Bursting the boil

1. Idol or mirror-image?

We are not to serve Mammon, we are informed in a familiar passage. And, we should like to add on this occasion, if anything, Mammon should serve mankind. But this is very clearly not the case. For over a year now, we have seen one crisis meeting of finance ministers, central bankers and prime ministers after another. Ever more frequently, statements have been published, open letters sent by one government to another, and telephone calls held between officials at the highest level. And all with one aim: to restore – or in the words of those involved, to "strengthen" – the credibility of the financial system. As if there were no other problems in the world, no other opportunities to be seized, everything has revolved around this single theme: the idol Mammon.

The worship of this idol involves both faith-healing and euphemism. The lack of content of these incantations is most clearly revealed in the speech by President Obama on the occasion of the downgrading of the creditworthiness of his country. It can be summarised as follows: "My fellow-Americans: that we have a problem is something we have known for a long time. We didn't need a rating agency to tell us that. But we don't have a problem because, despite everything, we are a Triple-A nation. Actually, we do have a problem, but we are in a position to solve it. It's true that Congress has struggled with the problem, and only managed to put it off. But we will solve it, nevertheless. So, we don't have a problem". In a genuine crisis – and there can be no doubt that this is what the developments on the financial markets represent – the impact of such inconsequentialities, particularly if uttered by the highest authorities, is typically not so much negligible as negative. For the inconsequentiality of such statements is deeply revealing; it indicates objective and subjective incompetence in the matter.

The statements of head of governments of varying quality and weightiness – from Mr Papandreou via Messrs Berlusconi and Sarkozy to Ms Merkel and Mr Obama – have long been greeted by the financial markets with indifference, if not indeed with serious displeasure. Not to mention the continuous barrage of comment from all the other functionaries of every imaginable organisation involved, from the indefatigable EU Commissioner for Economic and Financial Affairs, Olli Rehn, via the inept President of the European Commission, José Manuel Barroso, to the newly installed Managing Director of the IMF, Christine Lagarde, whose ostentatious grin particularly irritates the battered participants on the financial markets. For it is no laughing matter when the credibility of the system and its representatives is called into question to this extent.

Money, that mirror-image of the real world and the real economy, created to facilitate exchange and the maintenance of intrinsic value in real life, is dependent on this one single qualification: credibility. For money can be only a reflection; no more and no less. Whether backed, as many demand, by that strange metal, gold, or, as others think proper, by a well-considered and highly independent monetary policy on the part of the central bank that issues it, there is no way round credibility. When it can no longer be believed that tomorrow, the day after tomorrow or next year, a loaf of bread, a doctor's bill or the purchase of a house can be paid for with bank notes or from a bank account, or out of the value of a government bond, then the inconsequentiality of the idol Mammon has become reality. In our view, the key issue of our time is precisely the autonomy of money as an entity, which must inevitably result in the unmasking of this inconsequentiality – in the bursting of the boil, in fact.

It is ridiculous that we expect the very people who are in a position to undermine the monetary system – the politicians – to "strengthen", or regain, its credibility. With their ability to abuse the monetary system in the interest of a politically motivated debt-based economy, they would have to be at the bottom of the list when it comes to the provision of credibility. But who would be at the top? That's obvious: the central banks and those managers of the monetary system, the bankers; then perhaps, a bit further down the line, those representatives of long-term capital com-

mitment, the insurers. It is part of the crisis that neither the central banks nor the bankers are now in a position to evoke credibility. Why? Because they have become part of the political system. The assumption of TBTF (too big to fail) for banks of a given size and importance has effectively semi-nationalised what was once part of the private sector of the economy. In the 2008 financial crisis, the banking system offloaded its own excessive-debt problem onto the state, and is thus now partially responsible for the problem of excessive state debt. The central banks also allowed themselves to become part of the same problem, on the pretext of a politico-economic measure, by creating liquidity through the purchase of their own government bonds – quantitative easing (QE). To this extent, none of the significant central banks can any longer be regarded as politically independent.

And so now they dance, the heads of government, the finance ministers, the presidents of commissions, the governors of the central banks, around the hollow idol, chanting their intercessions for succour and healing – and believe that we believe them. The crisis that we now find ourselves in is identical with growing disbelief among the public.

