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Real and illusory dangers

1. Tectonic shifts

When apocalyptic events hurl ever more shocking images of horror ever more frequently onto our screens, then – for a while at least – we see the world as it really is: a dangerous place. Our innate preference for normality would of course rather blank out extreme events. It is also the case that the unusual but threatening is beyond the reach of mainstream thinking. For the countless minions in the mainstream lack the imagination to be able to incorporate the apparently unimaginable into their future scenarios. The functionaries of the welfare state who manage our well-being are untiring in their persistent and euphemistic efforts to celebrate normality, even as the nuclear power stations are in melt-down. The embarrassment of these efforts at social control is exceeded only by that of the twittering of the so-called experts, who saw nothing coming, but afterwards want to explain everything.

There are currently three tectonic shifts that appear dangerous, and must therefore occupy our attention. Firstly, the earthquake in eastern Japan – literally the result of increased tectonic tension – with all its incalculable consequences for nuclear technology; secondly, the political upheavals in the Arab world, which may have been somewhat pushed off the front pages and the CNN reports by the events in East Asia, but have lost none of their explosive potential; thirdly, the cautious approach by the European Union, or rather, the eurozone, towards a solution of the debt problems of various member countries. However varied these issues may appear, they do have commonalities. In all three cases the experience gained from the past is of little help. Rather, the need is for imagination. All in all, it must be admitted, we are confronted with serious unknowns. No surprise, then, that the financial markets, and the sensitive stock markets in particular, are currently in a serious state of nerves.

We have absolutely no idea how the Japanese economy and Japanese society, deprived for almost twenty years now of the pleasures of growth and confidence in the future, will react to the shocks of earthquake, tsunami and atomic radiation. Two contrasting options are entirely conceivable: ultimate paralysis, inability to cope with the blows of fate, unproductive wrangling within the anyway obsolete *classe politique*, a decline into depressive moods and attitudes – or a spirit of optimism, pride in the tremendous achievements of the rescue teams, nuclear technicians and plucky survivors in the affected areas, a renewal of the social and political elite, a restructuring of the unnecessarily unbalanced Japanese economy. Japan undoubtedly possesses sufficient resources to overcome the shocks. The country that, after the Second World War, and after Hiroshima and Nagasaki, grew to be one of the most powerful economies in the world might now be offered a second chance. Our cautious optimism is based on the combination of a culture of stamina in the face of hardship and the possibility that the scale and the urgency of the challenges might bring about the social revitalisation that Japan has needed for so long.

Is it possible that, in the wake of the various uprisings in the Arab world – or at least, wherever the previous regimes are indeed done away with on a lasting basis – something resembling a more open society might develop? Many of those familiar with these countries respond to this question with a resigned shrug of the shoulders: not likely. It is far more likely that the last dictator will simply be replaced by the next dictator. This has been the way throughout history, and there is no reason why things should change at all. That sounds plausible, and fairly hopeless, but might also be wrong. For, unlike far too many previous uprisings, revolutions and military putsches, the pan-Arab movement of 2011 lacks the elements of excessive nationalism or religious fervour. There are no American or Israeli flags being burnt. Rather, the emphasis is on the need to shake off the yoke of authority and enable the creation of individual prosperity. The taxi-driver in Cairo, the hairdresser in Tunis and the student in Benghazi, all facing the existential threat of sharply rising food prices, are this time more important than any apostle of political or religious salvation. It would, of course, be wrong to try to

read into the uprisings of 2011 any kind of move towards individual rights and freedoms. Wishful thinking is a poor councillor. But in the era of Google, Wikipedia and Facebook, social processes obviously operate on a different pattern, particularly in autocratic societies. The West finds itself confronted with the delicate problem that tried and tested partnerships with fairly unappetising regimes and royal houses (where over 70 percent of the world's oil reserves are to be found) threaten to become a thing of the past. What all this might mean, given the industrial nations' dependency on oil, is beyond imagining.

