Ineichen Research And Management

Risk management research

Ineichen Research & Management ("IR&M") is an independent research firm focusing on investment themes related to absolute returns and risk management.

Wriston's Law of Capital

10 July 2012

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"For those who unfairly lump Social Security in with Bernie Madoff, in all fairness, you should point out the difference. No one was ever legally required to pay money to Madoff."
—Anonymous

Feature

- Wriston's Law of Capital can explain nearly everything: "Capital will always go where it's welcome and stay where it's well treated… Capital is not just money. It's also talent and ideas. They, too, will go where they're welcome and stay where they are well treated."
- Democracies have turned authoritarian before. At one stage, it becomes a matter of survival for capital to move elsewhere. Under normal circumstances capital flight might be morally wrong. However, current circumstances might not be normal. Middle Eastern capital is on the move; Greek and Spanish capital is on the move too; London and Geneva thereby benefiting from *Wriston's Law of Capital*. German entrepreneurs are setting up shop in Switzerland as taxes, labour laws and red tape are insurmountable for start-ups at home. In Italy the Mafia is the largest lender. France just went Venezuela. Portugal is already in the process of going after the pensions of its citizens. Whether these anecdotes are early signs of a more destructive phase, no one knows. But the direction of the trend seems clear.

Macro

- Global economy continues to decline.
- Average PMI remains below 50 but has stopped falling.
- Business sentiment peaked in March and is declining. Consumer sentiment has been rising from December to April and is now declining.
- Europe remains a mess; cyclically as well as structurally.
- Monetary policy is easy. Cash is hoarded.

Wriston's Law of Capital

On a personal note

"The greatest enemy of knowledge is not ignorance; it is the illusion of knowledge."
—Stephen Hawking

"People who think they know everything are a great annoyance to those of us who do."
—Isaac Asimov

The IR&M logo explained

"A joke's a very serious thing."
—Charles Churchill (1732-1764), English poet and satirist[1]

This is a very serious publication. Nevertheless, allow me to start with a joke that has been floating around on the internet since 2009:

> *I asked my friend's little girl what she wanted to be when she grows up. She said she wanted to be Prime Minister of Canada some day.*
>
> *Both of her parents, NDP [social-democratic party in Canada] supporters, were standing there, so I asked her, "If you were Prime Minister what would be the first thing you would do?"*
>
> *She replied, "I'd give food and houses to all the homeless people." Her parents beamed, and said, "Welcome to the NDP Party!"*
>
> *"Wow…what a worthy goal!" I told her. I continued, "But you don't have to wait until you're Prime Minister to do that. You can come over to my house, mow the lawn, pull weeds, and sweep my yard, and I'll pay you $50. Then I'll take you over to the grocery store where the homeless guy hangs out. You can give him the $50 to use toward food and a new house."*
>
> *She thought that over for a few seconds, then she looked me straight in the eye and asked, "Why doesn't the homeless guy come over and do the work, and you can just pay him the $50?"*
>
> *I smiled and said, "Welcome to the Conservative Party."*
>
> *Her parents still aren't speaking to me.*

[1] Sometimes erroneously attributed to Winston Churchill.

While this jovial introduction is supposed to be funny, there is more to it. Humour, like beauty, is supposedly in the eye of the beholder. However, understanding how things work is not. Sometimes humour helps to understand things. Understanding of complex issues requires different perspectives. There is the possibility that, as Charlie Chaplin put it, "in the end, everything is a gag." This means, if we don't understand the joke, we might be missing a certain perspective. And we cannot deal with serious issues, such as managing risk for example, without covering all known perspectives, as Winston Churchill suggests in the side text. Missing a certain perspective means we don't really understand what is going on. More importantly, if we don't understand the joke, the joke might be on us; as the poker proverb (from 1979) states:

"It is my belief, you cannot deal with the most serious things in the world unless you understand the most amusing."
—Winston Churchill

> *If after ten minutes at the poker table you do not know who the patsy is—you are the patsy.*

Warren Buffett used this analogy when discussing the weird market gyrations of 1987. He used Benjamin Graham's metaphorical figure called "Mr. Market" and indicated that a skilled investor should have knowledge that is superior to that of "Mr. Market". Full quote from the 1987 report:

> *But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."*[1]

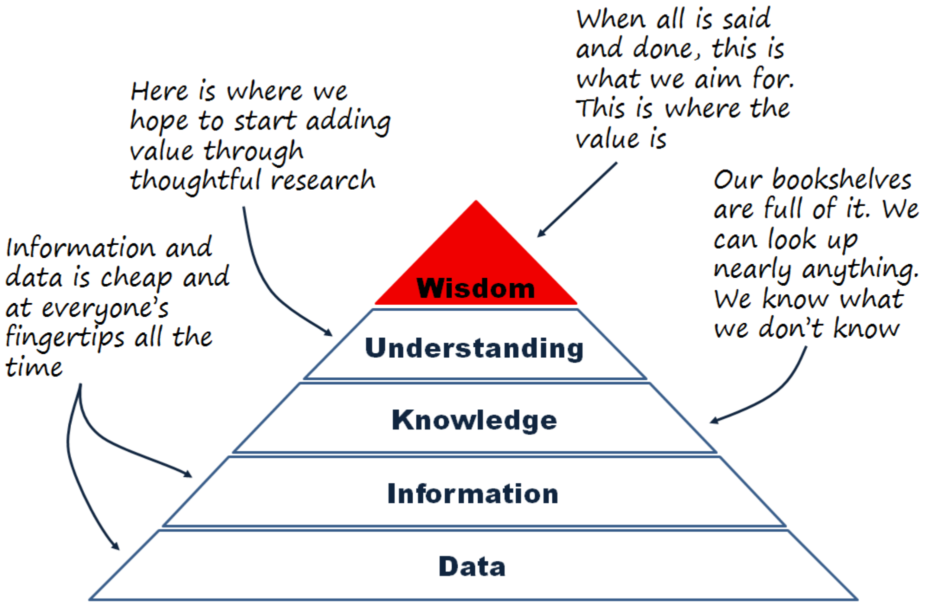
I have discussed the importance of knowing what one doesn't know in other research publications and surely will pick up the idea, which we can trace as far back as Confucius, in the future. Here I'd rather focus on knowledge, understanding, and wisdom.

"Real knowledge is to know the extent of one's ignorance."
—Confucius

While humour helps us understand, it is wise decisions that add value. More cynically, and potentially more importantly, it is the avoidance of the opposite of wisdom, foolishness, which adds the value. It is losses, especially large ones, which kill the rate at which capital compounds. This is why knowing what one doesn't know is so important. The purpose of this (still rather new) research effort is mainly to avoid foolishness. It is better to be safe than sorry. This means when things economic are deteriorating, a different exposure to risk is required than when things economic are improving. I have tried to capture this logic by using a symbolised version of the knowledge pyramid in the logo of IR&M. (See Figure 1.)

[1] Berkshire Hathaway 1987 Annual Report, 29 February 1988.

Figure 1: Knowledge Pyramid[1] and explanation of IR&M logo



Source: www.ineichen-rm.com, concept adapted from Ackoff (1989)

Understanding is rated higher then *knowledge*, which is rated higher than *information*, which is rated higher than just *data*. A great deal of damage has been done by the regulatory bodies by requesting ever more granular data and thereby focussing entirely on the lower end of the Knowledge Pyramid. And there is very little evidence that the matter is improving in that regard. Solvency II for example is so complex and ambiguous that smaller insurance companies will either not be able to cope or will cope at a prohibitive cost. The idea that one ought to simplify to reach "understanding" has not reached the regulatory bodies (or the tax authorities, for that matter). A stepping stone to acquire wisdom is—speculating a bit—being able to distinguish between *knowledge* and *understanding*. Howard Marks on "understanding":

> *In some ways, understanding the market is like mathematics. You don't have to be knowledgeable regarding the specifics of the underlying subject matter to know whether a conclusion makes sense. You just have to be able to apply principles, tell logic from illogic, and exclude the deleterious effects of emotion and psychology.*[2]

These are arguably wise words; easier said than executed of course.

***

Below I discuss some aspect related to *Wriston's Law of Capital*. I stumbled over this a couple of years ago and believe this "law" is pure wisdom. It explains nearly everything.

"There is a great difference between knowing and understanding: you can know a lot about something and not really understand it."
—Charles F. Kettering (1876-1958), American inventor, engineer, businessman, and the holder of 186 patents

[1] The Knowledge Pyramid is most often credited to Ackoff (1989). Some versions exclude "understanding". The idea also known as the "Data Information Knowledge and Wisdom Hierarchy" (DIKW) or the "Knowledge Hierarchy".
[2] Howard Marks, Memo to Oaktree Clients, 19 March 2012

Wriston's Law of Capital

One of the greatest books I own is *The Lessons of History* by Will and Ariel Durant, first published in 1968. It is only 102 pages long with reasonably large letters. I also own *The Story of Civilization* which comprises of eleven tombs, each several hundred pages of small print. The latter is of course a much tougher read. The former is a summary of the lessons from the latter. These lessons derived from examining 5,000 years of history should not be ignored; or so one would assume. However, some politicians do exactly that; thereby believing they know better, capturing the moral and intellectual high ground. However, when the elite political and academic intelligentsia are out of sync with the lessons of history, they eventually fail. This includes the contemporary pursuit of trading freedom for equality. In a chapter titled *History and Biology*, the Durants state the following regarding this trade-off:

"The past may not repeat itself, but it sure does rhyme."
—Mark Twain

> *Nature smiles at the union of freedom and equality in our utopias. For freedom and equality are sworn and everlasting enemies, and when one prevails the other dies. Leave men free, and their natural inequalities will multiply almost geometrically, as in England and America in the nineteenth century under laissez-faire. To check the growth of inequality, liberty must be sacrificed, as in Russia after 1917. Even when repressed, inequality grows; only the man who is below the average in economic ability desires equality; those who are conscious of superior ability desire freedom; and in the end superior ability has its way. Utopias of equality are biologically doomed, and the best that the amiable philosopher can hope for is an approximate equality of legal justice and educational opportunity. A society in which all potential abilities are allowed to develop and function will have a survival advantage in the competition of groups.*[1]

The idea to equalise incomes, to redistribute wealth from those that have to those who do not, to increase the role of government in the name of equality; the idea to increase living standards for everybody is arguably very laudable and should be applauded. (And, at the polls, most often is.) However, these ideas, while morally sound when examined superficially, eventually fail. In a game of competition it makes no sense to limit one's survival probability, it is unwise to do so. Lady Thatcher was obviously on to something in the side text; modern day Robin Hoods eventually run out of financing. Whether we call it socialist, or social-democracy, or *the third way* doesn't really matter. A society that gives incentives for ingenuity and innovation and is generally business-friendly prospers. A society that gives disincentives for ingenuity and innovation and is generally business-unfriendly doesn't. Chile is prospering; Venezuela isn't.

