Collapse, survival, adaptation: three scenarios

1. Things can't go on like this.

Scenarios are stories about the future. We use them to try to make the future imaginable. The simplest story is that everything will stay the way it has been. In the short term, this scenario generally applies, which is why it is so popular; in the medium and long term, however, it leads us astray. Not much less simple, and undoubtedly always true, is the scenario that goes back to John Maynard Keynes: "In the long run we are all dead". But it is at the same time utterly false, for, with the exception of an apocalypse (also a scenario …), death is relatively seldom a simultaneous, communal experience, so that contrary to Keynes's forecast, life does indeed always go on.

If the times and events indicate that the simple extrapolation of the recent past has little probability even in the short term, and is thus irrelevant for our decision-making, then we shall have to come up with some more elaborate stories about the future. At the same time, we need to avoid excessive complexity. From the experience gained over the few hundred thousand years of existence, mankind has assembled an archetypal fund of metaphorical scenarios: The Flood, The Golden Age, The Odyssey, Purgatory are concepts that eclipse all analytical descriptions. Experience and foreboding have combined into genetic imprinting to keep us capable of taking action in dangerous times. For a flood, we need a watertight ark; for an Odyssey, sufficient provisions, and an astute mind.

There can be no doubt that these are "dangerous times". The recovery of the American economy, coerced with an unbelievable amount of dirt-cheap money, is weakening, despite the continued supply of more of the same. The eurozone writhes like a mortally wounded beast, all the time spreading its germs, so that it will soon need the many heads of the Hydra to lick its wounds, as it waits to be put out of its misery. China seems to be having problems with a cooling economy and overheated enthusiasm for investment, which will, as well as the useful ones, doubtless leave behind many useless projects. The Arab spring does not look like being followed by a real summer. It looks more like a security nightmare, involving potentates who are variously deposed and condemned, deposed and not condemned, not deposed but bombarded, not deposed and halfway tolerated, and not deposed and supported by every means. The problem is the oil so urgently needed by both the West and China. About 30 percent of the annual production comes from the Arab world.

What is so dangerous about these times? That in none of these cases – and it would not be difficult to add others – does extrapolation from prior events seem to be a sensible option. Put more plainly: things can't go on like this. The world is heading towards inevitable decisions. Our task is to ascertain what options are open, what probability they should be assigned, and what consequences all this may have for our own dispositions (of our assets).

Just two years ago, we subjected ourselves, and of course our readers, to a similar process. Under the impact of the financial crisis, then in the course of subsiding, and of the abrupt collapse in global trading, and with an eye to the uncertainty of future developments, we created three stories about the future: the "Lazy L", the "Blood-red abyss" and the "Golden East". We want to link our new scenarios to these three previous stories, so we first need to revisit them briefly.

2. Simultaneous occurrence – with nuances

Were the three scenarios wrong? Of course they were. Scenarios always are. Real history is always different, and, above all, more complicated. At the time we supposed that these three stories – the "Lazy L", a gentle recovery while muddling through all the unresolved left-overs of the financial crisis; the "Blood-red abyss", a debt spiral in the Western states, spinning ever faster till it disappears into a hopeless abyss, and accompanied by political unrest; the "Golden East", unrestricted domestic growth in the Far East, accompanied by strong demand for Western equipment – would be more or less mutually exclusive. Ideally, scenarios should be constructed in that way, for only as genuine alternatives do they possess sufficient validity for strategic decision-making. On purely logical grounds we could hardly imagine that more or less all three scenarios would occur together, or perhaps rather, side by side.

This simultaneous occurrence is, however, exactly what has happened, and it is ultimately the reason why today we cannot just revert to simple extrapolation, but must again look for – as far as possible, mutually exclusive – stories. And they too will also be "wrong". But perhaps, hopefully, less wrong than just continuing past history, or than having no ideas at all.