We now need to look more closely at the third topic, the management by the European Union of the state debt crisis. For, with all respect for the obvious dangers arising out of the disaster in Japan and the military operations in the Mediterranean, this endogenous problem, which will keep the global financial system on tenterhooks for some time to come, cannot just be overlooked. Almost out of the public eye, an informal summit of the EU heads of government on this topic took place on 11 March 2011. The transformation of the theoretical 440 billion euros for the European Financial Stabilisation Facility into an actual 440 billion euros was celebrated as a significant breakthrough in solving the current problems, although it is still unclear where this money will actually come from. On 15 March, Ecofin, the conference of the trade and finance ministers of the EU, deliberated on future dealings with debtor states, including improvements to the Maastricht Treaty. All the component parts of the European Stabilisation Mechanism should be in place by 25 March. Problem solved by the end of the month, then. If this were a genuine solution, it would indeed be cause for celebration. Is Europe heading in the right direction? Is a tectonic shift with positive impact probable? This is worth a closer look.

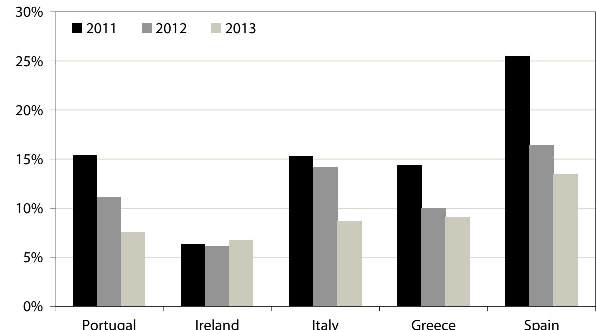
2. Three major challenges for the eurozone

Before we turn to actual or potential solutions, we need to outline the problem once again. Just over a year ago, as Greece became the first country in the eurozone to fall into disfavour on the financial markets, we attempted to take a comprehensive perspective on the problems of financing European state debt. We regarded the figure of 45 billion euros, then bandied about by Brussels, as far too low, comparable to the crass underestimates in 2007 by Henry Paulson, then head of the US Treasury, and Ben Bernanke, still head of the Fed, of 50 billion US dollars for the sub-prime crisis. The figure turned out to be around 2,000 billion dollars. Sweet-talking is obviously an integral part of expectation management in a crisis. Our figure of 1,000 billion euros, extrapolated at the start of the eurozone crisis from the rescue packages announced for all the PIIGS states (Portugal, Ireland, Italy, Greece, Spain) together, still seems to be realistic. How should we regard this figure?

Let's first look at the positions. The total known debt of all countries in the eurozone at the end of 2009 amounted to some 7,000 billion euros. Just on half of this belonged to the countries with the highest credit ratings: Germany, Finland, France, Luxembourg, the Netherlands and Austria. In the middle come the relatively small economies, such as Slovakia, Slovenia, Cyprus, Malta and – with some questions regarding its creditworthiness – Belgium. The vast majority of the remaining debt – some 2,900 billion euros – belongs to the PIIGS states.

Debt is not simply debt. What matters is the term of the debt. If very short-term financing of very high levels of debt is required, debtors often have to go looking for creditors; they are then entirely at the mercy of the mood on the capital markets. The financing of the short-term debt of some of the PIIGS states is precarious, for various reasons. Greece (debt currently 129 percent of GDP) suffers from low credibility and an irresponsible reduction in the term of its debt; Ireland (67 percent) and Spain (53 percent) from the financing needs of a banking system that has got out of control. Portugal (74 percent) is barely able to keep its head above water; only Italy (114 percent) is in a position to finance its record levels of debt remarkably economically, thanks to sound domestic sources.

Tricky years ahead



Source: Bloomberg, Wegelin & Co. analysis

Debt is not simply debt. What also matters is the type of national economy and state structures that lie behind the debt. As a faithful reader of the Investment Commentary rightly remarked at a recent conference in Munich, Germany at the end of the Second World War was effectively free of

debt, but the country lay in ruins. Today, it has a relatively high level of debt, at around 70 percent of GDP, but against this state of affairs must be set its tremendous, intact economic power. And, always with a grain of salt, the surprisingly intact coherence of German civil society. So we need to be cautious with apocalyptic forecasts here. What Greece lacks is both economic power and discipline, even if savings are now being made as a result of external pressure. When the cost of financing debt becomes so high, as a result of a lack of credibility, that with the best will in the world, the economic power of the state is no longer sufficient to service it, the state is bankrupt. We still reckon that Greece is well over this red line, or, put differently, the solution to the financing problem is not adequate.

