Well-being beneath the sword of Damocles

1. Astonishing simultaneity

Our decision in January not to commit ourselves to any one of the three scenarios that seemed to us conceivable for the economy and the financial markets was dead right. For in the meantime we have, so to speak, had a taste of small, trial portions of all three options at the same time – with the result that we now have a better idea of what these scenarios would mean in practice. This has also shown that there is still no way of deciding in favour of any one of the alternatives. Anyone who expects from his or her bank decisiveness with regard to forecasts is in for a disappointment – and is anyway axiomatically wrong. It is not possible to make decisive statements about states of uncertainty – which is what the future is. There are only two options: to consider possible developments, and, if there are sufficient indications, to allocate probabilities to these developments. Any more far-reaching commitments represent a dishonest overestimation of one's own capabilities.

We deliberately constructed our three scenarios so that they should be mutually exclusive. Consequently, it is not possible that all three scenarios should apply simultaneously for any length of time. Let's recapitulate: in the first of the three scenarios, despite the collapse in the financial markets and in global trade, despite the partial or complete nationalisation of important banks, despite the significant additional debt incurred by the Western industrial nations, the global economy continues to develop in a more or less similar fashion, if more slowly and less intensively. We called this scenario the "Lazy L", and pointed to the benefits of such an even development – the lack of inflationary pressure would keep interest rates low, so that state debt would not achieve the overwhelming significance that would inevitably be the case in the other scenarios. If we have interpreted the data from the first three months of this year correctly, there does seem to be a good deal of evidence for precisely this course of events, which also seems to be reflected in the so far very congenial developments on the stock markets.

We have however, during this period, been obliged to look more closely into the "blood-red abyss" of our second scenario. Greece's staggering state debt, by no means a result of the financial crisis, but much rather a structural problem of the eurozone deriving from deception and sugar-coating, has, through the immediate requirement for financing of a few billion euros, created an entirely new state of affairs on the international capital markets: the realisation that states, and not only marginal ones but established ones, supported and partially controlled by a community based on the principle of mutual solidarity, *can go broke*. Greece is just an episode; the real problem lies deeper, and its importance cannot be overestimated. The role of the state as debtor, the ultimate sheet anchor of stability in the system (or of what we have previously assumed to be stability) is now fundamentally challenged. Risk-free interest rates are a fiction. In reality, just such supposedly risk-free state investments may turn out to be the trap into which herds of investors allow themselves to be driven, eventually to become victims of the ultimate write-off of excessive state debt. At the time of writing, it seems that the worst may have been avoided. On the basis of the prices for Credit Default Swaps (CDS), risk premiums for Greek state debt seem to have normalised again, to some extent at least. But the mere fact that they very recently shot up to heights that implied a high probability of Greece becoming insolvent within a few months, and the fact that the euro has again come under pressure, are clear enough indications that the "blood-red abyss" scenario was not conjured up out of thin air, but remains hanging over us – a Damoclean sword, incompatible with the "Lazy L".

Lastly, there is also evidence for the third scenario; the notion that economic growth in the Far East, combined with the advantages of relatively low fiscal burdens and productivity increases fuelled by pent-up demand in the real economy, will shift the global balance of power weighting rapidly and irreversibly away from the Western industrial nations towards Asia. The growth figures for both China and India send a clear message: there's no longer any question of a crisis there. China currently reckons on a real annual growth rate of 10 percent, and India on one of just on 8 percent (IMF estimates). What is noteworthy for those of us who also think in terms of national security is China's unmistakable targeted investment in Africa and around the Indian Ocean. When the Chinese snap up Sri Lanka's key harbours from under the nose of the Indians, this is a matter of strategic significance. The intention is obviously to quickly reduce their dependence on the USA in this area as well, by means of a "chain of pearls" of friendly locations (the Chinese are past masters at the art of euphemism – we would probably refer to such a policy as a "naval-base strategy"). The problem with Scenario 3 for the West (and for any Western-oriented investment policy based on state debt) lies in the comparative disadvantages that derive from the hopeless social-policy entanglements, which represent an acute, long-term threat to competiveness. A relative loss of prosperity is inevitable; an absolute one, probable. In Scenario 3, the "Lazy L" would not long remain at least partially erect, but would soon begin to droop.