"Socialist governments traditionally do make a financial mess. They always run out of other people's money. It's quite a characteristic of them."
—Margaret Thatcher[2]

In the inaugural piece of this risk management research effort I made fun about forecasters as the future is not forecastable. The idea of this research is to understand the present that allows to determine whether things economic are improving or worsening. This determination then allows us—simplifying rather generously—whether we should hedge certain (mainly directional) risks or whether we can hope for the best in an unhedged fashion. However—and somehow there is always a "however" of some sort—if history does indeed rhyme, then the

"History does not repeat itself - at best it sometimes rhymes."
—Mark Twain

1 Durant (1968), p. 20.

2 Margaret Thatcher , in a TV interview for Thames TV This Week on 5 February 1976

sequent falling of domino stones might not be entirely random or unpredictable. I believe that *Wriston's Law of Capital* has some predictive power. What does it stand for and who was Walter Wriston?

Wriston's Law of Capital is named after Walter Bigelow Wriston (1919-2005). Walter Wriston was a banker and former chairman and CEO of Citicorp. As chief executive of Citibank / Citicorp (later Citigroup) from 1967 to 1984, Wriston, according to Wikipedia, was widely regarded as the single most influential commercial banker of his time.

The term "Wriston's Law of Capital" was coined by Rich Karlgaard from Forbes magazine in an article on his blog, *Digital Rules*, in 2006:

> *Capital will always go where it's welcome and stay where it's well treated… Capital is not just money. It's also talent and ideas. They, too, will go where they're welcome and stay where they are well treated.*[1]

The US is a magnet for capital whereby capital is defined broadly as risk capital, people, ideas, patents, IPs, talent, business connections, etc.

I came across this "law" a couple of years ago and believe it can explain nearly everything.[2] The key is that "capital" is not just money, its people and ideas too. The most prominent contemporary example is the United States of America. For most of its short history, the US has been a magnet for capital, i.e., risk capital, people who want to work hard, people who want to study hard, people who are unwelcome elsewhere, patents, ideas, talent, etc. It is no coincidence that *Silicon Valley* is in the US. The most extreme, history-changing fact I can think of is the *Manhattan Project*. The Manhattan Project didn't just occur randomly in the US. The people behind the Manhattan Project left Europe, Germany mainly, for the US. They brought a long their capital, relationships, brains, and ideas. Imagine for a moment how the 20th century could have evolved if Germany hadn't been a Semitic anti-magnet, but, like the US, a magnet. (The assimilation of various ethnic and religious groups in the US obviously didn't go as smoothly as these lines might imply.)

"It is a little embarrassing that after forty-five years of research and study, the best advice I can give to people is to be a little kinder to each other."
—Aldous Huxley

In a very commendable book called *Day of Empire*, the author, Amy Chua, professor of law at Yale Law School, examines tolerance in relation to empire building and empire sustainability. While her views on parenting might not be for everyone, the bottom line of the book is that tolerance—essentially the "welcome" and "well treated" parts in *Wriston's Law of Capital*—is very important or even key when building and sustaining an empire. The funny thing is that being nice to people is good for society. Who would have thought? It is not a coincidence, according to Chua, that both Germany and Japan failed in sustaining their empire. They weren't particularly nice to their neighbours in the first halve of the 20th century. So people, the lucky ones with well-developed survival instincts; dare we say the "fittest", just left. As Chua put it:

> *In 1930s Europe, Nazi intolerance caused the loss of incalculable scientific talent. The list of brilliant physicists and mathematicians who fled Hitler is astounding, including Edward Teller, known as the "father of the hydrogen bomb"; the aeronautical genius Theodore von Karman; John von Neumann, a child prodigy and the cocreator of game theory; Lise Meitner, after whom Element 109, meitnerium, is named; Leo Szilard, conceiver of the nuclear*

[1] "Predicting the Future: Part II," Rich Karlgaard, Forbes, 13 February 2006.
[2] I first came across Walter Wriston in *The Gartman Letter*.

> *chain reaction; Enrico Fermi, builder of the first experimental nuclear reactor; the Nobel Prize-winning physicists Hans Bethe and Eugene Wigner; Niels Bohr; and of course Albert Einstein…*
> *Up until the 1930s, Germany and Hungary were home to some of the world's leading physicists. Practically overnight, their departure turned America into "the world's dominant force in pure science." Einstein, whose property was confiscated by the Nazis in 1933, explained that he would "only live in a land where there reigns political freedom, tolerance and equality of all citizens before the law."*[1]

Not tolerance, but *relative tolerance* is the key

Tolerance comes and goes. It is essential in the beginning of attracting capital (again, capital in a broader sense) but eventually vanes. The history of Europe is a case in point. Chua explains the rise and fall of societies and empires over the past 500+ years of European history not with tolerance but with *relative tolerance*. Jewish and Asian immigrants in the 1930s might or might have been welcome in the United States. However, there was more "political freedom, tolerance and equality of all citizens" in the US than there was elsewhere in the world, hence the migration. It always seems to work like that.

Spain was once a magnet

Spain's rise and fall for example can be explained with *relative tolerance*; the "welcome" and "well treated" parts in *Wriston's Law of Capital*. Spain was for most of the 14th and 15th centuries a magnet, i.e., the best place (or the only place) for non-Christians to live and prosper in Western Europe. The benefits Spain reaped from its relative tolerance were vital to its territorial expansion and imperial rise. It all went away though. In 1478 the Spanish Inquisition was founded by papal bull. Thus ended the era of Spanish relative tolerance.[2] Capital, as defined above, left; moved elsewhere; somewhere where it was "welcome" and "well treated". The mass exodus of Spain's conversos (converted Jews) and Jews left a catastrophic financial vacuum. The price of capital increased as a result of "capital" not being welcome and well treated. By maltreating capital, Spain destroyed its own primary source of credit and thereafter became completely dependent on foreign bankers, including the Dutch, the Germans, the French, and especially the hated Genoese. It doesn't take too much imagination to transport the medieval maltreatment of capital and the political conflict derived thereof to today.

"The highest result of education is tolerance."
—Helen Keller (1880-1968), American writer and political activist

In a nutshell, Spain either destroyed or drove out its most valuable sources of human, financial, and social capital. By 1640 it was at the brink of collapse. In other words, the authorities going after the capital, rather than treating it well, the relative intolerance, takes a while to cause misery. The practical relevance today is that capital is on the move again. It is not well treated everywhere; hence the movement.

"Chavez is the best president Columbia has ever had."
—Columbian home owner[3]

Wriston's Law of Capital suggests that capital just moves on when it is not welcome and well treated. In the case of Spain, capital migrated to Holland. This is why the quote in the side text is not just funny; it is also full of historical wisdom. Socialist animosities (and governmental malpractice) towards the private sector resulted in benefits for its neighbours. It is the reason why the election of Mr.

[1] Chua (2007), p. 254.
[2] Ibid., p. 133.
[3] "Trouble in Venezuela brings benefits to its neighbour," Financial Times, 8 May 2012

Hollande could result in a similar relative economic decay of France; similar to the economic decay of Venezuela. I called this "going Venezuela" in one or two recent updates. Venezuela has been at odds with Wriston's Law of Capital for more than ten years; France since May 2012. When I read about a new socialist idea coming from Mr. Hollande or Mr. Ayrault I cannot help myself thinking how genuinely applicable the following three pieces of wisdom are. The first is from Thomas Sowell, the economist, and the latter two from Winston Churchill.

> *Socialism has a record of failure that's so blatant that only an intellectual could ignore or evade it.*
>
> *I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle.*
>
> *Socialism is a philosophy of failure, the creed of ignorance, and the gospel of envy, its inherent virtue is the equal sharing of misery.*

"Those who cannot remember the past are condemned to repeat it."
—George Santayana, Spanish-American philosopher, 1863-1952[1]

While this research effort tries to move away from forecasting, as forecasting the future is rather difficult, and not necessarily necessary from a risk management standpoint; I believe *Wriston's Law of Capital* allows making educated guesses about the movement of capital; and therefore about future prosperity. Certain patterns are repeatable. The "going Venezuela" idea is based on historical patterns and the ignorance towards these developments is just mindboggling; or insane, as Albert Einstein might have put it: "Insanity: doing the same thing over and over again and expecting different results."

Holland was a magnet; Hollande isn't.

The tiny Dutch Republic rose as Spain fell. It is a good example of *Wriston's Law of Capital*, relative tolerance or intolerance, or (Spain) "going Venezuela". Capital moved north after Spain failed and started hunting down those "who delivered the goods," essentially the doers, the talent, i.e., the "capital". The Dutch Republic became a magnet for streams of religious refugees from all over Europe—Protestants from the south Netherlands, Huguenots from France, German Lutherans, Quakers and Pilgrims from England, and Jews from Spain.[2] As the United States would do two centuries later, the Dutch used tolerance to attract capital (again, human capital, talent, etc.). These immigrants poured money into the Dutch Republic, infusing bank reserves, augmenting state funds, fuelling Dutch colonialism, and playing a central role in the establishment of the famous Amsterdam Stock Exchange. Collectively, these immigrants formed the engine that propelled the Dutch Republic. Max Weber[3] coined the term "spirit of capitalism" in reference to the massive influx of (Protestant) merchants, skilled workers, and industrialists. History does indeed rhyme and those who do not remember the past are most likely condemned to repeat it. Venezuela didn't remember the past. Many socialist governments in Europe do not remember the past. They think

[1] The Life of Reason, Volume 1, 1905

[2] Chua (2007), p. 149.

[3] Max Weber, a German sociologist, economist, and politician, wrote *The Protestant Ethic and the Spirit of Capitalism*. In the book, Weber wrote that capitalism in northern Europe evolved when the Protestant (particularly Calvinist) ethic influenced large numbers of people to engage in work in the secular world, developing their own enterprises and engaging in trade and the accumulation of wealth for investment. In other words, the Protestant work ethic, according to Weber, was an important force behind the unplanned and uncoordinated mass action that influenced the development of capitalism. Note that there is a parallel between the work ethic of the Calvinists and the work ethic of apostles of *The Church of Jesus Christ of Latter-day Saints* currently most vividly represented through Mitt Romney. Replacing the current freebies-for-everyone administration with Romney's hard-work-and-prosper attitude could potentially mark an inflection point.

there's a new way or a third way. The new leadership in France for example is going against most "don'ts" listed below.

The following bullet points are "cannots" based on historical precedence. To some extent these cannots capture the spirit of the Founding Fathers of the US. I believe they stem from Rev. William J. H. Boetcker (1873-1962), an American religious leader who lectured around the United States about industrial relations at the turn of the twentieth century. He authored the following pamphlet titled *The Ten Cannots* in 1916. At one time President Ronald Reagan used them in a speech, wrongly attributing them to Abraham Lincoln.

"Any man who is not a socialist at age 20 has no heart. Any man who is still a socialist at age 40 has no head."
—Georges Benjamin Clemenceau (1841-1929), French journalist and statesman[1]

- You cannot bring prosperity by discouraging thrift.
- You cannot help small men by tearing down big men.
- You cannot strengthen the weak by weakening the strong.
- You cannot lift the wage earner by pulling down the wage payer.
- You cannot help the poor man by destroying the rich.
- You cannot keep out of trouble by spending more than your income.
- You cannot further brotherhood of men by inciting class hatred.
- You cannot establish security on borrowed money.
- You cannot build character and courage by taking away man's initiative and independence.
- You cannot help men permanently by doing for them what they could and should do for themselves.