So, what exactly is the eurozone's problem? In our view, it has three parts. The most immediately urgent is, of course, the financing issue already mentioned. Should, however, the vehicle that the EU has come up with for this purpose prove to be a size too small, then the threat of insolvency will inevitably again become an issue on the markets. Should it, though, be a size too large, then the "sponsoring" nations will endanger themselves. Between the devil and the deep blue sea, then. The second part of the overall problem concerns the process for re-establishing the credibility of the various debtor nations. Because market forces reflect expectations, the proposed solutions also have an effect on the success of the financing efforts; procrastination ("We can discuss that in due course") is dangerous. How should the member states achieve a future equilibrium between their current level of performance and a supportable level of debt? Or perhaps rather, have such a beneficial state imposed upon them? Part three of the EU debt problem is the question of how, if it proves impossible to resolve parts 1 and 2 successfully and in a timely fashion, the more successful countries can protect themselves against infection from the south and the west of the continent. This question is taboo. Unfortunately, Brussels has turned the debt crisis of a number of euro-states into an existential question about the survival of the Union. (Sarkozy: "The Euro is Europe." Barroso: "We will defend the Euro, whatever it takes.") This linkage is extremely risky, for it is very far from certain that the "operation" will be successful.

3. Stability funds: extremely complex – and inadequate?

There is no doubt that the responsible bodies in the EU, particularly the EU Commission, the European Central Bank (ECB) and the heads of government of the member states, are aware of the seriousness of the situation. March this year should see the decisive steps. A start was made with the above-mentioned conference on 11 March. This was concerned with the urgent financing issues. The aim is to resolve them by means of a communal undertaking, the European Financial Stability Facility (EFSF). This is part of the overall stability package that also includes the European Financial Stabilisation Mechanism (EFSM) and the International Monetary Fund (IMF). The EFSM, available to all 27 EU member states (including, for example, Hungary), has at its disposal 60 billion euros.

The EFSF is a sort of Special Purpose Vehicle, an SPV of the type familiar to us as an appendage of various big banks and investment banks in the run-up to the financial crisis. It is equipped with a degree of autonomy, and thus able to finance itself on the markets by issuing bonds. To do this, it has recourse to guarantees from the eurozone countries; the most important decision of this conference was to determine the extent of these guarantees – 440 billion euros. For its part, the IMF has agreed to a maximum of 250 billion for European financing purposes.

The key element of the package is obviously this EFSF. It deserves a closer look, for it represents an entirely new element in European cooperation. The guarantees are allocated under an EFSF framework agreement between the member states of the eurozone, according to a special distribution pattern that reflects shares in the ECB. This means that the key supporters of the fund are Germany, with 27 percent or some 120 billion, France, with 20 percent or around 90 billion, and Italy (!), with 18 percent. However, this guarantee of 440 billion, as security for the financing of the debt of those countries that require it, is not available in full. For obvious reasons – this is about the financing of high-risk debt – there is a buffer (in the jargon: over-collateralisation) of around 20 percent. The remaining 352 billion must be further reduced by 16 billion for Ireland and Greece, which have already applied to the fund, and are thus unavailable as guarantors. From the resulting 336 billion must also be deducted the fees (1/2 percent) and a risk margin of probably 3 percent or around 12 billion euros. Lastly, the EFSF must hold part of its assets in the form of diversified Triple-A investments, in order to ensure a maximum credit rating for itself. According to Standard & Poors this sum amounts to just on 80 billion euros, so that ultimately, of the 440 billion euros at most 250 billion remains available as effective means of financing the European problem states.

There is an ambivalence about the complexity of the vehicle and the numerous safety measures to protect against any destabilisation. That every effort is being made to present the fund from being destabilised is understandable and praiseworthy. For this really would involve the almost inevitably lethal melt-down of the EU: who in the world would, or could, bail out the EFSF? That all measures are being taken to equip it with the highest credit rating is also undoubtedly sensible, for otherwise the financing costs would be too high. However, these efforts at such security have their price: there is relatively little left over for the financing of distressed states. If our estimate of a need for possibly 1,000 billion euros of financing is right, then despite all these efforts, the EFSM, the EFSF and the IMF will not be sufficient to solve the financing problem over the next two or three years. The 250 billion represents just 10 percent of the total outstanding debt of all the non-Triple-A countries in the eurozone.