2. Living with Taleb's "fourth quadrant"

Apparent indications of the simultaneous occurrence of mutually exclusive possibilities – a tougher intellectual challenge is hardy conceivable! Nevertheless, this is what we are faced with – on a daily, and very concrete basis, with our clients' asset portfolios. How often, in recent weeks, have we been confronted with the question of to what extent euro investments can still be regarded as justifiable; and how often have we had to pose the counter-question of whether dollar investments would be preferable, in the light of our worst forebodings. We have regularly come to the conclusion that in the country of the blind, the one-eyed man is king, but that the problem is not knowing who is in fact blind, and who one-eyed. And how often have we then been confronted with the question of the Swiss franc and its rate vis-à-vis the euro, as in: can Swiss franc investments be used to hedge or at least reduce, a serious problem with the euro? Should we buy gold? How much? Why, exactly? Is the current price not too high?

We shall try to give valid answers to these questions at the end of this Investment Commentary. We intend, though, to exemplify the intellectual process involved by means of a rather different, but nevertheless fundamentally related problem. This problem is anyway overdue for treatment, and pretty much forces itself upon us. It concerns the strategic options for a small and prosperous country at the centre of a continent that runs the risk of destroying itself through a concatenation of economic, political and moral failures. The country is Switzerland and the continent, Europe.

First, let us recall the intellectual approach taken by Nassim Taleb, the author of that well-known work, *The Black Swan* (2007), to relatively normal situations – that is, risks with calculable consequences – and to uncontrollable catastrophes. In one of his more recent essays (*Errors, Robustness and the Fourth Quadrant*, 2009), he creates a matrix with four quadrants. One axis of the matrix reflects the degree of calculability of the event occurring, and the other, the degree of complexity of the interconnections. While the "normal" situation (easily calculable/simple structure) applies to a large number of daily occurrences, and can be relied upon, or at least taken into account, the "disaster" situation (incalculable in terms of timing or scale/highly complex with regard to cause and effect) is almost impossible to deal with. The other quadrants (easily calculable/complex and incalculable/simple) can be managed reasonably well by means of risk diversification, but this does not apply to the fourth quadrant, the "Black Swan". It is precisely the nature of the "Black Swan" that its occurrence calls everything else into question: the crisis in the big financial conglomerates shook the whole financial system; Greece's financial crisis shakes the euro. Diversification across multiple banks is of little help in a financial crisis (as we know, the entire interbank market was de facto completely illiquid for months); if Greece goes broke, a well-diversified portfolio of Portuguese, Italian, Irish and Spanish bonds will be of little help – indeed even bonds of apparently more stable countries may no longer prove to be a safe haven.

Even if we accept that such "black swans" occur more frequently than is commonly held (that is, if we believe, probably rightly, that Benoit Mandelbrot's conclusions are correct); even if our perspective on world history inclines us to believe that linear development hardly ever happens, and that all significant events are the result of disastrous structural hiatuses, we cannot exist outside calculable, and mostly fairly straightforward normality. Herein lies the dilemma: we know about the Damoclean swords, but we must nevertheless go on living, as normally as possible, modestly and even with some sense of well-being. The question is, how?

3. Eurozone: structural problems revealed

For example, for over 60 years in Western Europe, and some 20 years now for the majority of the continent, a period of peaceful coexistence has prevailed that in historical terms has been unusually long and relatively unproblematic. Its foundation has been the close cooperation between France and Germany, and even EU sceptics will have to admit that this organisation has played an essential role in a situation that has been of great benefit to all the countries in Europe. Gradualism, that is, a particularly leisurely form of progress, has been, so to speak, institutionalised as part of European normality. The principle of unanimity requires a great deal of time-consuming tactical manoeuvring behind closed doors, and, from time to time, forthright action from one of the more equal of the equal leading nations of Europe.

The price of this system of governance with so much deliberate indecisiveness was, and is, the hegemony of the technocrats in Brussels, with its clearly observable elitist focus on feasibility and its associated remoteness from its citizens, resulting in low popular acceptance and a democratic deficit that is increasingly spreading to the member countries. For it has long become clear that what cannot be obtained by democratic means at home can be achieved by intensive lobbying in Brussels. Brussels has become a hub for the gratification of greed of every form; technocrats are particularly susceptible here, for they anyway tend to think in terms of specific goals, and prefer a close proximity of cause and effect to general rules without specific goals.