The combination of the various scenarios has meant that some developments have been rather more nuanced. Thus, the "Lazy L", the laborious recovery after the deep recession of 2008/2009, does apply to many industrial nations, such as the USA, Japan and part of Europe, but not to Germany and Switzerland, countries of particular interest to us. These two highly export-oriented economies have been benefitting for some while from China's marked enthusiasm for investment. The strong Swiss franc has so far not significantly hampered Switzerland's economic success; exporters to Europe (mostly Germany) may be moaning about the impact of the strong franc, but there is no question of a currency-related collapse. The Swiss labour market is experiencing shortages; where a year ago short-time working was needed, overtime is now being required and it is necessary to recruit apprentices from abroad. In certain areas, Switzerland actually appears to be heading for overheating: it's a long time since we have seen so many construction cranes at work. Interest rates are too low, capital too cheap.

Germany is once again displaying genuine domestic growth, in sharp contrast to the 1990s, but also to the comparatively auspicious global economic situation from 2003 to 2007. Export success has fuelled domestic confidence, most obviously visible in the consumption figures and in construction. At last, the finance ministry is again reckoning with a rising tax take. That German energy policy will undoubtedly prove horrifically expensive does not yet seem to spoil the party mood. Perhaps it's simply that the broad public doesn't really believe in it, for current German politics is capable of rapid change.

However, the "Blood-red abyss" has also gained a few nuances in the meantime. Nominally speaking, Greece and the other shaky European debtor countries, like Ireland, Portugal and Spain, are still regarded as theoretically solvent. It has been possible to delay the predicted bankruptcy for a lengthy period. Conversely, the entire eurozone relief column has been manoeuvred to the brink of the abyss. Even more astounding though, and ultimately the most threatening of all, is the fact that the United States, regarded by even the most hard-nosed commentators as a haven of stability, has for some months now been subject to the rigorous scrutiny of the rating agencies.

The dollar's weakness has thus become a straw for the euro to clutch at. The Chinese, with overflowing currency reserves (principally in US dollars…), have now assured the eurozone of their help. But overall, the two previously unchallenged reserve currencies, the dollar and the German mark, appear in their current form as but pale shadows of their former selves in a bygone golden age. They reflect the loss of credibility suffered in recent years by a one-sided financial system, oriented on and run by the West. And this precisely at a time when the real economy in the Far East is set to outstrip the West. The "Blood-red abyss" has given massive momentum to the arrival of the third scenario, the "Golden East".

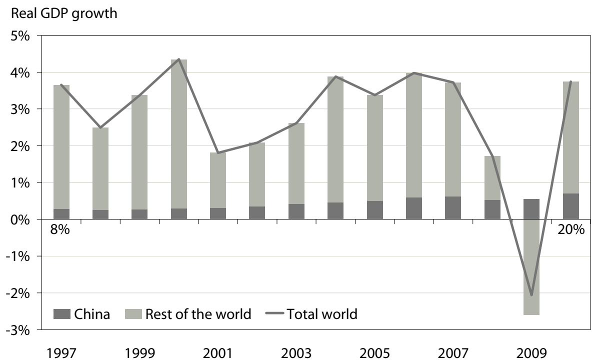
3. Now reality: the "Golden East"

We can confidently discard the "Golden East" as a scenario. China, India and the suite of countries that are becoming ever more closely interconnected with these giants in a sort of inner-Asian domestic market, now make up a self-evident and increasingly independent part of the global economy. When in future we discuss the global economy, it will be pointless to look (as many commentators have been inclined to do) just at the USA and at Europe as its sidekick. The USA remains politically and militarily the strongest country in the world, but it has lost its economic dominance. The American capital market still possesses superior attractiveness, not least thanks to its high level of liquidity. But regulatory risks, which ultimately amount to a special tax levied on capital market participants by law firms, auditors, state attorneys, law courts and the Treasury, are continually undermining these American advantages, with increasingly negative effects.

Meanwhile, financial markets formerly associated with the "emerging markets", such as those in South Korea, Singapore and Hong Kong, are developing into real magnets for capital. The relative disadvantage of these countries precisely in the area of regulation has been reduced by the erosion of ownership rights and market-economy freedoms in the West. The world has turned, in other words, and with regard not only to the real economy of goods and services, but also with regard to the financial system. Good news for all those who welcome a more diversified world; bad news for the previous monopolists. It may be that they no longer are.