We also need to consider the extent to which the EFSF is dependent on Germany. The figures are reflected in organisational dependency, for most operational functions are the responsibility of a special "Finanzagentur", or financial agency, based in Frankfurt, paying agency is the ECB; the management of the EFSF in Luxembourg consists of the CEO and a staff of just 12 people. The "Finanzagentur" is responsible in particular for risk management, which in this context is obviously a key function. No objection to this; those who (may have to) pay the piper should also be able to call the tune. But, look at it how you like, without Germany, Europe will not work. Can Germany cope with this, and will Europe put up with it?

4. Stability pact: fit for purpose?

As mentioned, the second part of the problem consists in finding ways of re-establishing equilibrium between the performance of individual countries and their level of debt. This is normally taken care of by the market. If credibility falls below a given level, then the risk premium for taking on debt rises. Higher financing costs are a tried and tested means of keeping extravagance under control. The bond markets are highly efficient in the exercise of their function of disciplining debtors. A look at the yields of bonds with, say, ten-year maturities reveals a very varied picture, that can also change very rapidly. Brazil, South Africa, Thailand, Korea, Croatia, New Zealand, Serbia: they are all subject to extremely rigorous scrutiny by market players who prefer making money to losing it.

In Europe, the differentials for risk premiums between various debtor states were more or less out of operation for a lengthy period. Despite the possibility of a bail-out being explicitly excluded in the Maastricht Treaty, the majority of market players obviously and persistently calculated that the eurozone would not let any member state go down. The assumption has proved to be correct, at least so far. Financing vehicles like the EFSF, and indeed the IMF, were there "merely" as bridging measures. De facto, however, a bridging facility for debtors who are insolvent goes beyond just taking on the debt. We shall deal below with the extraordinary phenomenon that precisely at the moment when the de facto guarantee became explicit, risk premiums reacted inversely, while throughout the whole, lengthy period in which people should have believed in the ban on bail-outs contained in the Maastricht Treaty, they were virtually nonexistent, so that countries like Greece and Portugal could take on debt at the same rate as Germany. The world turned upside down.

Now, the EU finance ministers (and above all their doyen, Wolfgang Schäuble) are aware of the danger of the intra-European defect of low or non-existent risk premiums. They have no wish to return to this state of affairs, but they also know that the successful rescue of distressed states heads precisely in this direction. If the market is systematically disabled through the acceptance of risk by large, strong countries to the benefit of weaker debtor states, it cannot be expected to exert any disciplinary effect. Consequently, there is a need for a replacement mechanism; this is called a "stability pact". When it comes to deficits, sinners are to be returned to the path of righteousness by means of much higher fines. "Sinners to face fines of billions", run the headlines.

Scepticism is in order. Firstly, in this area, no-one in Europe is without sin – literally and metaphorically. Both France and Germany are to be numbered among the sinners under the Maastricht Treaty when it comes to debt levels. Secondly: who is being fined here? Those who cause the excessive deficits? The politicians who were responsible? No; rather those who ultimately pay the bill for this and everything else: the taxpayers. Thirdly: are these fines automatic or are they levied by an authority. If the latter: by which authority? And on the basis of what majority? Fourthly: will there continue to be, as previously, more or less loosely defined exceptions for "justified" instances of deficit?

The European Union will have to decide between an open system in which the appropriate disciplinary incentives are applied by means of risk pre-

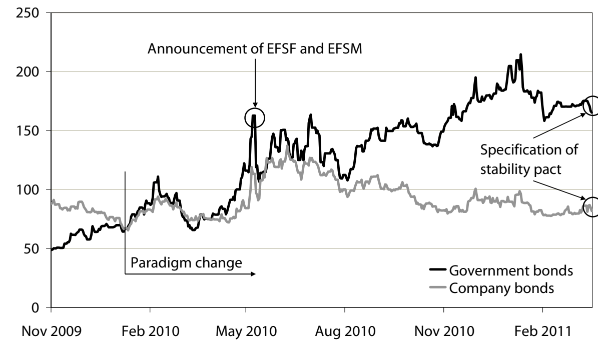
miums, and a construct in which, apart from the "Sinners to face fines of billions" approach, many other, entirely different matters will have to be enforced by means of decrees from on high: the elimination of differences in productivity, the harmonisation of taxation and social security benefits, and other like matters. If we advocate an open system, then we must be aware that the justification for risk premiums is the occurrence, from time to time, of real risks. But the attempts to avoid insolvency by means of preventative punishment: this is ultimately the planned economy. The possibility of insolvency with consequences (risks!) for creditors, the notorious "haircut", debt restructuring: these are the means to avoid a stability pact. The EU is at a crossroads, as never before. The tectonic plates are shifting. The more "successful" the financing exercise, the more likely a centralised, dirigiste state. A Greek tragedy indeed!