On its own, this particular institutional peculiarity of the EU would not be sufficient for it to be necessary to refer seriously to the “fourth quadrant”. For all Europe’s stupendous inertia, we must recognise that other comparable structures are ultimately little more efficient. A quick look at Washington is sufficient confirmation of this, and whatever our sympathy for China’s purposefulness, it is hard to imagine that its leadership, consisting overwhelmingly of functionaries, offers any particular advantages compared even to the complex reality of Europe. Everything is relative. Even if we assume that, with its current structures, Europe is on a slippery downward slope with regard to global competitiveness, it would still be absurd to forecast a genuine and dangerous structural hiatus that might change the course of Europe’s history, and not for the better.

The real reasons for alarm concern not what is being achieved with enormous technocratic effort, but what is being dodged, ducked, concealed or glossed over. Europe’s problem consists in the setting of incentives for individualistic, short-term benefit optimisation by the member states and the lack of incentives for accepting responsibility. The highly lauded principle of subsidiarity has remained an illusion. Greece’s difficulty in financing its debt comes as no surprise to anyone with a basic acquaintance with economics. The euro was a technocratic construct right from the start. Solidarity, understood and constructed simply as an ideal, cannot endure. Europe’s political classes conceived of the euro as an additional support for internal coherence, and a means of reducing the costs of the internal market. There was no external pressure. The Warsaw Pact had long become history. Internal coherence? The expansion of the European Union increasingly came to resemble a means to avoid grappling with the many questions of internal governance. In the knowledge of the lack of internal coherence, “Maastricht” was constructed as a regulatory corset, but one that was more about appearance than reality, for there is no point to rules without sanctions. Thus, it was permissible for new members – such as Greece – not only to break the rules on joining the monetary union, but to continue infringing them unhindered thereafter. Membership of the eurozone was also sweetened by unrealistic conversion rates; subsequently, the marginal member states enjoyed financing conditions on the capital markets that had previously only been available to the soundest economies, such as Germany or Holland. The absurdity of this implicit solidarity lay (and still lies) in its incentive for the weaker countries to pile on still more debt.

Any coherent and adequate regulatory system would include exclusion from the community as the ultimate sanction. And the process for such exclusion would have to be crystal clear, both for the country to be excluded and for the rest who would remain. Why? Because anything else would generate uncertainties that would be unacceptable to the capital markets. The current perception in the markets fluctuates between “rescue for all”, with a corresponding overall burden, and “no possibility of rescue”, with the resulting risk premiums for marginal countries. This is unsustainable. It is no accident that ten years after its introduction, the euro is still far removed from becoming a serious global reserve currency.

If, leaving the more marginal Greece to one side, we expand our perspective to include the more significant EU member states, we see that for them too, “Maastricht” is at best a fiction, and rather a piece of propaganda about supposed stability, aimed at the capital markets. The table below sets out the explicit state debt per country in US dollars, and also the debt as a percentage of GDP and per capita of the population. These figures, which provide information about the level of existing debt, are further set in relation to new debt in the form of budget deficits. Not included in the table are estimates of implicit debt; that is, social benefit commitments not included in the accounting. For most countries, these amount to a multiple of GDP! However the figures are juggled, "Maastricht" remains a fiction.

Well beyond "Maastricht"

	Forecasts of state debt, 2010			
	Absolute (USDm)	% of GDP	Per capita (USD)	Budget deficit
Germany	2'551'042	77%	31'148	-5.3%
France	2'264'625	83%	36'004	-8.2%
Italy	2'534'724	117%	42'105	-5.4%
Spain	977'925	66%	21'031	-9.8%
UK	1'889'459	80%	30'623	-13.3%

Note: Upper limits under "Maastricht": for state debt 60%, for the budget deficit 3% of GDP
Source: Eurostat, Goldman Sachs

Look at it how you like, we come to the same conclusion that we reached just six months ago with regard to the United States: there is good reason to suppose that the topic of state bankruptcy does not concern Greece alone. There is a great danger that the capital markets will – probably sooner rather than later – recognise the illusionary content of "Maastricht" for what it really is. The crisis of the euro as a currency will then be absolute.