That we need to treat the significant participation of Asia as a given, and no longer as a potential scenario, is borne out by a figure showing the development of global gross value-added, and an anecdotal comment. Two phenomena stand out in the development of Chinese GDP: firstly the impressive increase from an 8 to a 20 percent share in the growth of global GDP, and secondly the extraordinarily low volatility of economic growth. Without China's contribution, 2009 would have been even more of a disaster. Is this sustainable in the long term? Scepticism is growing. The key question will be how China can arrive at an equilibrium between investment, production *and* consumption. Abrupt developments would be fatal: a collapse in Chinese investment would cause long faces in Germany, Switzerland and elsewhere.

China's strength, quantified



Note: Real global GDP in US dollars (2005)
Source: Landert Family Office

The anecdotal comment concerns a speech by the Chinese envoy to the UN in Geneva, made at our bank's investors' day on the topic of sustainability. He Yafei's remarks were distinguished from much that has previously been said, much of it incomprehensibly, on the topic of CO_2 by their clarity and forcefulness, but also by a clear intention to play a part in the discussion. Obviously fairly far up the Chinese hierarchy, he spoke not only in faultless English, but also in plain language of the sort we seldom hear from Western politicians. "We have nothing to learn from the West": not only his message, but also a statement of reality. The world has turned. This may take some getting used to, but it can no longer be denied.

It only remains to add to the theme of the "Golden East" a word on Japan. Contrary to popular opinion, we do not believe that the past twenty years can be described as "lost years" for this country, which is unique in so many ways (and thus also difficult to analyse). GDP has undoubtedly stagnated. And this despite the fact that internationally active Japanese businesses have not only kept pace with the rest of the world, but have achieved particular success in many areas. In car manufacturing, Japan is far advanced in hybrid technology, and has a leading position in robotics. Japan's stagnation is domestic. And it is precisely here that we see an opportunity that could give Japan a competitive edge in the decades ahead. Japan has addressed the demographic problem, better than Europe, but above all better than the USA, a country plagued by an ageing population and obesity. The coffee machine that, if it is not used by an elderly person, sends a text message to a relation at their workplace may be dismissed as a gadget. But behind it lies the idea of care of the elderly that is not the responsibility of society. With regard to the demographic issue, Japan is ten or twenty years ahead of the West, overburdened as it is with "entitlements" due from society. That pensioners are now helping to clear up the damaged nuclear power station at Fukushima may help to underline this insight. We hold to our previously expressed opinion that, after the initial shock, Fukushima will have a positive impact on the Japanese economy.

4. Collapse: not yet, but ...

Let us now, taking due account of the way the world has been expanded by the Far Eastern nations, turn to the most likely scenario, the "Blood-red abyss". It is taken over, with the nuances mentioned but otherwise largely unchanged, from our repertoire of two years ago. The story on the "Blood-red abyss 2.0" is as follows:

"As we know, in the financial crisis it became clear that a number of Western banks, in particular big conglomerates and quasi-state institutions, were operating on an essentially dysfunctional basis, in that they were performing low-margin, *supposedly risk-free* transformation functions with absurdly high levels of debt on their own account. When American mortgage debt was no longer available as a credit substrate, they began to concentrate on *supposedly risk-free* state debtors. The national central banks and the European Central Bank (ECB) acted as godfathers in that they readily accepted this credit substrate as security. Instead of providing the private-sector credit needed by their economies, the big banks then began to heal the wounds of the financial crisis by means of this carry trade. This business with *supposedly risk-free*, generously collateralised state debt ran wild. German and French banks in particular built up risk clusters with the debt of European states, as did the ECB as the creditor of last resort. Their balance-sheet totals increased by a factor of five between 2008 and the end of 2010. Worse still: as of mid-2011 the German economist Hans-Werner Sinn surmises that there is a further 380 billion euros of endangered state debt substrate ("Target 2 loans") with the ECB and the national central banks.