5. What do the markets believe?

Belief cannot be commanded. This applies not only for individuals, but also for an indefinite number of individuals who, for instance, determine the prices on a market. As mentioned, for a long time, when according to the Maastricht Treaty precisely the opposite should have been believed – namely, that no country in the eurozone could count on being bailed out by the others – this indefinite number of individuals believed in an ultimate European guarantee. The interest rate differences between countries of varying debtor quality were low, if not negligible, and the financing possibilities for countries with questionable fiscal policies absolutely idyllic. In the markets, the eurozone, which had launched the new currency with a respectable degree of success, came to be associated with the implicit assumption that "it will fix things somehow".

Such implicit basic assumptions determine many market prices: we will examine this phenomenon more closely in section 6. For now, we will attempt to show that for Europe, or at least the most interesting problem countries, the assumption that "it will fix things somehow" has no longer applied for a considerable period. The paradigm change occurred in January 2010. The figure below, published not for the first time in a Wegelin Investment Commentary, but continually and deliberately updated, clearly shows this utterly astonishing phenomenon.

The world turned upside down – or not?



Source: Bloomberg, Wegelin & Co. analysis

The metric is the price for Credit Default Swaps (CDS), those financial instruments for hedging debtors' risk of insolvency that have from time to time been demonised by the politicians. They exist for counterparties in the private sector – industrial companies or banks, for instance – but also for debtors in the public sector, such as states. In economic terms they fulfil a similar role to that of fire insurance, but the contracts are tradable. This means that it is immediately possible to determine the current "fire risk", that is, the risk of the debtor's insolvency, from the continually recalculated prices.

It's hard to overestimate the importance of the figure: for the first time in history, as far as we know, the insolvency risk premiums for private-sector debtors have fallen below those for public-sector debtors. It is now reckoned that organisations relying solely on the tool of cash flow management are more likely to remain solvent than those that can enforce the payment of taxes and levies. This is in itself remarkable. And it is not a matter of a temporary statistical anomaly. For over 14 months now, a large number of individuals, none of whom wishes to lose money, have agreed on such a balance of pricing.

What is even more remarkable is how little impact all the rescue and stability measures in the eurozone have had. Neither the announcement of stabilisation facilities in May 2010 nor their specification a week ago has brought a change of trend. And if we translate the CDS premiums into probabilities of insolvency, the picture remains a shattering one. The table below sets out the current cumulative probability of insolvency of individual debtor states over the next five years, on the assumption of an insolvency dividend of 40 percent.

What the CDS premiums really mean

	CDS	Probability of insolvency
Portugal	500	36%
Ireland	590	41%
Italy	155	13%
Greece	965	57%
Spain	215	17%
Germany	44	4%

Source: Bloomberg

This means nothing other than that a large number of individuals on the markets are currently very far from believing that that the EU "will fix things somehow". The implicit basic assumption of the unlimited ability and willingness of an ultimate guarantor to deliver has evaporated; the markets have priced in the occurrence of risk. Not only the CDS premiums but also the (significantly more liquid) bond markets display a similar picture: Greece's ten-year bonds are still quoted at just on 70 percent, or a yield of 12 percent; for the same period, Spain has to pay 5 percent and Ireland 9 percent.