2. Excessive debt: what now?

It's probably not a bad idea to take one or two steps back, and ask: What is really the issue here? Is it the US dollar? Greece? The French banks? The euro? The stock markets? Supposedly risk-free government bonds? The danger of another recession? The now ageing zero-interest-rate policy (new entry in the vocabulary: ZIRP, "Zero-interest-rate policy")? Personalities like Geithner, Trichet or the grinning Frenchwoman? Yes and no; or perhaps rather: as well. But the backdrop is always the excessive debt accumulated in various geographical locations and in institutions of varying scale.

Excessive debt: as the term indicates, this is about too much. There is nothing wrong with debt as such: it is an economic reality and necessity. Capital is not so distributed that the required amount is always available exactly where it is needed and at exactly the right moment. Those to whom capital belongs are not necessarily the best people to find the ideal economic use for it. This is why there are economic allocation mechanisms, banks and bond markets, to perform the task of providing the economy with borrowed capital. The provision and acceptance of borrowed capital are based on the assumption that the repayment of the principal and the payment of interest are not only possible but highly probable, and can be compelled if need be. Debt only becomes excessive when repayment and interest payments cease to be highly probable, or are in all probability no longer possible at all.

Excessive debt must be distinguished from a liquidity crunch, which, if not associated with excessive debt, can be resolved by the provision of further funds (for instance, through a sale of part of the assets, or through additional borrowing). Assuming normal – that is, unconstricted – conditions on the financial and capital markets, a liquidity crunch not associated with excessive debt should, in economic terms, always find a solution. A great many of the "rescue measures" undertaken since the outbreak of the financial crisis in 2007 were based on the assumption of such a liquidity crunch, not involving excessive debt, and, apparently, also of abnormal conditions on the financial and capital markets. The flood of liquidity released by the central banks, initially to the benefit of the banks and now of whole countries, represented an attempt to compensate for the obviously excessive rigidity, and thus the failure, of the financial and capital markets.

However, the current crisis now indicates a different assessment of the situation by the markets. Essentially, the story about a liquidity crunch unassociated with excessive debt is believed less and less, and there is a growing assumption that the repayment of principal and the payment of interest will, in many cases, be highly improbable, if not impossible. This is no longer about banks, or the countries on the periphery of Europe, but about heavyweights like Spain, Italy and, so it is rumoured, even France. The assessments move from "still reasonably likely" (and thus still remediable) via "less likely" (but still worth trying to fix) to "fairly hopeless" and, ultimately, "impossible". Put differently, the spectre of the bankruptcy of large and important nations, long bandied about by a few tiresome commentators, has suddenly become a real problem.

So, what basic possibilities are there for debtors and creditors in a situation of excessive debt?

We see three, namely:

- Firstly, the provision of funds by a third party, as a kind of "gift", which may well be associated with conditions – up to and including taking over ownership from the debtor;
- Secondly, an agreement between debtor and creditor to write off part of the debt. Payment of interest and principal then become possible again, and thus more probable;
- Thirdly and lastly, actual bankruptcy, with sanctions on the debtor and a serious loss for the creditor.

What these three options have in common is that they are all very painful. Restructuring is not possible without some form of write-off. Those who have grasped this also understand why every effort is made to prevent the pain happening, and to gain time by means of obfuscation and delay. In practice, obfuscation and delay tend to be combined with a homoeopathically dosed, or straightforwardly dishonest, attempt to offload the problem onto a public that is in no position to defend itself. The Prime Minister of the Netherlands, Mark Rutte, was ordered back from his holidays by the Dutch parliament, because the experts in the finance ministry were unable to state whether the Dutch contribution to the European rescue package would now cost an additional 50 billion euros or not. The public noticed, and was not amused.

State debtors are undoubtedly somewhat special. Unlike a business in the private sector, a state has no equity as such. It is thus not possible simply to determine that its debt is excessive on the basis of an adverse balance sheet. There are, however, other indicators that point to budgetary discrepancies – in particular, a budget deficit: an imbalance between income and expenditure. Or the current level of debt in relation to the economic strength of the country. Or the interest burden in relation to the tax revenue.