4. Europe's fourth quadrant

This state of affairs alone is still not sufficient for a "fourth quadrant situation". But its unpredictable consequences are. Under the pressure of events, the EU might deviate from its normal modus operandi, and go over from gradualism to hectic activism. The first signs are already visible. In Germany there is talk of a European Monetary Fund (EMF), and in France, of the need for a European economic government. Instead of reverting to a focus on the variety of Europe and the decentral exercise of responsibility, replacing bogus solidarity with federal subsidiarity, it looks more as if a transition is under way from the fictional idyll to a community based on compulsion. The euro and the EU in their present form are to be saved at any price, and the damage resulting from large-scale, persistent abuse limited.

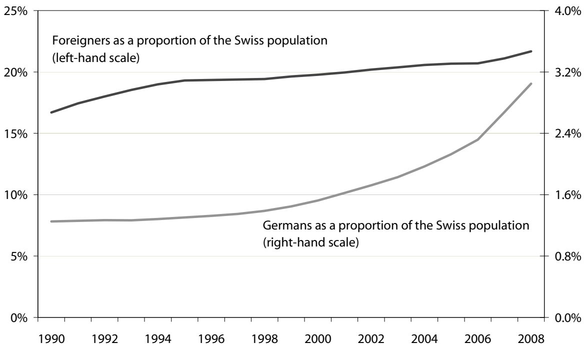
It is sometimes worthwhile to read certain newspaper articles with particular care. Such as the one by Mario Monti, previously EU commissar for the internal market and then for competition, in the *Financial Times* of 5 April 2009 on "How to save the market economy in Europe". In it, Monti laments the European countries' difficulties in financing their welfare state programmes under the pressure of competition over taxation. He pleads for a comprehensive harmonisation of taxation across the EU, and for a taxation policy that not only puts an end to so-called "tax havens", but also eliminates legal tax optimisation. We need to be aware that this "saviour of the market economy" has been mandated by the President of the EU Commission, José Manuel Barroso, to present a proposal for relaunching the concept of a uniform internal market. The project is likely to be concluded in the months ahead. Its content is not hard to forecast: Monti will seek to turn Europe into a fortress of social welfare with some market-economy facets. As a result of the conjunction of acute financial problems in some EU states, the crisis in the eurozone and the general post-crisis anti-business and anti-market mood, these efforts are likely to encounter far fewer obstacles than at the last attempt, in 1992. Until a couple of years ago, the risk for European tax harmonisation was calculable: the British would either nip any such attempt in the bud, or degrade the reform project into a nominal exercise with little impact. The dramatic state of financial emergency in London and Dublin in the wake of the crisis, however, raises increasing doubt about their steadfastness over tax policy – the more so, in that the great transatlantic paradigm, the USA, has itself embarked on a comprehensive neo-colonialist fiscal attack on the rest of the world. We now face the threat of economic and tax fortresses on both sides of the Atlantic.

The problem is that Europe will not survive this remodelling. The democratic structures required for political equilibrium – the checks and balances between the estates, the rule of law with regard to private property, the possibilities for constraining the power of the state and its fiscal appetite – are too weak for such a uniform structure to be able to survive. Collapse or compulsion would be the consequence. In his book, Taleb states that it is necessary to be able to think the unthinkable. In our view, it would be a great step forward if people were prepared to think the thinkable.

Failure is pre-programmed, for never in history has harmonisation led to lower average burdens. That is simply a technocratic pipe-dream, way outside political reality. The incentive situation is entirely asymmetrical: the financial requirements (and the fiscal hunger) are immediate and urgent; the benefits of a lesser burden are purely hypothetical and would affect the greater prosperity of the broad general public, which is not in a position to organise itself politically with regard to the harmonisation process. The result will be a level of taxation inimical to growth and an erosion of global competitiveness. The next step is then also pre-programmed: the ring-fencing of European markets against alleged dumping prices from the rest of the world. Such a European Union is inconceivable without a strong element of compulsion. A representative of a think-tank recently mentioned the probability that within five to ten years, there would be in Europe one or two powerful politicians of the type of Hugo Chávez. There would be no lack of applicants for the position, if we see things right…

A fourth-quadrant Europe would be a catastrophe for the productive middle classes, for the increased tax burden would still further reduce the incentive for entrepreneurial activity, while a still greater part of the population would fall into direct or indirect dependency on the welfare state. And inevitably, in the fourth quadrant private assets would be highly endangered, for the combination of fiscal distress, national interest, envy and greed would have a corrosive effect on the preservation of private property.