The historic parallel between the rise of the Dutch Republic and the United States is obvious. There might be a parallel in relation to their fall too. The *Glorious Revolution* of 1688 saw the Dutch William of Orange ascend to the throne, and win the English, Scottish, and Irish crowns, ending eighty years of rivalry between the Netherlands and England. After becoming king of England, William brought over the financiers to continue provisioning his forces, which now included the English army. They would soon be followed by many of Holland's talent. Thus began a massive outflow of capital—as defined broadly before—from the Dutch Republic to England. As Chua puts it:

> *As an ironic result, it was England that would overwhelmingly benefit from the amalgamation of Dutch and English power. Basically, the Dutch Republic exported its tolerance, its most enterprising financiers, and its entire "business model" to England, which then replaced the Dutch Republic as Europe's preeminent land of freedom and opportunity for immigrants and religious minorities.*[2]

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[1] According to research by Mark T. Shirey, citing *Nice Guys Finish Seventh: False Phrases, Spurious Sayings, and Familiar Misquotations* by Ralph Keyes, 1992, this quote was first uttered by mid-nineteenth century French historian and statesman François Guizot (1787-1874) when he observed, "Not to be a republican at 20 is proof of want of heart; to be one at 30 is proof of want of head." (N'être pas républicain à vingt ans est preuve d'un manque de cœur ; l'être après trente ans est preuve d'un manque de tête.) This quote or a variant thereof has been attributed variously to George Bernard Shaw, Benjamin Disraeli, Otto von Bismarck, and others. The following quote, for those who—like myself obviously—are into these things, was falsely attributed to Winston Churchill: "If you're not a liberal when you're 25, you have no heart. If you're not a conservative by the time you're 35, you have no brain." Churchill was obviously a conservative first; then, later in life, developed a "heart".

[2] Chua (2007), p. 166.

Currently the United States is exporting its "business model" too. However, Chua argues that China is unlikely to repeat the US "business model," i.e., will not become what she calls a *hyperpower*. China is not a magnet. It is a closed society, even if not as closed as Japan. Chinese PhDs (where PhD stands for "poor, hungry and devoted") want to move to the US rather than the other way round. The Chinese way of life may be not as appealing and exportable as the American way of life. Only time will tell, of course. Speaking of timing:

"We've had a couple hundred bad years, but now we're back."
—Shanghai resident[1]

Timing and rough patches

A one-sentence and somewhat mean-spirited (for which I "somewhat" apologise) but not entirely meritless summary of European history in the 20th century could be the following: Europe gets itself into a big mess and then gets bailed out by the Americans.

This statement would certainly apply to the Great War. It was European in the making and American in the ending. It also applies to WWII. WWII was European (and Japanese) in the making and American in the ending. (We could "blame" the *Treaty of Versailles* for WWII, which was not entirely European in the making.) It is potentially also true for the Bosnia War that started without US involvement, showed Europe incapable of solving a problem on its own soil on its own, and was, again, ended via involvement of the US. (We know today that whether the US has the collective blessings from the UN Security Council or not is a minor detail. Also, if the IMF or World Bank bails out some European sovereign it is essentially a "bailout by the Americans" as these organisations are mainly American.)

(There is a first indication that this trend will continue in the 21st century: The Libya conflict—which was not caused by Europe but was geographically at its borders—was solved via involvement of the US. Officially a NATO offensive, the European forces run out of munitions only one month into the conflict. If this weren't so sad, it would be comical.)

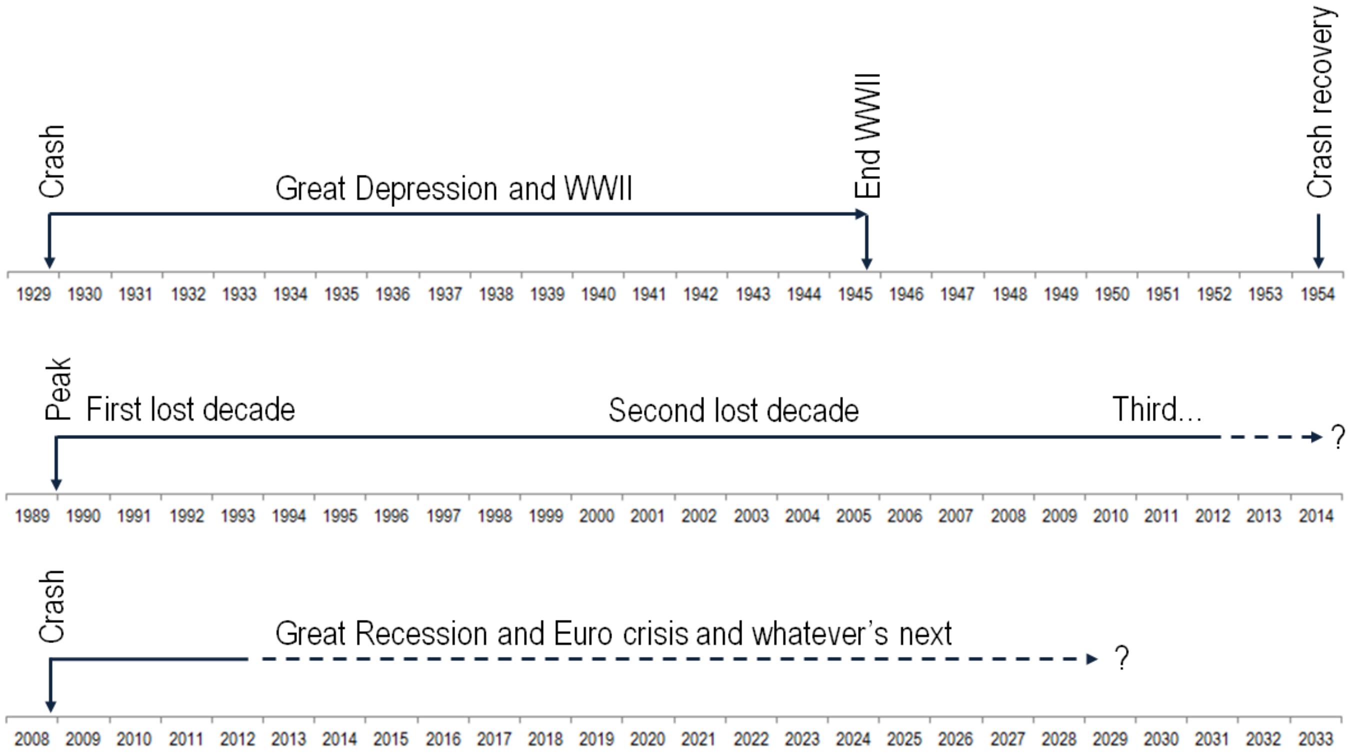
"Europe is the result of plans. It is, in fact, a classic utopian project, a monument to the vanity of intellectuals, a programme whose inevitable destiny is failure: only the scale of the final damage done is in doubt."
—Margaret Thatcher

In our investment management profession, event risk is all the rage at the moment. It's all about tail risk and Black Swans. The main reason for this development is mainly the 2008 experience that had an impact on the financial professional's mind while Nassim Taleb supported the vocabulary we use today. But the tail risk is done. We had the crash. Tail events are unlikely to occur when everyone expects them to occur. What is more worrisome is the aftermath of the tail event. I like to use the term "negative compounding" which essentially means that money, wealth, and assets deflate away in real terms. This is not really "tail risk;" a "rough patch" would be the better description. The problem, of course, is that these investor-unfriendly environments can last long. Figure 2 was designed to add the perspective as to how long these things can last.

"I'm not worried about markets trading down. I'm worried they won't trade at all."
—Peter Fisher, Head trader for the NY Federal Reserve visiting LTCM[2]

[1] From Chua (2007), p. 288.
[2] From Lowenstein, R. (2000) "When Genius Failed—The Rise and Fall of Long-Term Capital Management," New York: Random House, p. 297.

Figure 2: Selection of "rough patches"



Source: Ineichen Research and Management

The first "rough patch" in Figure 2 started with a financial crash in October 1929. The crash itself was primarily a financial event. It affected financial people; essentially investors and speculators, especially those using leverage. It didn't affect everyone. The crash was a harbinger of things to come. It was the first domino to fall, triggering a series of events that brought misery and suffering for large parts of the global population for an extended period of time. It marked the end of one era and the beginning of the next; an inflection point of sort.
Equities had reached their high-water-mark by 1954 in real total return terms. US government bonds were under water in real total return terms from 1940 to 1988. Japan is another example. The Nikkei 225 had its peak in December 1989 and if all goes well and the index starts compounding at 5% from the current 9,000 level (for an equity risk premium of 4%) then the index will have reached high-water-mark in 2041. I joined the financial industry roughly one year prior to the Nikkei 225 hitting its peak. Throughout my whole career, certainly since 1995, there always was someone out there who made the bull case for Japanese equities. However, the equity market still compounded negatively for decades. These things can happen. And "these things" can last longer than generally is imagined.

If we apply the first time scale in Figure 2 to today, Albert Einstein had his property confiscated roughly around now.

"Capitalism has created the highest standard of living ever known on earth. The evidence is incontrovertible... Yet those who are loudest in proclaiming their desire to eliminate poverty are loudest in denouncing capitalism. Man's well-being is not their goal."
—Ayn Rand (1905-1982), Russian-American novelist and philosopher

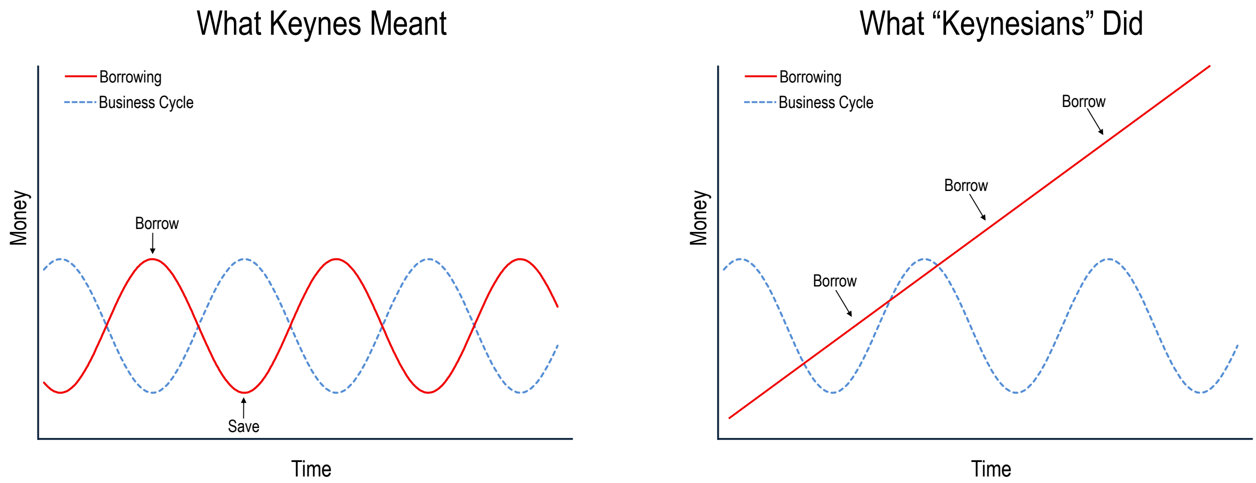
What Keynes meant and what Keynesians did

Financial professionals in Portugal already had their pensions confiscated. (Perhaps we shouldn't be too surprised, given Portugal's history in the 1970s.) The practical relevance of all this is that the current investment landscape resembles a "rough patch". The movement of capital has already started. The rough patch is not just a liquidity-turned-credit-turned-sovereign-crisis, unfortunately. I do not want to scare anyone but potentially the welfare state idea as we know it is coming to an end. This could be disruptive for many years. Whether we call this the age of deleveraging, or great depression II, or rough patch doesn't really matter. What matters is that we do not know how bad it's going to get. We also don't know how long it takes. Figure 2 is just a hint that these things can last long and become progressively worse before they become better. Since this line of research is supposed to be related to risk management and because risk management is not a quantitative exercise but a thought process, we need to think about these things. Many investors agree that the ideas from the 1980s and 1990s do not work as well anymore. Furthermore, the second quote in the side text has arguably merit. Figure 3 below is a take on what went wrong in the industrialised economies.