To a certain extent, the state can also exist comfortably, even unconcernedly, because it is not obliged either to show the liabilities it has incurred on its books, or to back them or finance them on the market. The amount of implicit debt thus created, which has often been pointed to in our Investment Commentaries, generally exceeds explicit debt by multiples, and is among the most threatening aspects of any analysis of the Western industrial nations. The inability of our demographically challenged societies to refrain from making unfulfillable promises is among the greatest shortcomings of our times. Implicit excessive debt can also only be dealt with in the three ways we have described. And certainly not painlessly.

We have previously mentioned the special means the American Treasury employs to finance a large part of its requirements via quasi-state agencies, rather than on the markets. Here, we merely draw attention to it once again. In this way, the USA manages to convert around one-third of its explicit debt of some 14,600 billion dollars into semi-implicit debt, and to keep it away from the market and its control functions.

There's just one thing we need to be clear about: despite all the specificities pertaining to national budgets, the assumption that there is, so to speak, a never-ending possibility of incurring debt is false. National budgets are neither risk-free nor unlimited. This insight is the theme of the current crisis; it is as obvious as it is painful.

3. Decontamination through centralisation?

In practice, the bridging of liquidity gaps and restructuring, from partial to radical, are often intermingled. Thus, overindebted countries have taken up funds on the pretext of a bridging loan for a liquidity crunch that is partly self-inflicted and partly due to apparent market rigidities, and used them to cover current market liabilities. When an auction of new bonds financed in this manner is "successful", there is rejoicing at this "reassurance of the market and the investor community". At the same time, as part of this rescue package, type-1 and type-2 approaches are being followed to deal with excessive debt: "gifts" from third parties and/or agreements between debtor and creditor to write off part of the outstanding debt. Thus, the "European Financial Stability Facility" (EFSF) self-evidently represents a transfer facility from the more stable to the less stable countries, in that with their guarantee they make their own creditworthiness available and – to the extent of the default probability of the guarantees assumed – weaken their own situation; off-balance-sheet, admittedly, but that's no longer of any interest to the markets. Accordingly, the credit risk premiums for qualitatively relatively unchallenged debtor states, such as Holland or Germany, have also risen massively. The "voluntary" participation in the haircut requested from the private sector for the debts of the peripheral countries of Europe represents the beginning of a type-2 agreement between debtors and creditors, in order ultimately to be able to manage the so far unacknowledged excessive debt.

Right and wrong remedies in an intransparent mix, overlaid by complex constructs like the EFSF: can this be the way forward? After over a year of energetic efforts to overcome the state debt crisis, the answer is now clear: no. Nor could the notorious "domino effect", the infection of hitherto intact parts of the eurozone by those already affected, have been avoided. The absolute contrary is the case: the frantic efforts to avoid default, and thus the clear, explicit, involuntary participation of creditors in the excessive debt, has (so far) protected them from this, but at the high price of spreading the risk to the whole collective. There are two particular areas of concern: first, the already-mentioned EFSF, which is so constructed that if it is called on by an additional debtor state, the burden on the remaining countries increases disproportionally. What was un-

problematic in the relatively minor cases of Greece and Portugal would be more like a nuclear meltdown in the case of Italy or Spain. Italy has guaranteed some 80 billion euros for the EFSF; Spain a good 50 billion. The EFSF could become the wedge that splits the EU and the eurozone, for sooner or later the guarantor countries, or rather, their citizens, will get frightened. The same applies to the "eurobond" advocated by the French.

The second area of concern is the European Central Bank. With its Target-2 system, a regulatory mechanism designed to provide the member countries and their banks with euro liquidity, it has become one of the most important creditors for the debts of the distressed countries. In April 2011, the economist Hans-Werner Sinn calculated the ECB's exposure to dubious Target-2 credits at a net 455 billion euros. Recent events and decisions mean that the figure is now probably considerably higher. Further, the ECB is anyway buying up the debt of the shaky member countries. It has thus itself long become a party to the matter, which is exactly what an independent central bank should not be.

The quantitative easing programme set up in the USA on an economic pretext, by which the Fed buys up its own Treasury's debt, is to be regarded in the same light. It is supposed to be brought to an end now, but what if the market will not, or cannot, swallow the new T-bills flooding the market? We know, after all, that 54 percent of American state debt, or 5,054 billion dollars, will fall due over the next three years. QE3, QE4 and QE5 look to us to be pre-programmed.