Emigration: just to enjoy the alps?



Source: Federal Office of Statistics

Economically active and/or prosperous citizens in countries already in a particularly exposed position with regard to taxation have for some time faced the question of whether it is worth staying. This question becomes more pressing with the possibility of Europe slipping into a Monti-style fourth quadrant. The Swiss immigration figures must give us pause for thought; not from any fear of being overrun by the Germans, but because the physical dislocation of people speaks volumes about the situation in the place abandoned – which includes one's homeland, family and friends, and familiar surroundings. What if a compulsion-based EU becomes even more of a probability? Or if collapse threatens, accompanied by loss of law and order?

5. The Achilles' heel of a benchmark country

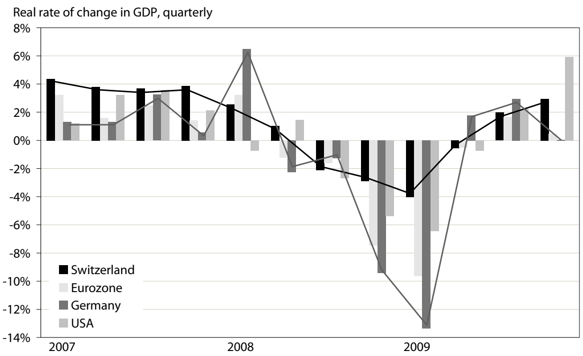
Very superficially, the obvious stress for many Europeans citizens of having to live simultaneously in a not particularly attractive normality and under the Damoclean sword of structural hiatus leading to a compulsion-based EU or to outright collapse, might appear to be a cause for rejoicing in Switzerland.

For firstly, the reality of clearly observable immigration indicates that we must be getting something right here: indeed that we have preserved many advantages. That is undoubtedly true. Almost all the indicators reveal particularly attractive conditions in Switzerland: optimistic and favourable to growth. According to forecasts by the Swiss Federal Department of Finance, in 2010 the total debt in the public sector – the federation, the cantons and the communities – will amount to just 43 percent of GDP. Last year, the Federation achieved a surplus of over 2,000 million francs (excluding expenditure for public-sector social insurance). In 2009, the city of St Gallen, where our bank is domiciled, distributed shopping vouchers to its citizens, as it had generated a surplus in the previous year. In recent years, various cantons have begun to reduce their corporate tax levels. According to KPMG, the average rate of tax for legal entities in Switzerland is around 21 percent of net profit. The comparable rate in Germany is around 29 percent, in France 33 percent and in the UK 28 percent. This last – high – rate of tax caused Ineos, a chemicals company and one of the biggest British firms, to decide to move to Switzerland. Thus, immigration concerns not only private individuals, but commercial enterprises as well. (The decision as to whether the move can take place does, however, still depend on credit provision by the banks, including RBS and Lloyds. These are now, in the wake of the financial crisis, owned by the British state. We shall see whether business considerations or the national interest carries the day.) The current rate of Swiss VAT is 7.6 percent; in Germany it's 19 percent, in Italy 20 percent and in France 19.6 percent.

Together with Holland and Norway, Switzerland is considerably better placed than practically all the other European countries to meet the demographic challenges of an ageing society: its social insurance is not based wholly on a pay-as-you-go system, but also includes pension funds financed on the funding principle. The Swiss healthcare system may be relatively expensive, but it is also extremely comfortable. And despite being exposed to political pressure, a relatively free labour market survives, which is why the unemployment rate is a mere 4.4. percent (by comparison: Germany, 7.5 percent; France, 10 percent; Spain 19.5 percent).

Switzerland has also survived the crisis of the past two years relatively unscathed. It is true that it was found necessary to prop up the UBS with a hefty take-over of the risks of its toxic assets, and the Federation found it necessary to participate in the requisite recapitalisation. The Swiss National Bank is unlikely to be able to rid itself that quickly of its exposure to American real estate, but the Federation has already unloaded its UBS shares, and at a profit. Overall, then, we've got off lightly. And there is considerably better news on the economic growth front. Switzerland too did experience a recession; the export industry was, and remains, severely challenged by the crisis, with many companies having to manage with turnovers 20, 30 or 40 percent down on 2007. But there has been no noticeable recession in the construction (immigration!) or consumer goods sectors. The overall picture of the Swiss economy looks correspondingly unproblematic in comparison with the international environment.