"Expect the best, plan for the worst, and prepare to be surprised."
—Denis Waitley, American motivational speaker and author of self-help books[1]

"There can be few fields of human endeavor in which history counts for so little as in the world of finance."
—John Kenneth Galbraith[2]

Figure 3: What went wrong in the West



Source: Protégé Partners 4Q 2009 quarterly letter

Keynes idea was about counter-cyclical fiscal stimulus, i.e. boosting aggregate demand by expanding debt to weather the trough of the business cycle and correspondingly shrinking demand by retiring debt during the ensuing boom.[3] However, this latter point was sort of ignored. The West, supported intellectually by scholarly Keynesians, just kept on spending and now the West is arguably in a borrowing-frenzy related mess. There are many ways to reduce debt and take from those with wealth, inflation being probably the most politically palatable and elegant. However, inflation is not the topic of this document. History teaches us that there are other ways to get to the money.

"None of us can have as much as we want of all the things we want."
—Oliver Wendell Holmes (1809-1894), American writer

[1] This quote, or a variant thereof, is occasionally attributed to Dwight D. Eisenhower.
[2] Galbraith, John Kenneth (1994) "A short history of financial euphoria," London: Penguin Books, p. 11.
[3] From Protégé Partners 4Q 2009 quarterly letter

Real assets should do well in times of debt monetisation

At the moment, many market wizards and former market wizards are recommending real assets in this environment. The investment thesis, which is beyond the scope of this publication, is sound. However, if the real assets get nationalised the investor loses everything. Democracies have turned authoritarian (or totalitarian) in the past. This is not something to *worry* about; the notion is something to *think* about. (Well, depending on the reader's location, it might actually be something to worry about.) History teaches us that failed authorities—simplifying a bit—somehow get to the money.

"Disobedience, in the eyes of anyone who has read history, is man's original virtue. It is through disobedience and rebellion that progress has been made."
—Oscar Wilde (1854-1900)[1]

In February 2012 Warren Buffett made the case that if the gold stock of 170,000 metric tons were melted together to a cube it would measure 68 feet per side and fit on a baseball field. The value of this cube would be equal to all the US cropland, 16 Exxon Mobils, and USD1 trillion in cash. His argument was that the latter was superior to the former for cash flow reasons. This is of course true. However, if you own cropland, blue chip shares, and cash and private property is nationalised and the currency devalued, you have nothing. Whereas in the case of hiding some physical gold from the authorities, you still own some gold. The cash flow argument, therefore, is true and very well-articulated. However, it applies to normal circumstances; to an environment in which the authorities have no incentive to look for money where it can be found. We might not be living in such an environment. The cash flow argument is valid only when we assume the current financial repression is not turning into something worse, say, something more authoritarian. Students of history won't find this last line of argument too farfetched.

Source: Capital Finance International

At the time of writing (early July) a big bank was in the process of stumbling over a scandal that involved manipulating Libor by a couple of basis points, potentially in a cartel like fashion with some other big banks. This is of course a scandal at a time where bankers are probably not at the pinnacle of the population's collective admiration and affection. However, it pales compared to the governmental-approved manipulation of interest rates, or, nowadays, the whole yield curve. Interest rates were supposed to be one of the most important parameters for investors and savers to make their allocation decisions. Interest rates have been distorted for years or decades even; not by a couple of basis points but by hundreds of basis points. Central banks too operate in a cartel like fashion. How can a heavy smoker be surprised if his kid tries a fag?

Corruption and the welfare state bubble

In the following I juggle with two variables, the incentive of the authorities to expropriate its citizens and the likelihood of them doing so. I use high government expenditure as a percentage of GDP as a proxy for the former and the *Perceived Corruption Index* (PCI) as a proxy for the latter. High government expenditure is an indication for the welfare state which I believe is on the way out because—in its current form—is non-financeable. The Perceived Corruption Index I like to use as a proxy for how rotten and dishonest the authorities are. The idea of this analysis is that the higher the incentive to steal and the more corrupt the authorities, the higher is the risk for the holder of wealth.

[1] From *The Soul of Man Under Socialism, Fortnightly Review (London, February 1891, repr. 1895).*

Table 1 show the tax burden as percentage of GDP, government expenditure as percentage of GDP, as well as the *Perceived Corruption Index*. Columns four and five show the rank of columns two and three from a sample of 168 countries. The last column shows the average rank. I apply our Reggae colour coding to the whole list. The table shows worst to best from a selection of European countries, as well as Russia, US, China, the worst from the 168 (Libya) and the best (Singapore). I have added the whole table into the Appendix of this document, sorted from best to worst.

"There is only one way to kill capitalism: by taxes, taxes and even more taxes."
—Karl Marx

Table 1: Government expenditure and corruption, selection from 168 countries

	Tax burden % GDP (1)	Govt. expend. % GDP (2)	Perc. Corruption Index (3)	Rank of (2) from 168	Rank of (3) from 168	Average rank from 168
Libya	5.4	52.3	2.0	158	159	159
Russia	34.4	41.4	2.4	115	136	126
Greece	29.4	52.9	3.4	159	77	118
Italy	43.5	51.8	3.9	157	66	112
Hungary	39.1	50.2	4.6	151	52	102
France	41.9	56.2	7.0	163	25	94
Portugal	35.2	49.8	6.1	150	32	91
Belgium	43.2	54.1	7.5	161	19	90
Austria	42.8	53.1	7.8	160	16	88
United Kingdom	34.3	51.2	7.8	155	16	86
Spain	30.7	45.8	6.2	138	31	85
Denmark	48.2	58.4	9.4	165	2	84
Sweden	46.4	55.2	9.3	162	4	83
Finland	43.1	56.2	9.4	163	2	83
Ireland	27.8	48.2	7.5	145	19	82
Netherlands	39.1	51.4	8.9	156	7	82
Germany	37.0	47.5	8.0	143	14	79
Norway	41.0	46.4	9.0	141	6	74
United States	24.0	42.2	7.1	121	24	73
Luxembourg	37.5	42.2	8.5	121	11	66
China	17.5	23.0	3.6	33	72	53
Switzerland	30.3	33.7	8.8	85	8	47
Singapore	13.4	17.0	9.2	9	5	7

Source: IR&M, Heritage foundation, transparency.org
The first two columns are for 2012, the Perceived Corruption Index is from 2011.

"From a historical perspective, since the War on Poverty began in the 1960s, the government has spent $19.8 trillion (inflation-adjusted) to fund a growing list of welfare programs. This is nearly three times the cost of all military wars in U.S. history from the Revolutionary War through the current war in Afghanistan."
—Robert Rector, senior research fellow at The Heritage Foundation[1]

- Investing in Singapore or Switzerland is probably safer than investing in Libya or Russia.

- The *Nordic model* seems to work for the moment despite being most likely on the wrong side of the Laffer curve[2]. Scandinavia created itself a welfare-state nirvana. The running costs are high. However, problems in Europe are elsewhere. Furthermore, Scandinavian countries are among the least corrupt. One could argue the authorities are already expropriating its citizens via taxes. One critique point of the Nordic model is that women need to work as there is little of the family's patriarch income left after all these redistributive taxes have been collected. However, a regression between the European countries in column 2 of Table 1 and the World Bank's women workforce participation rate reveals that there is no correlation, i.e. women have to work elsewhere too. In a nutshell, the Nordic economies do indeed have an incentive to go

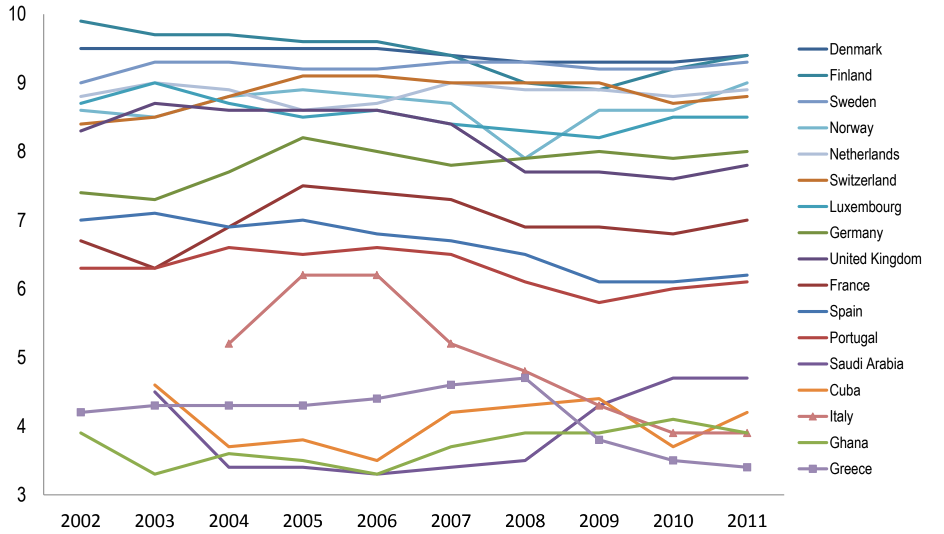
[1] Welfare: Tackling the Fastest-Growing Part of Government Spending, The Foundry, 12 April 2012

[2] I live in the canton of Zug in Switzerland. The canton of Zug started to realise what is behind the Laffer curve in the 1950s. Prior to understanding the Laffer curve, there were only grazing cows here. However, Zug has been a magnet for business ever since understanding what is behind the Laffer curve. I have added some remarks on the Laffer curve in the Appendix of this document.

after the money to finance their expensive welfare state but are already doing so via the tax authorities.