Supposedly risk-free: Until the financial crisis there were no significant risk premiums between the individual debtor nations within the eurozone. Greece and Portugal and Ireland and Spain and Italy were able for a very long time to borrow money on the same terms as better-quality debtors like Germany, Holland or France. Only in the course of 2009 did concrete doubts as to the solvency of these countries arise on the markets. The eurozone countries reacted to the crisis with generous financial support, described as "rescue packages", first for Greece and later for Ireland and Portugal, but in doing so were mainly focused on their own banks. The countries affected were, and are, obliged to embark on a series of austerity programmes, to convince the markets of the seriousness of their efforts. The ultimate monetary instance, the International Monetary Fund (IMF), which has just been awarded the French finance minister as replacement for its disgraced former head, Dominique Strauss-Kahn, is becoming deeply involved in the issue of European state debt. According to its statutes, it is not actually allowed to, but the gravity of the situation indicates pragmatism.

The markets, however, are fairly unimpressed by all these efforts. The reason for this is the refusal of the responsible bodies to admit the structural weaknesses of the single currency, and to work towards a solution that would rectify them. Apart from the profligacy observed in Greece, and elevated into the principal target of the austerity policy, the irreconcilable heterogeneity of the countries in the eurozone is tacitly ignored, to the displeasure of the markets. The average correlation of the economic growth of the various countries in the eurozone for the period from 1980 to 2010 is just 0.6 percent. Countries like Greece or Portugal follow a cycle entirely decoupled from the eurozone. The massive interest-rate support since the introduction of the euro has resulted in somewhat greater consistency of pace, but there can be no question of homogeneity. This is seen particularly in productivity differences, which effectively condemn the structurally weaker countries to incompetitiveness. The markets thus rightly doubt that salvation for the heavily indebted countries is possible without the classic restructuring tools of haircuts and devaluations.

Similarly, public opinion in the affected countries increasingly doubts the sense of the measures. The flight of capital and emigration by the wealthy and the young are followed by unrest and revolt. Because restructuring is not carried through, what the eurozone always sought to avoid, the domino effect, now becomes reality. The insolvency of the smaller countries is followed by that of two large countries, Spain and Italy, and because these two countries had to act as important guarantors of the European rescue fund (Italy: 80 billion euros for the EFSF, Spain 52 billion, out of a total guaranteed sum of 440 billion euros), the whole rescue structure comes apart at the seams. In the wake of the collapse of several big banks, political unrest affects Germany and France as well. Disagreement over the future of the euro causes a row between Paris and Berlin. The structures that have kept peace in Europe stand at the edge of the abyss.

In the meantime, an apparently unstoppable collapse is taking place on the bond markets. Apart from all the problems in the eurozone, market participants have also now realised that the extremely short-term maturity structure of US T-bills will result in an insupportable burden on the capital market when it comes to refinancing. Whether they like it or not, both the ECB and the Fed are obliged to raise interest rates. The projected interest-rate burden for the state debtors staggers even those not involved. It becomes increasingly clear that for far too long virtual insolvency – by no means affecting only the small debtor nations – has been battled against in the belief that the problem was liquidity."

5. Hoping for the best

The second story is based on the observation that during the financial crisis it was indeed possible to attack the virtual insolvency of big banks with sufficiently generous liquidity support. This can be continued indefinitely:

"Apart from Lehman Brothers, an unfortunate accident, and those institutes forcibly integrated into solvent banks, most banks have in the meantime been able to recover. This is due to the continuing record low interest rates and the possibility of unproblematic refinancing by the central banks. The constantly positive yield curve once again makes quasi-risk-free term transformation possible.

Among the central banks, self-belief is so high that they regard the vast expansion of their own balance sheets though the purchase of domestic bonds (QE 1 and QE 2), and the resulting dilution of their equity, as unproblematic side-effects. The losses against gold or the hard currency of the Swiss franc are dismissed as the handiwork of speculators. Sooner or later it will be necessary to put a stop to it by means of a Tobin tax, the fiscal punishment of inappropriate transactions. The draft of such a G20 resolution has long been prepared, and filed. It is just a question of waiting for a particularly egregious case of speculation, so as to give this intervention in the market sufficient momentum among the general public.