Swiss economic growth: remarkably robust



Source: Bloomberg

We could also add a variety of "soft factors", such as internal security, the involvement of citizens in public life, a very disciplined approach to the payment of taxes, and the ability to integrate a high proportion of foreigners more or less smoothly – but let's not. For there are also two fairly obvious problems. Firstly, Switzerland's advantages really are only relative. In absolute terms, mistakes have been made here too, and ones that will be difficult to put right. Thus, at the beginning of March, the Swiss voted for the systematic erosion of their pension fund system through the payment of excessively high pensions. The first pillar of the social security system, organised on the pay-as-you-go principle, has a high level of implicit debt. The EU-Swiss bilateral agreement on the free movement of persons resulted in significant limitations on the free market for labour being conceded to the trade unions. In every area of politics, there is a clear trend towards centralisation with the Federation; the cantons are effecting a clandestine centralisation by means of syndicates with little democratic legitimation ("Konkordate"). So, it can fairly be said that Switzerland too finds itself on a slippery slope, with the difference that the slope is less slippery than those round about.

Secondly, and much more importantly, Switzerland's relative but still striking success is increasingly becoming its strategic Achilles' heel. For it is highly unlikely that Switzerland will be able to entirely escape a wave of European harmonisation, should this be recommended by Mr Monti, and should the EU accept his proposals. Au contraire: Switzerland would become an ideal target for all of Europe's envy and despair at its own deplorable (and self-inflicted) situation.

Targets would (or do already) include the cross-border asset management business, the flat-rate taxation of wealthy foreigners, the taxation of holding companies, VAT, and ultimately, probably, corporate tax and income tax. In interstate trading, transfer prices for goods would come under pressure, as would royalties. The tussle over Swiss banking secrecy would then become the prelude to a much more far-reaching attempt to eliminate a tiresome benchmark in the middle of a Europe determined on tax harmonisation at a considerably higher level. This perspective might be regarded as unacceptable negativism and an insult to our European colleagues. However, the logic of the situation argues in its favour.

6. Strategic options for the star pupil

The situation is not yet fully described, though. One important element is still missing: the almost complete powerlessness of the Swiss side. The star pupil in the class may be bright, but he's not tough (a not uncommon situation in schools). On the contrary, Switzerland is highly dependent on its environment. A significant proportion of the infrastructure is jointly operated, with shared usage; there are major interdependencies concerning the trading of goods and the provision of services; and local cross-border traffic is so closely integrated that it is sometimes difficult to know which side of the border one is on. This (mutual) dependency relies on a cooperative approach; the exercise of power would rapidly cause the fragile construct to collapse.

So, what options are open to the weedy, pale-faced star pupil, if he wants to avoid the risk of one day being beaten up in a dark corner of the school basement? We see the following options:

1. The "big brother" strategy. The threat of a higher, more powerful instance is useful – and Switzerland made extensive use of it with a "don't move" attitude during the Cold War. It does, however, require that there really is a big brother, and that he might put in an

appearance, at least theoretically. In the current situation, not least on account of the UBS's unfortunate problems with the USA, this strategy is no longer open to Switzerland – especially as last year's G20 summit resulted in a degree of commonality in the pursuit of interests on both sides of the Atlantic.

2. The "join them" strategy. Full membership of the EU (at probably the most disadvantageous moment) would mean a complete change to the previous way of life. It would cost us our direct democracy, our strongly democratic legislation, our internal tax competition, our currency, and so on. Give the scale of the gap, a loss of prosperity would be certain, particularly in a Monti-style fourth quadrant.
3. "Change schools". This often happens with unhappy star pupils, and often works well. It is, however, essentially impossible for a country located in the middle of a continent. It is true that in recent years the structure of Switzerland's foreign trade has shifted strongly in favour of the Asian countries. In this respect, Switzerland is one of the most global countries in the world. The virtualisation of business processes via the Internet has further accentuated the possibility of territorial detachment. Nevertheless, realistically we must accept that we will remain within Europe for the foreseeable future.
4. "Intelligent interdependence". This corresponds to the attempt by a star pupil to make use of his or her complementary advantages. It's a very effortful method, involving always taking care to give enough of everything to everyone, without ever giving them grounds to ally together and extort still more. This method also requires that the star pupil continually eliminates all his or her dependencies, and gives top priority to ensuring his or her own invulnerability. The star pupil should not become too dependent on his or her colleagues or become their slave. The outlook for this strategy is best when Strategy 3 – "change schools" – is also available in case of emergency.