- Greece and Italy are different. The authorities there too have an incentive to go after the money. However, their societies, especially the political apparatus, are rotten. From a risk management perspective this is a big difference. Italy shares its ranking on the Perceived Corruption Index with Ghana, Macedonia, and Samoa and is therefore perceived as more corrupt than Cuba and Saudi Arabia.[1] (The 945 members of the Senate and the Chamber of Deputies earn an average annual salary of EUR140,000 – almost twice as much as British MPs. They are chauffeured around in expensive cars. According to one source, there are a staggering 30,000 of these executive cars and they cost the Italian taxpayer an estimated EUR2 billion a year. And that's just the tip of the corruption ice berg, a minor anecdote.) What are the chances that for example property rights will be respected when the going gets a bit tougher?
- France, Spain and Portugal seem to be in between these two regions. They too have an incentive to go after the money but are not as corrupt as Italy and Greece. However, nationalisation-prone Portugal has already started; nationalising some pensions, as already mentioned before. Figure 4 shows the PCI for a selection of countries.

Figure 4: Perceived Corruption Index, 2011, selected countries



Source: IR&M, transparency.org

Table 2 shows the best and worst 15 countries based on our ranking between government expenditure and corruption. These tables obviously need to be taken with a pinch of investment salt.

[1] Comparing Italy to Ghana is potentially unfair. Ghana currently has growth prospects.

Table 2: Government expenditure and corruption, best and worst from 168 countries

	Tax burden % GDP (1)	Govt. expend. % GDP (2)	Perc. Corruption Index (3)	Rank of (2) from 168	Rank of (3) from 168	Average rank from 168
Singapore	13.4	17.0	9.2	9	5	7
Hong Kong	13.9	17.3	8.4	12	12	12
Bahamas	15.3	22.2	7.3	30	21	26
Costa Rica	13.8	17.5	4.8	14	47	31
Macau	27.4	19.9	5.2	20	42	31
Chile	16.1	24.4	7.2	40	22	31
United Arab Emirates	1.8	25.8	6.8	45	28	37
Mauritius	18.9	23.5	5.2	35	42	39
Qatar	5.6	29.7	7.2	63	22	43
El Salvador	14.0	17.2	3.4	10	77	44
Australia	27.1	33.1	8.8	79	8	44
Peru	15.2	17.4	3.4	13	77	45
Switzerland	30.3	33.7	8.8	85	8	47
Rwanda	12.3	26.8	5.0	49	46	48
Madagascar	10.5	14.6	3.0	3	95	49

	Tax burden % GDP (1)	Govt. expend. % GDP (2)	Perc. Corruption Index (3)	Rank of (2) from 168	Rank of (3) from 168	Average rank from 168
Libya	5.4	52.3	2.0	158	159	159
Burundi	18.1	50.7	1.9	153	163	158
Equatorial Guinea	2.2	49.0	1.9	148	163	156
Maldives	14.1	64.9	2.5	166	128	147
Ukraine	36.9	48.5	2.3	147	144	146
Zimbabwe	39.0	45.2	2.2	134	146	140
Belarus	24.9	46.6	2.4	142	136	139
Angola	9.0	39.5	2.0	111	159	135
Solomon Islands	23.8	48.2	2.7	145	114	130
Uzbekistan	20.8	34.2	1.6	87	167	127
Russia	34.4	41.4	2.4	115	136	126
Yemen	8.0	35.2	2.1	92	155	124
Lesotho	56.9	65.5	3.5	167	74	121
Moldova	32.0	45.2	2.9	134	107	121
Venezuela	14.5	33.0	1.9	78	163	121

Source: IR&M, Heritage foundation, transparency.org
The first two columns are for 2012, the Perceived Corruption Index is from 2011.

- One of the lessons of the 2008 financial crisis was that one ought to know where one's money really is. It shouldn't be too surprising that increasingly investors want Singapore or Hong Kong as a booking centre. At the moment, it seems safer there.
- Note that Chile and Peru are on the green list in Table 2 while Venezuela is on the—appropriately coloured—red list.

Not the welfare state but the *welfare state bubble* is of great concern

Please note that I do not have a problem with the welfare state; it is the *welfare state bubble* that is of concern. The welfare state idea is a good one. It lifted large parts of various populations out of poverty. A developed society should clearly care about minimising suffering. However, the idea was taken too fare. At times it feels like socialism in a new wrapper; the "third way" being a marketing gimmick akin the "new economy" a couple of years ago. The practical relevance from a risk management perspective is that it is becoming apparent that the financing of this welfare state bubble is not working very well and authorities who have had their backs at the wall in the past did some really—how shall I put this—capital-unfriendly things.

"We will have to cut benefits. We shall promote individual responsibility. And our guiding principle will be that we can only redistribute what we have earned."
—Gerhard Schröder, to the Bundestag, 14 March 2003[1]

The table below shows the *social welfare function*. The social welfare function, proposed by Amartya Sen in 1973, is a measure of a society's overall welfare calculated as the product of GDP per capita and the difference between 1 and the society's Gini-coefficient. The Gini-coefficient is a measure between 0 and 1 with a low number indicating income is more equally—and in the minds of a vast majority therefore more fairly—distributed. The colour coding was applied to the whole sample of 126 countries where both indicator where available.

[1] *Germany reformed its social model. Europe can, too*, Josef Joffe, Bloomberg News, 17 April 2012

Table 3: Social welfare function, top 20

	GDP per capita 2011	Gini coefficient (latest)	Social welfare function
Luxembourg	88,787	0.26	65,702
Norway	57,092	0.28	41,106
Singapore	61,103	0.43	35,134
Sweden	41,447	0.23	31,914
Switzerland	47,817	0.34	31,703
Denmark	41,015	0.24	31,171
Austria	42,122	0.26	31,170
Netherlands	43,339	0.31	29,947
Germany	39,414	0.28	28,378
Ireland	41,642	0.32	28,317
Iceland	37,115	0.25	27,836
Belgium	38,633	0.28	27,816
Finland	37,581	0.26	27,810
Canada	40,541	0.32	27,527
United States	48,442	0.45	26,643
Australia	39,466	0.35	25,574
France	35,194	0.28	25,340
United Kingdom	36,511	0.34	24,097
Hong Kong	49,990	0.52	23,845
Spain	32,701	0.32	22,237

Source: IR&M, World Bank, Wikipedia, own calculations

Note that the success of Luxembourg can be (partly) explained by *Wriston's Law of Capital*. Luxembourg's main business is funds which employs thousands of lawyers, tax advisors, financial engineers, administrators, etc. i.e., well remunerated white collar workers. It's a hub; a magnet. Prior to becoming a financial hub there were only cows and steel there, with both gradually becoming less competitive. In 1966 Switzerland introduced tough regulation for funds. At the time Switzerland was a hub for the funds business. Switzerland wanted to protect investors. (History does indeed rhyme, does it not?) The tough regulation was hardly revised between 1966 and 1994. When Europe introduced more business friendly funds regulation[1] in 1985, business just left. The funds business was more "welcome" in Luxembourg, and has been "well treated" there ever since.

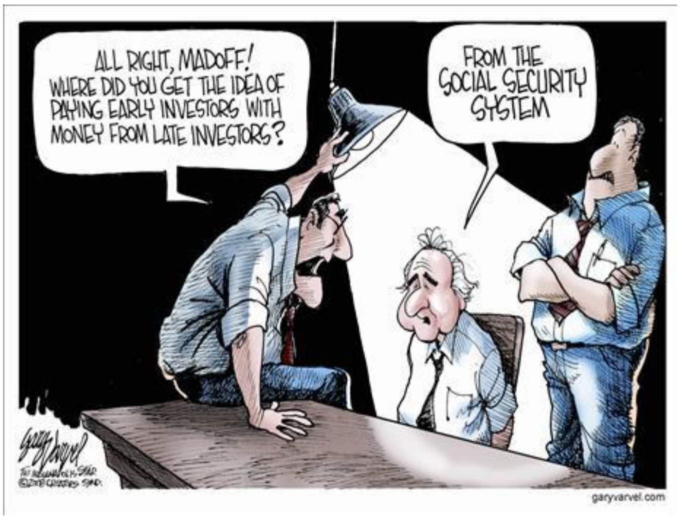
I have used the term "going Venezuela" for France's remarkable move towards the political left; essentially a move diametrically opposed to *Wriston's Law of Capital*. The reason for this term is that Venezuela more or less did everything wrong economically over the past 10+ years; it too went against the "law of capital". When a society shoots one own goal after another, its socio-economic fate becomes predictable. Prosperity, in absolute terms and irrespectively of how it is measured, goes down while social tensions and crime rise. In relative terms, it becomes less competitive than its neighbours, hence the brilliant quote in the side text for the second time.

"Chavez is the best president Columbia has ever had."
—Columbian home owner[2]

[1] 85/611/EWG

[2] "Trouble in Venezuela brings benefits to its neighbour," Financial Times, 8 May 2012

Carlo Pietro Giovanni Guglielmo Tebaldo Ponzi would be proud



France is by no means the only economy potentially "going Venezuela". Over the past two months I have been picking on France mainly because its electorate move in the wrong direction was the most recent as well as quite fascinating, and because some of the one and two-liners by the new government officials were/are particularly daft. But electoral success through overpromising and thereby loading debt on the shoulders of future generations is by no means a French or European phenomena. France is not the only country that is run by an intellectual with no hands-on business experience; the US for example, is too.
According to one estimate the present value of the US's liabilities including unfunded welfare promises is north of USD50 trillion. According to another estimate, apparently, more than 50% of the US population is *net* receiver of transfer payments. In Germany more than three quarters of the population benefit from a transfer payment in one form or another. The trend is clearly towards "getting worse". It actually resembles a Ponzi or a pyramid scheme; which—actually—is illegal in most jurisdictions. (A Ponzi scheme is illegal by definition.)

There is a consensus that governments borrowing senselessly cannot continue forever. As professor Joseph Stiglitz, for what it's worth, put it:

> *Economists agree this can't go on. We can borrow and borrow, but eventually there will be a day of reckoning.*

"There are two ways to conquer and enslave a nation. One is by the sword. The other is by debt."
—John Adams (1735-1826), Founding Father and second US President

Or Ludwig von Mises, essentially saying the same thing in the 1940s:

> *The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression, is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of the voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved.*[1]

The West is already in a *liquidity trap* where cash is hoarded and monetary policy instruments were overused and are now largely ineffective. This essentially means more and more borrowing results in fewer and fewer options. As Richard Fischer, President of the Federal Reserve Dallas, put it in March 2011:

> *Throughout history, feckless governments have dodged their fiscal responsibility by turning to their monetary authority to devalue the currency, monetize debt and inflate their way out of structural deficits.*[2]

[1] Von Mises (1996), p. 572.
[2] "In GOLD we TRUST," Erste Group, July 2011.

Making a mockery out of democracy

I find it fascinating how the following quote applies to today. It is nearly a hundred years old. We, as risk managers, now really need to become students of history; the faster the better.