Look at it how you like: delegating a problem of excessive debt to a higher instance, whether a central bank or a European or international currency fund, only postpones the issue, and does not resolve it; it is also highly problematic in that it can result in the contamination of previously sound substance. It is no accident that so-called "no bail-out" clauses – prohibitions of collective debt management – were incorporated in the regulations of higher-order institutions, such as the statutes of the IMF or the Maastricht Treaty. Clauses are, however, only of any value if the rule of law applies, and not arbitrariness. To this extent, the current debt crisis is also an institutional crisis.

4. The cult of the Swiss franc

At a time of such complex problems, with such incalculable effects and side-effects, such a high degree of contamination, and ever shorter incubation times, it's certainly no surprise that the world looks to what is pure, beautiful and unchallenged. Gold, used by people to decorate themselves, almost insoluble on account of its chemical structure, and with a specific gravity that makes even tiny fragments relatively valuable, satisfies this yearning for purity. So too, for some time now, has the currency of a beautiful alpine country in the heart of Europe. Clear mountain streams, gleaming glaciers, yodelling herdsmen, clean streets, punctual railways and incorruptible civil servants – the absolute opposite of the shambles all around us, no?

Except possibly when making a speech on 1 August, the Swiss national day, no Swiss would ever speak in those terms. Our own assessment is a good deal more sober, which is in itself a sought-after quality, in an age rife with over-inflated egos. Whatever: the value of the Swiss franc has risen continually over recent years, and it has now become a currency of refuge par excellence, even a kind of gold substitute. Since its low point against the euro, on 11 October 2007, with an exchange rate of CHF 1.68, the franc has appreciated continually. At its peak to date, on 9 August 2011, the euro was only just over par, at CHF 1.0075. Things seem to have changed since this point, as a result of statements by the Swiss National Bank, and undoubtedly also on account of interventions on the money market, though the franc is still far off purchasing power parity. Is this shift sustainable? The next report of disaster in the eurozone or the dollar area will show us.

The strong Swiss franc has now also become the favourite topic of discussion in Switzerland itself. Fukushima is history, and of no further interest. Soon we shall have as many experts in monetary theory as we have inhabitants. And, of course, this all generates a lot of nonsense. It is worthwhile taking as sober a view as possible of things. Firstly, what are currency exchange rates? What influences them?

Exchange rates are prices; that is, states of equilibrium, constantly generated in the market, at which a buyer and a seller agree to exchange one currency for another. Generally then, there are on both sides reasonable adults, who would in principle rather win than lose. It is important to remember this. For all too quickly, the discussion revolves around speculators and other miscreants, who apparently "manipulate" the exchange rates. This is nonsense. You can only manipulate something if you can influence it. No-one in the world is rich enough to be able to manipulate a currency. Even George Soros needed the support of the market and the prevailing circumstances,

which were unfavourable for the British currency, for his attack on the pound in 1992.

What calculations lie behind decisions to buy and sell currencies? Many currency specialists would point first to interest-rate differentials, or rather, the shifts in differences between interest rates. If the interest rates in one currency are rising more sharply than in another, that currency must be attractive. Swiss franc interest rates are currently at zero, and some banks are even charging penal negative rates for deposits in Swiss francs. So, the Swiss franc must be the least attractive currency in the world!

Price differentials? If the same goods and services on both sides of a currency border have different prices, or there are differing expectations regarding inflation, and free trade is possible, then the currencies will have to converge. Interestingly though, purchasing power parity is not a good empirical guideline for short-term currency decisions. Information and transaction costs are probably too high for continuous convergence to occur.

Productivity differences between currency areas would surely be mentioned in third place. That makes economic sense according to international monetary theory, but is of little use on a daily basis, for productivity differences cannot be bought on the market, but only calculated laboriously as statistical values. They cannot be determined exactly, and nor are they ever up to date. If we look at Switzerland's current account, we would have to conclude, given the significant surplus in the first quarter of 2011, that the Swiss franc is actually undervalued.