Of course the European state debt crisis is a matter of concern, but the view is that, as long as any suggestion of state bankruptcy is avoided by means of a sufficiently generous rescue package, the problem must be soluble. Critics who describe this approach as excessive, and warn of inflationary consequences, are countered with the accusation that they are wantonly endangering the achievements of the single currency, and ultimately putting at risk the peaceful social order of Europe. All it will take is sufficient economic growth over a sufficiently long period, and the problem will solve itself, so to speak. So, the title of our second scenario is "Regenerational survival".

Fears that the capital market will be stressed by the short maturities of the American Treasury's debt are dismissed as exaggerated. If the exact wording of the latest speech by the Governor of the Fed, Ben Bernanke, is studied with sufficient care, it is clear that the American central bank is keeping all its options for the refinancing of existing Treasury debt open. In this respect, according to some experts, we may be looking at a sort of "QE3". It is regarded as particularly satisfactory that deflationary forces still dominate at global level, so that despite the unwelcome increase in commodity prices, there are no signs of inflationary pressure. Nothing thus stands in the way of a continuation of the very-low-interest-rate policy, particularly as the "core rate of inflation", which has little to do with the inflation experienced by the average American at the petrol pump, remains at a low level. Three cheers for the statisticians. "Survival" also involves a good deal of perception management.

Back to Europe: here, the idea of the unification of the currency area gains some real momentum. The state debt crisis has shown in exemplary fashion that much is amiss with the harmonisation of economic, social and tax policies. The centralisation of decision-making and guarantees that "social dumping" can be prevented by the definition of minimum standards on socio-political issues are enthusiastically advocated by supporters of a more homogeneous eurozone. It is, incidentally, deeply regretted that the attitude to these efforts adopted by the United Kingdom is somewhere between passive and dismissive. Switzerland is expected to comply with the socio-political minimum standards and requested to align its taxation policy at the European level. There must be an end to cherry-picking, once and for all. The alpine republic cannot expect to profit unilaterally from the restructuring of European debt.

With regard to the loss of prosperity and the increase in the cost of European products caused by the unification policy, there is confidence that, by means of the targeted stigmatisation of social dumping in the emerging markets, the markets for goods and services can be sufficiently disciplined that this market failure can be eliminated by pressure from higher authority. This has, of course, nothing whatever to do with protectionism. As the thus stipulated shift to "European goods from European production for European consumers" gradually produces inflationary consequences, Brussels considers the temporary installation of price controls. The European Central Bank will only increase its base rate if this means of fighting inflation proves inadequate."

6. Underestimated feedback mechanisms

With the third scenario, we may run some risk of being misunderstood. And this in two respects: firstly, this story of the future might create the impression of being merely a compromise between the "collapse" and "survival" scenarios, and thus not offer any real alternative. Secondly, the suspicion might arise that this is just a matter of "muddling through", and that such an approach might even prove successful. We are of a very different opinion: muddling through is not a scenario. The liberation of the (Western) world from an excess of debt – deleveraging – is unavoidable. With Scenario 1 this occurs in a profound social and political crisis, involving confiscation; in Scenario 2 by means of gaining time for economic recovery. Scenario 3, "Rapid adaptation", relates to a phenomenon that has never existed with this breadth and intensity, and which has the potential to write a story of its own:

"We still have only a fragmentary awareness of what immense changes modern means of communication will bring about. When we discuss Facebook and Twitter, we think only – and wrongly – of inconsequential exchanges between adolescents. What we overlook is the impact these and other social media have now achieved on the formation of public opinion. It doesn't take Wikileaks to uncover wrongdoing and dubious behaviour: the basis of public debate on anything and everything is broadening continually. Long gone are the days when editors condescended to allow a little space for public opinion on the letters page (or not). Public opinion has emancipated itself on a global scale.