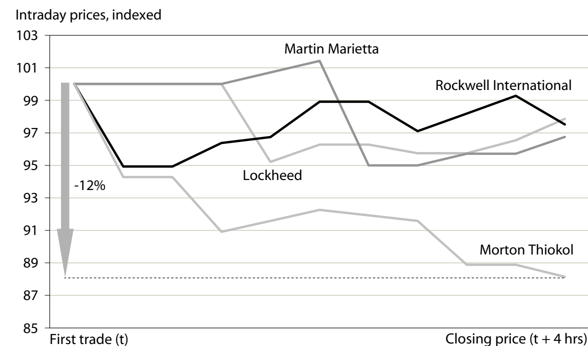
The irony is that, given this market situation, there could be no more opportune moment for the European Union to do what would be needed for the future disciplining of debtors, and for the provision of adequate expectations for creditors: to allow risks to occur! It is patently obvious that the restructuring process – that is, the orderly process for managing insolvency – has already largely been completed by the markets. True, there remains some need for correcting the balance sheet valuations of some entirely, or partially, or not at all private-sector banks. But here too: the erroneous valuations exist only on the books; the markets have in all probability already done the repricing. So, it would only be a matter of completing the necessary impairments and restructuring with the readily available instruments of the central banks and the supervisory authorities. As we said: there will never be a better moment.

6. So, are the markets efficient?

Market sceptics will object that the long-lasting misjudgement of the "no bail-out" clause in the Maastricht Treaty demonstrates precisely how inefficient, indeed misguided, the markets are in their judgements. It would therefore be reckless to base a political process on signals that derive from such persistently erroneous sources. Such an assessment rests on a fundamental misunderstanding of what markets are, and what they can do. It is precisely the nature of a balanced pricing system that it uses a continual process of trial and error to determine the limits that come closest to the prevailing perception of reality. So, a market is a continuous state of error – or, more correctly, a market is a continuous state of the correction of error.

There is a large number of analyses that show how efficiently markets can deal with new information – which is synonymous with the adjustment of perceptions previously regarded as correct. Repricing after the occurrence of an accident or a catastrophe happens unbelievably quickly and accurately. Some readers may recall the crash of the Challenger space shuttle in 1986. Analyses have shown that it took only a few hours for the stock market to punish the company that had contributed significantly to the accident: Morton Thiokol. It delivered to NASA the valve whose sealing ring failed in the cold. The figure below shows that the "not guilty" companies Lockheed, Martin Marietta and Rockwell were very quickly cleared of suspicion.

Revaluation within hours



Source: Maloney & Mulherin (2003). The Complexity of Price Discovery in an Efficient Market: The Stock Market Reaction to the Challenger Crash. Journal of Corporate Finance, pp. 453–479

Note: The chart is based on the ten biggest trades after the crash and the final price at the close of business on the day of the accident.

The punishment of Morton Thiokol not only affected the right target, but was also remarkably accurate in its extent. The loss of 12 percent of its market capitalisation within a few hours corresponds fairly exactly to the company's expected loss of approximately 200 million dollars – for law suits, damages, loss of profits, and exclusion from the NASA programme. So far, so good, as far as market efficiency is concerned.

However, on closer examination, we sadly discover that the probability that the valve would prove defective was already known before the Challenger disaster. Engineers from Morton Thiokol had warned NASA of potential sealing failures and the company had also, correctly, come clean to the financial analysts at an early stage. So why on earth did the markets not process this information? Why on earth was it only after the disaster that they reacted so efficiently?

Is the efficiency of markets hopelessly overestimated after all?

The answer must be a differentiated one. However impressive the reaction in a crisis, we need to be no less cautious when diffuse conditions prevail or, probably even worse, when the presence of one overwhelmingly impressive player – in this case NASA, with its uncontested professionalism – eclipses all possible and conceivable problems. We mentioned above the "implicit basic assumption" that someone or something "will fix things somehow". If such an implicit basic assumption exists, the markets obviously find it difficult to process information.

Why is this? Because in 99 out of 100 cases, the processing is not worthwhile. Over and over again, the Cassandras are ignored or disbelieved. The overwhelming brilliance of the entity that is believed "will fix things somehow" has the effect that important and relevant information has no impact on prices for a very long time. For market players, it is more worthwhile to believe what others believe than to invest time and money in gathering information that will probably have no influence on prices.

This kind of market "failure" contains the stuff of catastrophe. Replace NASA by Fannie Mae or Freddie Mac, and we have the entities that will "fix things somehow" thanks to which the American real estate market was driven to absurd heights – to then trigger the virtual collapse of the global financial system and the worst recession of the post-war era. We might also replace NASA by the Swiss Confederation, of which it was believed that it would "somehow fix" Swissair. Or by the American Fed, which was expected to rescue Lehman Brothers. Implicit basic assumptions regarding some kind of saviour that will fix everything plainly harbour the stuff of all those illusions that we and the whole world have fallen victim to over past years. We cannot expect that market prices will equip us with the right information at the right time. Those who would not fall victim to illusions must think for themselves.