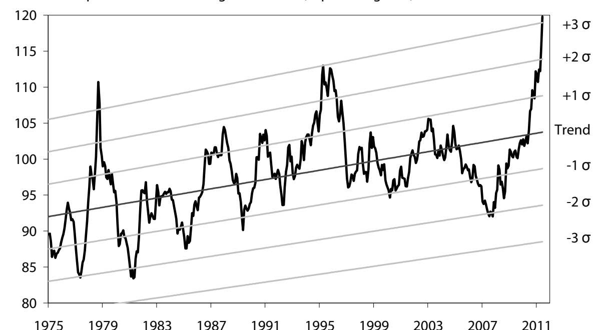
Differences in monetary policy, or in their perception by the general public? Is liquidity being poured into the system? Or are things being kept on a tight rein? What are the market's expectations regarding the activities of the central bank? Where does it look more worthwhile to invest, given the expected future monetary policy? Such considerations also make economic sense according to neoclassical investment theory. However, the statements by representatives of the central banks are often so vague that it is impossible to derive a strategy from them. It's better to follow the interest-rate policy. But at the current level of zero, that's not much help either.

Put differently, the relationships between currencies are based on an indeterminable, multi-factor system in which psychology (expectations) and chance also play a role. Or, conversely, to describe a currency as over- or undervalued would represent a considerable presumption of multi-factor intellectual ability of a high order. This also applies for the current value of the Swiss franc. So it might well be that the high rate is an appropriate reflection of future productivity differences against the eurozone in two or three years' time, when we bear in mind the impact of the transfer union now advocated on various sides. Who is to say that market participants' current expectation on this are that far wrong?

5. Transition to activism?

What we can say is that the changes in exchange rates over the past weeks and months have taken place extraordinarily quickly. So quickly that businesses have had no time to adjust their production processes. Export industry finds itself in existential difficulties. Cost is often incurred in Swiss francs, but the revenue is in euros or dollars. This reduces, or eliminates, margins. The same also applies to the banks (in asset management). Given this extraordinary dynamism, it is not unreasonable to expect extraordinary measures from the central bank. The ideal solution would be a cushioning of short-term developments, in the overall direction of the long-observed upwards movement of the Swiss franc.

CHF: upwards trend with strong fluctuations



Note: 2005=100; σ represents standard deviation: the chosen period relates to the end of Bretton Woods.
Source: OECD, analysis

What means, apart from "masterly inactivity", are available to the central bank? We believe there are essentially three, namely:

- Firstly, continuous intervention on the currency markets, by issuing Swiss francs and buying up foreign currencies, without any fundamental change in monetary policy;
- Secondly, pegging the franc to one of the key trading currencies, i.e. the euro or the dollar, and thus abandoning any independent monetary policy;
- Thirdly, setting an upper limit for the external value of the franc against a key trading currency, which would then be defended at all costs; a limited change in monetary policy, then.

The first two options can be dealt with relatively rapidly. Continuous intervention – as practised extensively but ineffectively by the Swiss National Bank (SNB) in spring 2010 – can be rejected on theoretical grounds, as changes in monetary policy that are only temporary are insufficient to break the markets' expectations. In practice, interventions result in the inflation of the central bank's balance sheet and the build-up of immense foreign-currency reserves, with their inherent risks. If these risks materialise, as they did dramatically in spring 2010, the equity evaporates or debt becomes excessive. This is admittedly not an immediate problem for a central bank, but once capital has been destroyed, neither the cantons nor the federation can be supported financially, and nor would it be possible, should the need arise, to again rescue a big bank. The market's awareness of this "hardship limit" seems to us to invite speculation against the central bank.

Pegging the franc to the euro or the dollar (option 2) at the present rate would not solve any of the problems. There would be little impact on the stresses of the export economy. And, in contravention of the constitution and the National Bank Act, be it noted, sovereignty over monetary and exchange-rate policy would have been abandoned. This would be extremely problematic, even with a brief and temporary peg. If the eurozone and its currency crashes and burns, which is by no means impossible, then the price to be paid for such an approach would be exorbitant.

This leaves us the third option, the definition of an upper limit for the external value of the Swiss franc. It is soundly based in theory, is practicable, and also the most intellectually interesting option. Its advocates in Switzerland are growing in numbers, particularly among serious economists. Just over a week ago, the doyen of Swiss political economists, Ernst Baltensberger, and the current head of the economic research centre at the Swiss Federal Institution of Technology in Zurich, Jan-Egbert Sturm, argued for such a change in the monetary policy of the SNB (*Neue Zürcher Zeitung*, 10 August 2011, pp. 16, 17).