In terms of systems theory, this means that the relatively few long-established, and thus easily influenceable, social feedback loops are being continually supplemented, if not replaced, by very direct and much more important influencing mechanisms. A month ago, we ventured an interpretation of the pan-Arab uprising that went in this direction. As if guided by an unseen hand, similar uprisings occurred at fairly unrelated locations. They have one thing in common: broad support by the remarkably well-informed masses. This is new. Formerly, the masses were dumb.

Today – and this is surely legitimate within a story of the future – we venture a step further. It's generally known that for months now, we have been brooding over the phenomenon that two realities exist in European debt circles – two parallel universes, so to speak. One is the sugar-coated perspective, carefully maintained by Brussels and Luxembourg and Frankfurt and Berlin, that the state debt problem can be solved by the European efforts at stability. The other is a realistic, market-based perspective of exorbitantly high CDS premiums and interest rates for the highly indebted countries, despite all efforts at stability, which continues to assume the high probability of bankruptcy for not just one, but several states. Here we have a feedback mechanism at work that is entirely unaffected by any spin-doctoring.

But for feedback to be effective it must be picked up by entities able and willing to adapt. This is what is really interesting, and novel, about Scenario 3: that entities adapt! Thus the eurozone has so far assiduously avoided using the word "rescheduling". But for some weeks now, we have been hearing about the "reprofiling" of Greek state debt. This is understood to mean exactly the same as "rescheduling". So far the Eurozone has made every effort to avoid accepting the insolvency, the "default", of Greece as a reality. All the efforts go in precisely the opposite direction, and with good reason, for it would mean that overnight a vast number of valuation differences in bank balance sheets would have to be resolved. Instead of "default", for some weeks now the discussion has been about the "voluntary participation" of private creditors (which mainly means the banks) in a "reprofiling" exercise. Amazing! When the state says "voluntary", in reality this means "obligatory". Put differently: without admitting it, the eurozone is currently conducting the bankruptcy of Greece.

It will be objected that this clandestine adaptation by the eurozone is not happening quickly enough, and nor will it be sufficient. That is undoubtedly true. The systems (including those that have done all they could to elude democratic influence) will first have to learn adaptability. But the events speak for themselves: adaptation is occurring. Building on this, we might make up the following continuation of the story: by autumn 2011 the European banks have "voluntarily" completed the impairment of Greece's, Portugal's and Ireland's debt. On the market, and thus in those balance sheets that are based on market values, the write-down of course happened earlier, and is long digested.

In the meantime, a force has established itself in the EU, under pressure from emancipated Italian and Spanish Internet forums, that calls for a "reality-related" agenda. In plain language, this includes the demand for a currency split along the productivity divide in the EU. Although vehemently rejected in the EU capitals, and naturally in Brussels, the idea rapidly becomes part of public discussion. As in the previous case of the interest-rate differences and CDS premiums of highly exposed debtor states, the financial markets begin to anticipate the break-up of the eurozone. The volatility of the euro against other currencies continues to increase, and there is turmoil on the bond markets, while interestingly, Italian and Spanish stocks start to boom. In spring 2012 Jean-Claude Juncker, the chairman of the Euro-Group, presents the interesting new concept of a "dual-harmonious Europe".

Nor does adaptation stop at either Europe's explicit debt or the intra-European productivity divide. Also, and above all, it embraces the implicit debt generated by the demographic situation and the baseless promises of the political system. Under the slogan of "Active Old Age" the Western pensions systems are radically restructured, and with the concept of "Lean and Healthy", public healthcare is reduced to an affordable scale. With a resolution in Congress entitled Capital Market Advocacy Program (CMAP), the USA abandons the anti-capital-market Foreign Account Tax Compliance Act (FATCA) passed in 2010 and intended for introduction in 2013. The world in 2014 is doing considerably better than might have been feared in 2011."