"The longer you can look back, the farther you can look forward."
—Winston Churchill

> *Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some. The sight of this arbitrary rearrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become 'profiteers,' who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery.*[1]

Negative real interest rates impoverishes the saver

The current risk-on/risk-off market environment does indeed resemble a lottery. Whether citizens are impoverished through negative real interest rates caused by inflation or deflation-fighting or financial repression doesn't really matter; it's the impoverishing bit in Keynes statement that matters from a risk management perspective. The following literary titbit is also relevant today. It stems from Alexander Fraser Tytler (1747-1813), Scottish-born lawyer, writer, historian, and professor of history at the University of Edinburgh:

> *A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse (money-benefits) from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury with the result that a democracy always collapses over loose fiscal policy followed by a dictatorship. The average age of the world's greatest civilizations has been 200 years.*[2]

"We must re-establish the primacy of politics over the markets."
—Angela Merkel, May 2010[3]

The practical relevance is the following. Under normal circumstances it is illegal as well as morally wrong to go against one's countries rules, regulations and law. In a capitalistic system, the rule of law is the most important thing, even more important than roads and cheap energy. But what happens when one's own country turns illegal and corrupt? If history is a constant battle between freedom and repression, as some claim, then the spirit behind the quote in the side text doesn't cause property owners, entrepreneurs, holders of wealth, and capitalists to break out in uncontrolled festivity and joy, does it. It's of course not just one quote—potentially taken out of context—that is worrisome. It is the deep rooted spirit and freedom-adverse beliefs that stand behind such statements that are the

[1] Keynes in *The Economic Consequences of the Peace*, 1919.
[2] *The Decline and Fall of the Athenian Republic* (1776)
[3] Firefighting, The Economist, 14 July 2011

bone of contention. A temporary short selling ban is just a minor detail but it is potentially a harbinger of things to come that are much uglier. History does indeed suggest that repression in one form or another can go on for a long time until it eventually fails. Risk management would get much more difficult if temporary short selling bans turn into permanent short selling bans and then permanent short selling bans turn into a ban of all other hedging instruments and techniques; like short futures, long puts, CDS, long gold, physical or otherwise, cash, etc. Well, the holding of cash is already being punished via negative real interest rates.

Democracies have turned authoritarian before. At one stage, it becomes a matter of survival for capital to move elsewhere; again, capital defined broadly. Under normal circumstances capital flight might be morally wrong. However, does the adage "normal circumstances" really apply to today? Given where some countries rank on the Perceived Corruption Index and given where the West stands in terms of the stage in its welfare-state-pyramid-scheme? Middle Eastern capital is on the move; Greek and Spanish capital is on the move too; London and Geneva thereby benefiting from *Wriston's Law of Capital*. German entrepreneurs are setting up shop in Switzerland as taxes, labour laws and red tape are insurmountable for start-ups at home. In Italy the Mafia is the largest lender. Portugal is already in the process of going after the pensions of its citizens. France just went Venezuela. Whether these anecdotes are early signs of a more destructive phase, I do not know. But the direction of the trend seems clear.

"Democracy is the road to socialism."
—Karl Marx

Authorities turning against capital and savings are a game changer. However, there is no one sticking up a red flag and warning us that now indeed the game has changed. Change in this case happens gradually. This is why the term "tail risk" is in a bubble and might not be very helpful. Tail risk implies a sudden, low-probability, high-impact event of some sort, causing losses. However, this report is mainly about *gradual* change to the investor's disadvantage. These gradual changes are more difficult to identify or spot. An earthquake is an earthquake and the impact is sudden and clear to everybody. However, an extended period of negative real interest rates or slow expropriation via nationalisation and/or taxes is a different beast entirely.

"Most of the poverty and misery in the world is due to bad government, lack of democracy, weak states, internal strife, and so on."
—George Soros[1]

One of the lessons of history is that democracies do not last very long and die from suicide, rather than murder. John Adams in a letter to John Taylor dated 15 April 1814:

> *Democracy has never been and never can be so durable as aristocracy or monarchy; but while it lasts, it is more bloody than either. … Remember, democracy never lasts long. It soon wastes, exhausts, and murders itself. There never was a democracy yet that did not commit suicide. It is in vain to say that democracy is less vain, less proud, less selfish, less ambitious, or less avaricious than aristocracy or monarchy. It is not true, in fact, and nowhere appears in history. Those passions are the same in all men, under all forms of simple government, and when unchecked, produce the same effects of fraud, violence, and cruelty. When clear prospects are opened before vanity, pride, avarice, or ambition, for their easy gratification, it is hard for the most considerate philosophers and the most conscientious moralists to resist the*

"Civilizations die from suicide, not by murder."
—Arnold J. Toynbee (1889 – 1975), British historian

[1] Note that George Soros's biography also relates to Wriston's Law of Capital. His family "was not welcome" at home, so they left.

temptation. Individuals have conquered themselves. Nations and large bodies of men, never.

Please note that I might be biased when it comes to democracy: I'm Swiss and live in Switzerland. From where I sit, Germany, for example is not democratic, and the whole European Union complex is not really democratic either. Many nations in Europe got the Euro as well as a European constitution and wanted neither. Hardly any northern European citizen wants Eurobonds, i.e. the mutualisation of financial folly, but might get exactly that. The intellectual elite make the big decisions for the citizens. Some argue this is the ultimate arrogance by elitist people whose combination of ignorance and arrogance is so profound that they claim to understand things they do not even know they do not know.
(A German colleague once told me that—in the case of Germany—it's better that way because the German electorate made some really poor decisions in the 1930s. The colleague's view; not mine. I think the gentlemen in the side text hit—as so often, it seems—the proverbial nail on its head.)

"It has been said that democracy is the worst form of government except all the others that have been tried."
—Winston Churchill

Not only is the European Union not democratic, it cheats and is dishonest too. One of the Maastricht Treaties' criteria from 1991 was that government debt should not exceed 60%. Another one was that government deficit to GDP shouldn't exceed 3%. The treaty signees made a complete mockery of the rules, regulations and law. And the authorities and politicians expect banks and hedge funds and other market participants to abide the law? Who is kidding who? So the Eurozone is not only a failing experiment, it's a fraud too. But it's not just the Eurozone. The pyramid scheme is directly related to democracy. Politicians need to get elected and want to gain political capital. That is how they are incentivised. But one cannot do that by promising blood, toil, tears and sweat. Political capital is gained by promising early retirement, free money, and whatever the goodies de jour might be.

"With the exception only of the period of the gold standard, practically all governments of history have used their exclusive power to issue money to defraud and plunder the people."
—F.A. Von Hayek

Switzerland is perceived as more democratic than other, so-called democracies. What is relevant for this publication is that Switzerland is not only *relatively tolerant* from a movement of capital point of view, it is also adheres to Wriston's Law of Capital *constantly,* as opposed to an on-and-off basis. Many countries politically ping-pong (a very sophisticated political science term) between an administration that is business friendly and one that isn't. This ping-ponging cannot be efficient. Switzerland followed Wriston's Law of Capital without interruption for decades.[1] This means it was a magnet for capital in the 1930s as well as today and all periods in between. It is reasonably obvious that failed and/or corrupt governments don't like that, and do whatever they can to tie off these flows and migrations. This was the case in the 1930s as it is today; it's just that the

"Me? Switzerland. Still the best. Got a healthy distrust for big government."
—Gordon Gekko, response to the question where he puts his money, Money Never Sleeps

[1] Switzerland too has socialists. However, apart from travelling to Davos in January to throw a couple of cobblestones into a McDonalds window or parade in Zurich on the first of May, no real harm is done to society. Never ever was there a socialist or communist majority on a national level, hence—touch wood—the sustained prosperity.
The Swiss are often perceived as humourless and boring by non-Swiss. Many years ago, I made the case that "boring is good" as a reference to Gordon Gekko's "greed is good." The argument was that compounding of capital is best when it is "boring", i.e., there are no unnecessary risks and "exciting" drawdowns. Volatility, non-participation in wars, socio-economic experiments, and the political ping-ponging between business-friendly and business-unfriendly administrations might be attractive from one perspective; but from a sustainable wealth building and prosperity point of view, it isn't. Or as Oscar Wilde put it: "It is better to have a permanent income than to be fascinating."

political means that are different.[1] It seems to me, that failed and corrupt governments have a tendency to put non-failed and non-corrupt governments under pressure, in their pursuit of "going after the capital." Again, what constitutes a failed and corrupt government, and what not, is—potentially—dependent on the beholders location.

The difficult part to gasp is that the movement of capital, that would be illegal under normal circumstances, might be essential for survival in non-normal circumstances. (Again, this is of course specific to the investor's location. Whatever the case might be, in banking, the location of the booking centre is already an issue for some investors; probably the more sophisticated, history-sensitised and thoughtful.) Given that the movement of capital has already began; the risk management process has changed and might become increasingly difficult for large pools of capital with inert decision market processes. It might be an even greater challenge for state-sponsored institutions; especially if the sponsoring state is a (financially and morally) bankrupt fraud.

"For those who unfairly lump Social Security in with Bernie Madoff, in all fairness, you should point out the difference. No one was ever legally required to pay money to Madoff."
—Anonymous

***

Ending the first section on this cheerful note, let's have a look at the macro landscape.

[1] Some readers will object to this last sentence and argue that some countries are involved in buying stolen data; thereby the ends justifying the means. If the means are illegal (fencing is illegal) and the ends are corrupt and repressive, then there is indeed an uncomfortable parallel to earlier epochs.

Macro perspective

> ***"Rarely has politics seemed so crucial for investors, and yet so impotent. The craft of government has become defensive, reactive, small-minded and profoundly frustrating to watch. "***
> —Gillian Tett[1]

Global economy: declining

Summary

- Global economy continues to decline.
- Average PMI remains below 50 but has stopped falling.
- Business sentiment peaked in March and is declining. Consumer sentiment has been rising from December to April and is now declining.
- Europe remains a mess; cyclically as well as, or especially, structurally.
- Monetary policy is easy. Cash is hoarded.

Table 4 shows a summary of what we believe are the economic trends and surprises. A brief comment as well as some technical information on the stock market has been added. Changes since our last update are marked.

Table 4: Summary

	Fundamentals							Remarks	Technicals		
	IR&M Models						Surprises**		Moving averages		
10 Jul 12	Percentile (2006-)	Change*** (29 Jun 12)	Rank	Direction*	Average (100-day)	Above average?			50D	200D	50D> 200D?
Global	57	-3.3		Falling	Falling	No	Negative	Declining.	Falling	Rising	No
US	69	-1.9	2	Falling	Falling	No	Negative	Declining.	Falling	Rising	Yes
Europe	46	0.1	5	Falling	Falling	No	Negative	Declining.	Falling	Rising	No
Germany	51	-3.4	4	Falling	Falling	No	Negative	Declining.	Falling	Rising	Yes
France	40	-1.2	8	Falling	Falling	No	Negative	Declining.	Falling	Rising	No
Italy	40	2.0	7	Rising	Falling	No	Negative	Declining.	Falling	Falling	No
UK	63	-0.2	3	Falling	Rising	Yes	Negative	At inflection point.	Falling	Rising	No
Switzerland	41	2.0	6	Rising	Rising	Yes	Positive	Safe harbour.	Rising	Rising	Yes
Japan	76	-3.4	1	Falling	Falling	No	Negative	At inflection point.	Falling	Rising	No
China	21	6.5	9	Rising	Rising	Yes	Negative	Still at an inflection point.	Falling	Falling	No

Source: IR&M
Notes: * Direction: average last five days versus previous five-day average; ** Surprises are from Citigroup except Germany (which is our own). Surprises for France and Italy are for the Eurozone as a whole. *** Change in percentile points relative to date shown in brackets.