To understand the concept, we must first distinguish between a devaluation situation and an upward valuation situation, from a central bank's point of view. Apart from raising interest rates, the only defensive measure a central bank can take against devaluation is to deploy its currency reserves. These are invariably limited. Market forces are well aware of this, so they can simply go on speculating against the central bank. Ultimately, the central bank runs out of reserves, and devaluation occurs; all that is left is the tool of a drastic rise in interest rates. Things are different with upwards pressure on the currency. Here, the central bank can intervene on an unlimited basis, by issuing its own currency and buying up foreign currencies. The market's awareness of the bank's unlimited ability to issue its own currency must ultimately mean, given a) that the credibility of the central bank is intact, and b) that its communication of the measures it will take is crystal clear ("defending the upper limit at all costs"), that no one can have any interest in continuing to speculate against its superior power. Under these conditions, the central bank does not even need to carry out its intentions; the money supply does not need to be inflated.

Baltensperger advocates a gradual reduction in the upper limit of the franc's external value, or a rise in the lower limit for the euro, to a level that could be described as "fundamentally correct", CHF 1.30, for instance. A start would be made at 1.15, with the intention – if the manoeuvre is successful – of reaching 1.20 or 1.25 in one or two months, and eventually reaching 1.30. We do, however, raise the question in this context of why the markets, knowing of the target of 1.30, would not head straight for this value. The result would be an unparalleled devaluation shock for holders of Swiss francs, and thus a form of expropriation, with highly problematic aspects of its own. A gradual process without any announcement of further specific targets could, in our view, mitigate this potential development.

Back to the model then: interest rates in Swiss francs would in theory have to rise above the level for the euro, as otherwise the lower limit would offer opportunities for arbitrage. Around 1 percent would be the current expectation for short-term rates; what would happen with long-term interest rates for bonds and the like would depend on the change in the expectations concerning the inflation outlook for the Swiss franc that would be associated with this manoeuvre.

This brings us to the key issue, and perhaps an Achilles heel, of this approach. For the central bank not to have to make use of its unlimited ability to issue Swiss francs would require it to possess a high degree of credibility in the market. It is hard to say whether this is sufficiently the case at present. The ineffectual monetary activism of 2010, the questionable profit distribution to the federation and the cantons despite the losses incurred, the closeness to the political arena involved in the rescue of UBS all raise question-marks. And what if the SNB really had to defend a lower limit, and the result was a balance sheet of, say 500 billion francs? Would the Governing

Board be able to stomach such a development? And would it be acceptable to the rest of Switzerland?

Which brings us to another Achilles heel. Apart from such a massive meltdown, with extreme inflation of the monetary basis, the concept also harbours inflationary dangers even if all goes well. For it might be that in devaluing the franc against the market, ultimately the wrong lower limit was chosen – particularly if the eurozone were to find itself in its death-throes. In other words, for one thing, this concept raises questions concerning the (timely) absorption of any surplus in the money supply, and for another, such a single, hefty intervention in the market would probably result in a further series of unavoidable interventions. This would represent a shift towards an activist policy for the central bank, far removed from the comfortable Taylor Rule of relatively passive monetary manoeuvring. In 1978 the SNB shifted to a similar approach, but then missed the right moment to absorb the surplus, with the result that the rate of inflation shot up from 1 percent in 1978 to 6.5 percent in 1981.

Far be it from us to offer advice to the central bank. There are others better qualified to do so. But we do need to make our clients aware of possible scenarios. For the exchange-rate fluctuations of the past months have obviously left their mark on investment portfolios. It's now a matter of not reducing the foreign currency component (indispensible for diversification) at the worst possible moment. In the current situation, much speaks for an attempt to break the upwards trend definitively. Not least, such a manoeuvre would restore order to the SNB's equity situation, which might be a matter of some interest in that body's deliberations.

