is necessary to be aware that the short-term financing of long-term projects in an environment of rising interest rates can become a revenue-devouring burden. Intra-balance-sheet risk should be kept as low as possible.

As far as quality of debt is concerned, we recommend avoiding investments that, as the result of (rightly or wrongly) assumed guarantees, have excessively low risk premiums. The deleveraging process can go wrong, and if that were to happen, then states would default, and on such scale that there is no body in the world that could provide guarantees without endangering itself. In this event, state bankruptcy would become a (relatively) normal occurrence, comparable to the bankruptcy of a large airline. In such a scenario, state certificates of indebtedness could well coexist with the intrinsically valuable bonds of industrial borrowers.

Apart from seeking to reduce risk, we also need to think, and act, positively. The state of emergency caused for investors by zero returns on fixed-interest investments, which is closely related to the global deleveraging process that lies ahead, calls for alternative investments. Essentially, this is a matter of finding symmetrical investments: those that offer some upside as well as the inherent downside. In this context, we believe that it is worth considering stocks, whose dividends will in all probability produce high longer-term returns than the interest on bonds. So long, that is, as one has the time and the self-possession to withstand the occasional drop in their prices.

Time – something that we believe most people have more of than they think. Many investment problems would be much better resolved were it not for the oft-observed stress of the next performance report. And we also need to make time. Particularly at a time when the world has serious clearing-up to do, it is worth putting one's own house in order. The agreeable atmosphere on the stock exchanges since March 2009, and the probably not too disagreeable first few months of the current year offer an opportunity for a brief halt for a bit of "rest and recuperation".

KH, 18.01.2010