- From this perspective, very little has changed since our last update from 2nd July. There is far more red than one would want.

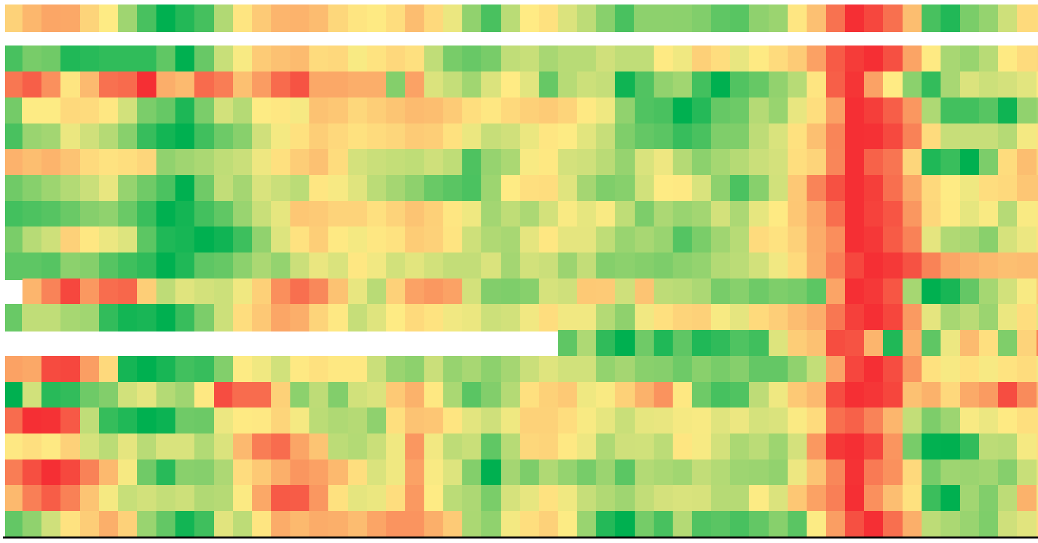
[1] Financial Times, 10 July 2012

GDP growth rates: falling

Table 5 shows year-on-year GDP (seasonally adjusted in most cases) for a range of economies. We have colour-coded the data to show highs (green) and lows (red), synchronisation of the data, and past and current trend. The average is equally weighted.

Table 5: Global real GDP, SAAR (seasonally adjusted annual rate)

Jun 1998 to Jun 2011



	09 11	12 11	03 12
Average	2.9	2.3	1.9
US	1.5	1.6	2.0
China	9.1	8.9	8.1
Germany	2.7	2.0	1.2
Eurozone	1.3	0.7	0.0
Japan	-0.5	-0.6	2.8
UK	0.5	0.6	-0.2
France	1.5	1.2	0.3
Italy	0.4	-0.5	-1.4
Spain	0.8	0.3	-0.4
Brazil	2.1	1.4	0.8
Canada	3.0	1.9	1.7
India	6.7	6.1	5.3
Russia	5.0	4.8	4.9
Australia	2.6	2.5	4.3
South Korea	3.6	3.3	2.8
Taiwan	3.5	1.9	0.4
Hong Kong	4.4	3.0	0.4
Singapore	6.0	3.6	1.6
Switzerland	1.6	1.9	2.0

Source: IR&M, Bloomberg. Notes: Not seasonally adjusted: Japan, South Korea, Singapore, and Switzerland. Original data: US: Bureau of Economic Analysis; China: National Bureau of Statistics; Germany: Federal Statistical Office; Japan: Economic and Social Institute; UK: Office for National Statistics; France: INSEE; Italy: ISTAT; Spain: Eurostat; Brazil: IBGE; Canada: STCA; India: Central Statistical Organisation; Russia: Federal Service of State Statistics; Australia: Bureau of Statistics; South Korea: Bank of Korea; Taiwan: Directorate General of Budget Accounting & Statistics; Hong Kong: Census & Statistics Department; Switzerland: State Secretariat for Economic Affairs.

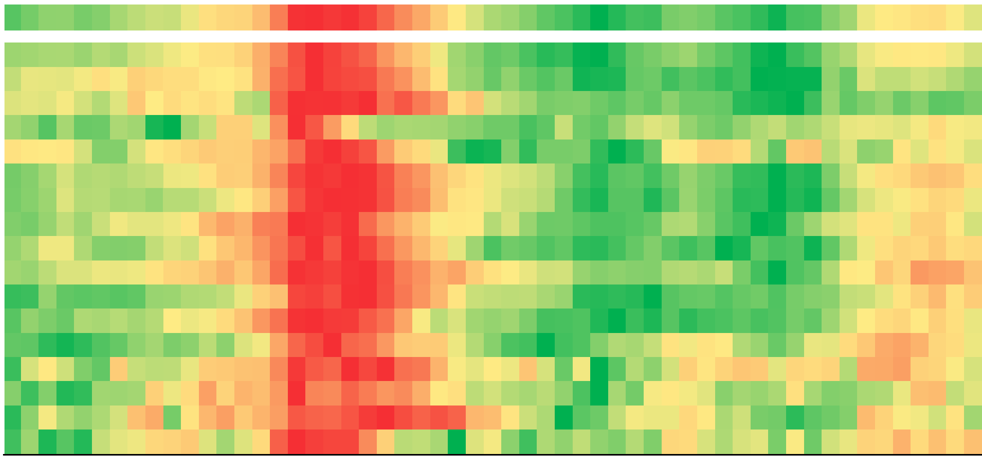
- Average GDP peaked in Q2 2010 and has fallen more or less gradually ever since.
- Japan and Australia surprised on the upside.
- The Eurozone and some countries in Europe are for all practical purposes in recession.

PMI: below 50 but stable

Table 6 shows a selection of global Purchasing Manager Indices (PMI) for the manufacturing sector. These are diffusion indices and therefore oscillate between 0 and 100. A reading above 50 is associated with an expanding industrial activity whereas a reading below 50 signifies contracting activity.

Table 6: PMI

Jul 2007 to Jan 2012



	Feb	Mar	Apr	May	Jun
Average	52	51	49	48.7	48.6
Global PMI (JPM)	51	51	51	50.6	48.9
US: ISM	52	53	55	53.5	49.7
US: Chicago	64	62	56	52.7	52.9
China	51	53	53	50.4	50.2
Japan	51	51	51	50.7	49.9
Eurozone	49	48	46	45.1	45.1
Germany	50	48	46	45.2	45.0
UK	52	52	50	45.9	48.6
France	50	47	47	44.7	45.2
Italy	48	48	44	44.8	44.6
Switzerland	49	51	47	45.4	48.1
Sweden	50	50	50	49.0	48.4
Brazil	51	51	49	49.3	48.5
Australia	51	50	44	42.4	47.2
New Zealand	58	54	48	55.7	n.a.
South Africa	58	55	54	53.6	48.2
Singapore	50	50	50	50.4	50.4

Source: IR&M, Bloomberg. Original data: Global: JP Morgan; US: Institute for Supply Management; Chicago: Kingsbury International; China: China Federation of Logistics and Purchasing (CFLP); Japan: Markit/Nomura; Eurozone, Germany, UK, France, Italy, New Zealand: Markit; Switzerland: Credit Suisse; Sweden: Swedbank Markets; Brazil: NTC Economics; Australia: Australian Industry Group; New Zealand: Bank of New Zealand; South Africa: Kagiso Securities; Singapore Institute of Purchasing and Materials Management.

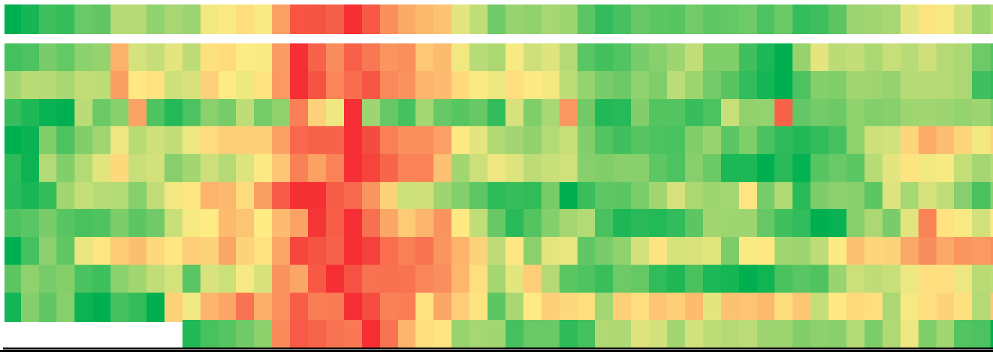
- Average PMI peaked in February 2011, had fallen to 49 in October and November of 2011, and had risen to a lower peak in February 2012. The average PMI has been in decline ever since.
- The widely followed ISM indicator fell below 50 in June, while a fall from 53.5 to 52.0 was expected.
- Europe, especially the Eurozone, continues to contract. The PMIs of the Eurozone and Italy have been below 50, i.e., the economies are contracting, since August 2011.
- Please note that the updates of this table allowed spotting the difference between the seemingly growing US with stagnating Europe very early on. In other words, the table does not just inform about the general trend, it allows us to spot geographic differences as well.

PMI Services: below 50 but stable

Table 7 shows a selection of global Purchasing Manager Indices (PMI) for the services (non-manufacturing) sector. These are diffusion indices and therefore oscillate between 0 and 100. A reading above 50 is associated with an expanding activity whereas a reading below 50 signifies contracting activity.

Table 7: Non-manufacturing PMI

Jul 2007 to Jan 2012



Feb	Mar	Apr	May	Jun	
52	52	49	49.0	49.7	**Average**
56	55	52	52.5	50.6	**Gl. Services PMI**
57	56	54	53.7	52.1	**US: Non-Man**
57	58	56	55.2	56.7	**China**
49	49	47	46.7	47.1	**Eurozone**
53	52	52	51.8	49.9	**Germany**
54	55	53	53.3	51.3	**UK**
50	50	45	45.1	47.9	**France**
44	44	42	42.8	43.1	**Italy**
54	53	49	47.7	47.4	**Sweden**
47	47	40	43.5	48.8	**Australia**
57	54	54	49.7	53.0	**Brazil**

Source: IR&M, Bloomberg. Original data: See previous table.