Overoptimistic? Illusionary? Probably. But there is something plausible about the idea that, despite all assurances to the contrary, under the now much greater pressure from an on-line public (a sort of new version of direct democracy ...) the focus will shift relatively quickly to the relatively important. We see the term structure of interest rates as a key indicator of whether or not we can reckon with this scenario. Given that the central banks have jeopardised their credibility in dangerous fashion, will the bond markets be able to prevail in time? Credibility can only be regained by means of higher interest rates. With the recklessly short maturity of much public debt, the foreseeable burden on the capital markets ought to initiate such an adaptation in the very near future, when the central banks' room for manoeuvre to create additional liquidity is exhausted.

7. What are we to do?

It only remains to allocate probabilities to the three various stories of the future. A perilous undertaking, for even a commentator oriented on the medium and long term is not entirely immune to daily fluctuations. Realistically, we must assume that Scenario 2, the continuation of the flood of liquidity to buy time and solve the problem through growth, will be continued. The institutional incentives tend almost exclusively in this direction, including the threat of loss of face in the event of failure or premature discontinuation. But as in our view the scenario is based on a series of illusory assumptions – undoubtedly including the by now absurd concept of the state as a "risk-free" debtor – we must almost daily expect the financial system to slide into a new crisis along the lines of the "abyss". Scenario 2 inevitably carries with it the Achilles' heel of Scenario 1. Scenario 3, by contrast, the remarkable, and remarkably rapid, ability to adapt, could develop relatively independently. Indeed, it might seem as if we were still in the middle of Scenario 2 even as ever more evidence of adaptability surfaces – not just with concepts like "reprofiling" or "voluntary participation", but with facts like a significant rise in interest rates.

The situation for investors is not a particularly comfortable one. Let's start with stocks. In the "Blood-red abyss" scenario they will be exposed to nominal price turbulence, but they may represent one of the few means of salvaging the situation, in that they retain intrinsic value. Scenario 2, by contrast, could mean an apparently endless up and down, as in Japan over the last 20 years. In Scenario 3, the stock markets will be instrumentalised to enforce public opinion. Generally higher valuations with more abrupt volatility would be expected, as the structural problems that have dogged the stock markets in recent years would be gradually cleared away.

The situation is not much better on the currency front. Because the occurrence of the "Blood-red abyss" scenario is substantially more real for the eurozone than for the US dollar, we must assume that the greenback would remain the ultimate currency of refuge in the crisis, despite all the structural weaknesses. In Scenario 2 both currencies would probably seesaw downwards together. Scenario 3, by contrast, would enable the strengthening of the Western currencies, and thus the reestablishment of the capital markets' credibility.

On the interest-rate front the "Blood-red abyss" would ultimately result in an abrupt rise in rates for the remaining currencies, while with the liquidity miracle of Scenario 2, rates would of course remain low across all maturities. A rise in interest rates is an integral part of Scenario 3.

What are we to do? It may not be that difficult to know. As long as the "Blood-red abyss" cannot be assigned an infinitesimally small probability of occurrence, we stick to our recommendation to keep around 30 percent of one's wealth invested in real-value assets, by way of insurance. Expressed negatively this means for that part of the assets deliberately forgoing promises or commitments of any kind, whether made by states, banks, insurers, central banks or other bodies defined by the making of promises or commitments. Ice-cream machines, telephone networks, mines and oil and gas fields are of a more tangible nature.

In Scenarios 2 and 3 on the other hand, the bodies that can make promises and commitments do not go down. So, asset allocation can be correspondingly more "classic". If the central banks succeed in maintaining their credibility, despite their unabated provision of high levels of liquidity, then medium to long-term bonds may even continue to serve, the more so as nothing else in the fixed-interest sector produces any real return. For Scenario 3, these bonds could also be replaced by stocks with high dividends, provided the bumpy ride inherent in the adaptation process can be tolerated.

Whatever: when it is a matter of debt relief, of deleveraging, on the scale described, the real risks for assets come not from price losses that can be mitigated by adjusting asset allocations, but from clandestine, or indeed open confiscation. Genuine asset management advice includes consideration of this disagreeable sub-scenario. Advice here might be somewhat more difficult; corresponding action undoubtedly so.

KH, 4.7.2011