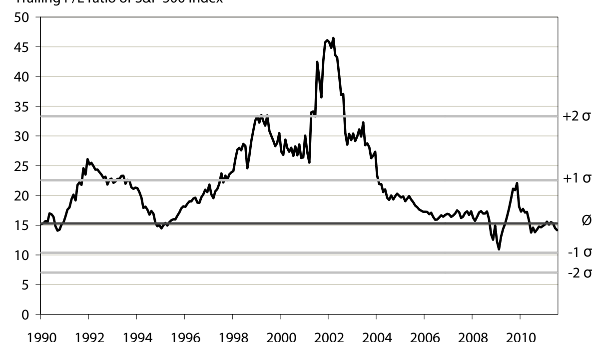
One thing must, however, be clearly understood, even if this may sound like a piece of advice: if moves are made in the coming weeks, they must succeed. There is no room for any mistakes. You don't go to war without being certain of being able to win. If doubts arise, or there is conceptual uncertainty, or a failure of nerve, then "masterly inactivity" would be preferable.

6. Resilient stock markets

With all the complexities of the situation, the useless, indeed counterproductive postponement of the resolution of the debt problem, the almost insufferable claptrap from the political sector, the clear and present dangers of a shift to monetary activism, it is easy to forget how resilient the economy and businesses have proved to be so far. There is no company management that has not been confronted with extraordinary strategic challenges. The focus has not been on balance-sheet structures, and thus in most cases not, fortunately, on overindebtedness; rather, the battle is for margins, and for survival. Cost reductions and cross-regional, even global, synergies are the key topic not just for Swiss exporters but for all companies. In other words, a new efficiency drive is under way, and will continue regardless of all the discussions about state debt and currency issues.

The behaviour of the stock markets over the difficult past weeks reflects this impressive resilience on the part of businesses, and their remarkably extensive decoupling from the problems of the financial system. Sure, if panic breaks out, the stock markets drop too. But the drive for recovery is obviously unbroken. After its dive at the beginning of last week (an overall drop of 9 percent), the Swiss Market Index SMI put back 10 percent in just two days' trading. In our view, this resilience in the market is based on essentially sound fundamental data. None of the valuation ratios indicates overvaluation; even in very long-term comparisons, the price/earnings ratio remains in a very reasonable range. The precondition is, of course, that there is no new global recession.

Stock market: no evidence of overvaluation



Note: σ represents standard deviation; average calculated over the last 60 years; "Trailing P/E" is based on company profits calculated on a rolling 1-year basis.
Source: Bloomberg; analysis

What seems to us of particular interest at present is the dividends of a variety of rock-solid companies. We incline to the belief that a bad period on the stock exchange – which is certainly a fair description of the last 10 years – is followed by a period of extraordinary dividends. These dividends would represent, in a sense, the evidence that company managements take their investors seriously, and are well aware that they need to compensate for the long absence of rising prices.

Here are a few examples of these "diamond dividends":

Appetising …

Stock	Dividend	P/E ratio
Swisscom	6.3%	9.7
Roche	5.5%	12.9
Vodafone	5.4%	10.9
Royal Dutch Shell	5.1%	7.3
Unilever	4.0%	14.9
Nestlé	3.9%	18.3

Note: Market data on 15 August 2011
Source: Bloomberg; analysis

Of course, however stable and well run such companies are, they too suffer under poor conditions on the capital markets. But those investors who prefer the provision of a real regular cash-flow to a portfolio statement arbitrarily compiled at a given point using daily rates may be inclined, as victims of the ZIRP (zero-interest-rate policy), to replace the odd non-performing bond with a dividend-bearing stock.

There can be no doubt that the unappetising boil of excessive debt is in the process of bursting. The institution of risk premiums for once supposedly risk-free state debtors is a painful process, which can no longer be put off. The deep involvement of the guardians of a credible financial system in the worship of hollow idols will continue to give rise to crisis-like developments in the area of currencies. The global pre-eminence of the Western industrial nations, due to the excellent functioning of their financial markets, will be relativised. New providers of stability and credibility will arise.

We must be clear that, despite all this, or perhaps indeed, thanks to the current crisis, the real value of the world is not declining, but continually increasing. As long as the rage and destruction of Tottenham does not spread, overwhelm whole societies, and even set country against country, we continue to live in an extraordinarily interesting world, which is determined to find its way to more, not less prosperity. We need to bear this in mind, particularly when the blood-red market indicators seem to be heralding global apocalypse. It's not on the horizon.

KH, 15.08.2011