Those at all familiar with the matter will be aware that the efforts of our bank, which has since 2001 (Investment Commentary No. 209, How Europe is saving) campaigned for a degree of equilibrium with our most important neighbours in the problematic area of cross-border asset management, and in particular for the concept of a compensatory withholding tax, correspond exactly to this fourth option, "intelligent interdependence". This is a matter of achieving invulnerability, or creating a "win-win situation". However, it should be clearly stated that, sadly, the limits of this option lie precisely at the Monti-style fourth quadrant. Compulsion or collapse would result in uncooperative forms of behaviour in Europe. Accordingly, Switzerland cannot avoid the need to pursue a simultaneous and decided globalisation strategy. "Independently global", as the economist Zeno Staub put it in the latest number of the *Schweizer Monatsheft.*

7. Provision for disaster: more room for manoeuvre and more well-being

Which brings us back to the original question. If we see things correctly, in recent years, situations have arisen in the financial system and political structures on both sides of the Atlantic that make a shift from a more or less "normal" state of affairs to a far more incalculable structural hiatus, whose impact would be highly complex, considerably more probable than before. However gratifying the gentle economic recovery may be, there is no denying the existence of the Damoclean sword of the "blood-red abyss". However much we might hope for the democratisation of European structures in a spirit of subsidiarity, the European fortress is a real possibility. However much we might wish that the replacement of the American dollar as the unique global reserve currency take place without major disruptions, we must still consider that the USA may be overtaken by the workings of the capital market, so that there would be a problem in financing the American budget. The result would be a major bond crash, and the colonnades of the government buildings in Washington would bear a frightening resemblance to the ruins of Athens.

How are we – as private investors or citizens of a community – to deal with this? Essentially, we see three necessary areas of clarification. Firstly, we must make every attempt, with all our (perhaps apparently absurd, and undoubtedly politically incorrect) imagination, to think the so-called unthinkable. The mere naming of Taleb's fourth quadrant brings relief; denying its existence amounts to self-deception.

Secondly we need, in the broadest sense, to prepare "emergency reserves" for this fourth quadrant. What is the minimum that I shall need for survival, should the worst happen? That is the key question, for it is this that determines the allocation of resources, and this allocation of resources involves depriving oneself; it is, in the broadest sense, a savings process. But let's try to look at this positively: anyone who has assets that are not immediately and essentially required has the freedom of manoeuvre to make appropriate dispositions. It is only a matter of using this freedom; the result will be agreeable and beneficial inasmuch as one will not find oneself so quickly with one's back to the wall. Well-being beneath the sword of Damocles, so to speak.

Thirdly, there is the problem of the intrinsic value of assets in the event of catastrophe. This has only a hypothetical solution, because the catastrophe is (so far, hopefully) only a hypothetical one. For a Switzerland closely integrated with the EU, we have posited a very decided globalisation strategy as a fall-back position. For asset management clients who wish to survive the "blood-red abyss", some while ago we created the so-called "real value portfolio". It is made up of one-third gold, one-third stocks of intrinsic value, and one-third "currency reserves" – that is, an investment in the currencies of commodity-rich countries. Simultaneously, the (sadly, possible) collapse of the domestic currency is diversified away. We are increasingly convinced that we should keep these "fire insurance" assets separate from the "normal assets", at least intellectually, and preferably physically, for their economic functions are entirely distinct. Whereas the normal portfolio must fulfil its function today, tomorrow and the day after, the value of the "real value portfolio" is irrelevant today, tomorrow and the day after – it must only be of value when the worst happens. This cannot be achieved with standard asset management.

Accordingly, at the bank we are currently revising our considerations on the strategic positioning of the funds entrusted to us. Discussions with our clients over the coming months will be full of challenges. But as the saying goes: "When the going gets tough, the tough get going". The going will be tough enough.

KH, 22.03.2010