What stands out is the fact that these market "failures" above all involve an assessment of public bodies. NASA, the Fed, the Swiss Confederation, the eurozone authorities: they may be of varying brilliance, but they are of similar nature. They all generate hope as a principle; they all live from hope as a principle. False, illusionary hopes of an ultimate saviour – the markets obviously have problems with pricing on this basis. Over and over again, reality breaks through, but only during, or in the wake of a catastrophe.

7. Illusions are the real danger

The reference to catastrophe brings us back to the present. That there are such things as earthquakes, and that they can have devastating effects is well known. No one suffers under the illusion that there is any earthly agent that will "fix" that. Sound construction and sufficient capacity for crisis management are essential in the endangered regions. If there were any illusions in the current case, then only with regard to the competence of the experts and the quality of the technology involved in the utilisation of nuclear power. There has clearly been a good deal of sugar-coating in this area, in an attempt to play down the far from negligible, if infrequent major risks. The catastrophe in Japan has enabled us to achieve a new level of understanding in these matters; the financial markets have probably already done some highly efficient processing, and the valuations are likely to be correspondingly realistic.

Any assessment of the situation in the Arab world is more difficult. The assumption that America will be indefinitely able and willing to ensure the security of the supply of oil to half the world is a pretty bold one – not to say reckless or illusionary. It is not inappropriate to think in scenarios in which countries hopelessly dependent on Arab oil (China!) collect their supplies themselves – because they have to. The price for this would be an end to globalisation, because international conflicts would be inevitable. But here too, ultimately: as long as real shocks do not collide with utterly unfounded illusions, the impact on the global economy and the financial markets will be contained. Both exporting countries and importing countries will be able to accustom themselves to new distribution systems for oil; should transport costs rise drastically, the substitution of oil will happen that much quicker here. So, no catastrophe.

We were also close to sounding something of an "all clear" with regard to the debt crisis in the eurozone. For the illusion-free pricing of CDSs and government bonds by the financial markets has pretty effectively done away with any belief in some ultimate saviour. We are doubtful, however, and herein lies one of the concerns of this Investment Commentary, that the responsible bodies recognise the window of opportunity that now exists to achieve adequate risk premiums within the eurozone for some time to come, by accepting the existence of real risk. Rather, it is to be feared that the decisions at the end of March will represent a massive exercise in disinformation, again based on the principle of hope, with the aim of

conjuring up supposed stability by means of new illusions.

It only remains to point to the ultimate illusion, which has yet to be priced in by the financial markets: the implicit debt of the Western nations. At a conference for financial intermediaries recently organised by our bank, Laurence Kotlikoff, an economist who teaches at Boston, calculated the USA's "fiscal gap". The fiscal gap is the difference between the present value of all future expenditure and all future fiscal income. Kotlikoff put it at 202,000 billion dollars, or fourteen times American GDP. The 9,000 billion of explicit debt is a wholly arbitrary figure: creative accounting, so to speak. The USA is just as bust as Greece.

We may dismiss the professor from Boston as a prophet of doom. We may dislike him as a bringer of bad tidings. The mainstream has too little imagination to think in terms of the infrequent but extremely threatening, as we noted at the start of this Investment Commentary. If business, society and the financial markets were to become disillusioned about the effectively much weaker than supposed financial clout of the public sector, this would be such an infrequent (because for ever put off and continually trivialised) but extremely threatening event. But the pricing of European state debt since the beginning of the euro-crisis shows that such disillusion could occur. And we also know that there is, precisely in the eurozone, the potential for disaster in the form of concealed implicit state debt. How long will we go on behaving like the engineers at NASA?

So, even after the hefty shake-ups on the financial markets towards the end of the first quarter of 2011, we continue to advocate real-asset oriented investments. For we wish to have no part in, or exposure to the tremendous ultimate earthquake of the collapse of overestimated nominal values. We much prefer the sometimes fairly rough and tough ups and downs on the stock markets.

KH, 21.03.2011