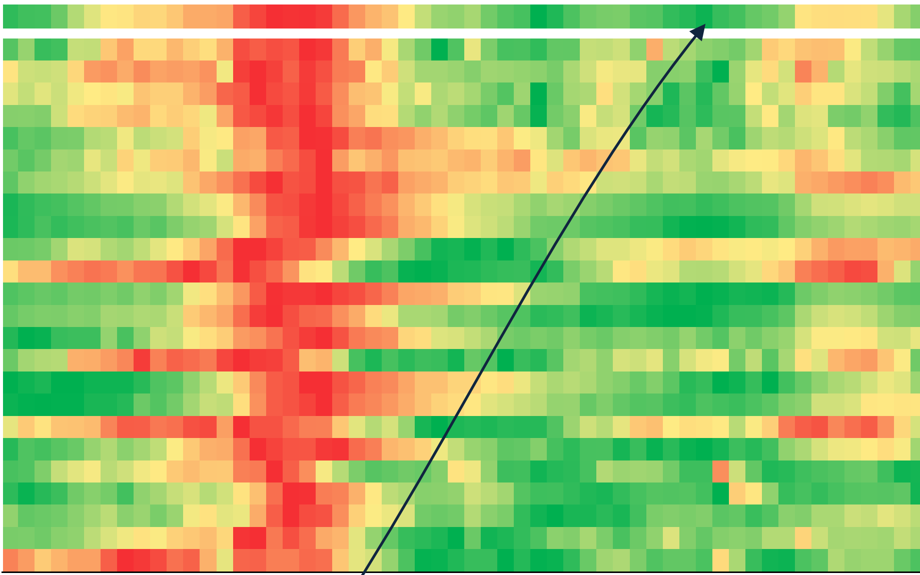
- The services PMI are reasonably consistent with the manufacturing PMI, i.e. peaking some while ago and falling ever since.
- The services PMI for Germany, the beacon of hope in Europe, has been falling too.
- In 2008/2009 the Eurozone services PMI was below 50 for 15 months. Currently, the services PMI has been below 50 for 10 months, ignoring one brief spike to 50.4 in January.

Business sentiment: declining

Table 8 shows a selection of business and economic sentiment and expectations indicators for the past five years. Some are more leading than others. We show all figures in percentiles. The period high is set to 100 and is shown green. The period low is, therefore, set to 0 and is red. The colour coding allows getting a feel for the trend on a reasonably high frequency basis. There is an update nearly every day.

Table 8: Business sentiment

Aug 2007 to Feb 2012



Aug 2007 to Feb 2012	Mar	Apr	May	Jun	Jul	
	68.3	66.8	60.2	52.9	52.7	**Average**
	81	60	76	53	n.a.	**US: Empire State**
	67	62	44	30	n.a.	**US: Philadelphia Fed**
	68	78	63	53	n.a.	**US: Richmond Fed**
	85	68	66	79	n.a.	**US: Dallas Fed**
	81	89	88	56	n.a.	**US: AIM**
	58	69	68	53	n.a.	**US: NFIB**
	41	33	21	16	15	**EZ: Sentix**
	59	56	50	49	n.a.	**EZ: Economic**
	68	63	58	55	n.a.	**EZ: Business**
	33	26	27	n.a.	n.a.	**China**
	71	72	61	39	n.a.	**Germany: ZEW Exp.**
	83	83	73	68	n.a.	**Germany: IFO Climate**
	75	75	69	58	n.a.	**Germany: IFO Exp.**
	54	63	53	57	n.a.	**UK (EC)**
	78	74	31	39	n.a.	**UK (Lloyds)**
	68	61	56	54	n.a.	**France**
	48	45	38	43	n.a.	**Italy**
	58	60	56	31	n.a.	**Switzerland**
	68	68	66	62	n.a.	**Sweden**
	91	95	87	80	n.a.	**Japan (ESRI)**
	90	85	84	80	n.a.	**Japan: Small biz**
	63	65	73	67	63	**South Korea**
	66	69	57	56	n.a.	**Australia**
	85	87	79	65	n.a.	**New Zealand**

Source: IR&M, Bloomberg. Original: US: NY Fed, Philadelphia Fed, Richmond Fed, Dallas Fed, AIM (Associated Industries of Massachusetts), NFIB (Small Business Optimism Index), Eurozone (EZ): Sentix Behavioral Indices, EC (Economic Sentiment Indicator and Business Climate Indicator); China: National Bureau of Statistics, Germany: ZEW (Expectation of Economic Growth), IFO (Business Climate and Business Expectations); UK: EC, Lloyds TSB; France: INSEE; Italy: ISEA; Switzerland: ZEW/Credit Suisse, Sweden: National Institute of Economics, Japan: ESRI, Japan Finance Corp for Small Business; South Korea: BoK; Australia: National Australia Bank; New Zealand: National Bank of New Zealand. Note: The table sows percentiles. 100 (green) marks high for period shown, 0 (red) is the low. The average is equally weighted.

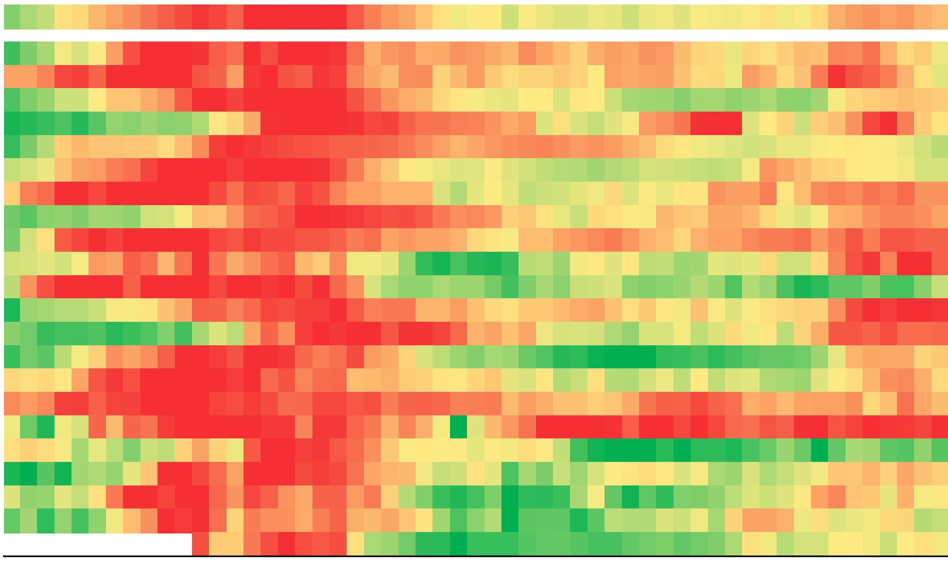
- The most recent peak of the average of these business sentiment and expectations indicators was in February 2011.
- The average of all these indicators started to rise in December and peaked this April. There was a sharp drop in May and, on average, these indicators have been falling ever since.
- This table too allowed to spot the divergence between the US and Europe reasonably early. The table showed that while the US has been shooting the proverbial lights out, Europe wasn't.
- Four indicators stand out as being earlier than other indicators: The Philadelphia Fed Business Outlook Index, the ZEW Germany Expectation of Economic Growth Index, the UK's Lloyds sentiment index, and the ZEW-Credit Suisse Switzerland Expectation of Economic Growth Index. Note that these four indices have turned orange recently.

Consumer sentiment: declining

Table 9 shows a selection of consumer sentiment indicators for the past five years. We show all figures in percentiles. The period high is set to 100 and is shown green. The period low is set to 0 and is red.

Table 9: Consumer sentiment

Aug 2007 to Feb 2012



	Mar	Apr	May	Jun	Jul
Average	43.7	45.7	45.6	44.2	44.3
US: Conf Board	51	50	45	42	n.a.
US: Michigen	60	60	68	51	n.a.
Eurozone	45	43	45	44	n.a.
China	18	36	43	n.a.	n.a.
Germany	64	62	61	61	62
Japan	66	65	70	n.a.	n.a.
UK: GfK	22	22	27	28	n.a.
UK: Lloyds TSB	45	44	44	52	n.a.
France	31	38	41	41	n.a.
Italy	27	0	0	0	n.a.
Spain	50	51	39	60	n.a.
Netherlands	0	13	2	0	n.a.
Switzerland	29	39	25	n.a.	n.a.
Sweden	47	55	58	52	n.a.
Denmark	63	66	63	54	n.a.
Ireland	46	50	46	52	n.a.
Greece	7	8	13	22	n.a.
Brazil	94	100	95	85	n.a.
Canada	51	43	53	n.a.	n.a.
Australia	38	35	36	37	n.a.
New Zealand	54	62	62	44	n.a.
South Korea	56	64	67	56	n.a.

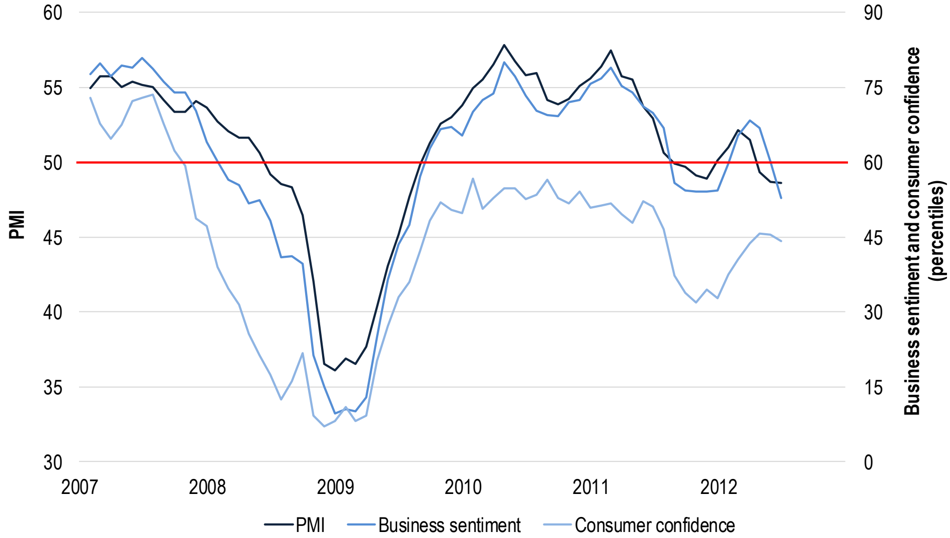
Source: IR&M, Bloomberg. Original: US: Conference Board and University of Michigan Survey Research Center; Eurozone, France, Spain, Greece: European Commission; China: National Bureau of Statistics of China; Germany: GfK (for the month ahead); Japan: Economic and Social Research Institute (ESRI); UK: GfK and Nationwide; Italy: ISAE; Netherlands: Dutch Statistics Office; Switzerland: UBS; Sweden: National Institute of Economic Research; Ireland: IIB Bank; Brazil: Fundacao Getulio Vargas; Canada: OECD; Australia: Westpac Banking Corporation; New Zealand: ANZ Bank; South Korea: Bank of Korea, since July 2008. Note: The table sows percentiles. 100 (green) marks high for period shown, 0 (red) is the low. The average is equally weighted.

- One of the characteristics of the aftermath of the Great Recession is that consumer sentiment never really recovered; unlike after most other post-WWII recession.
- The average consumer sentiment has been falling to October 2011, has risen to May 2012 and has been stable ever since.
- Sentiment in Italy and the Netherlands is at a low point; understandably in case of the former, less so in the case of the latter. The consumer sentiment in Greece has been rising throughout most of 2012.
- Note that some of the consumer sentiment indicators, that turned red early on in the last recession, have turned orange and red now too.

Summary PMI, business and consumer sentiment

Chart 1 below shows a summary of the average PMI (Table 6), average business sentiment (Table 8) and consumer sentiment (Table 9).

Chart 1: Summary



Source: IR&M, Bloomberg

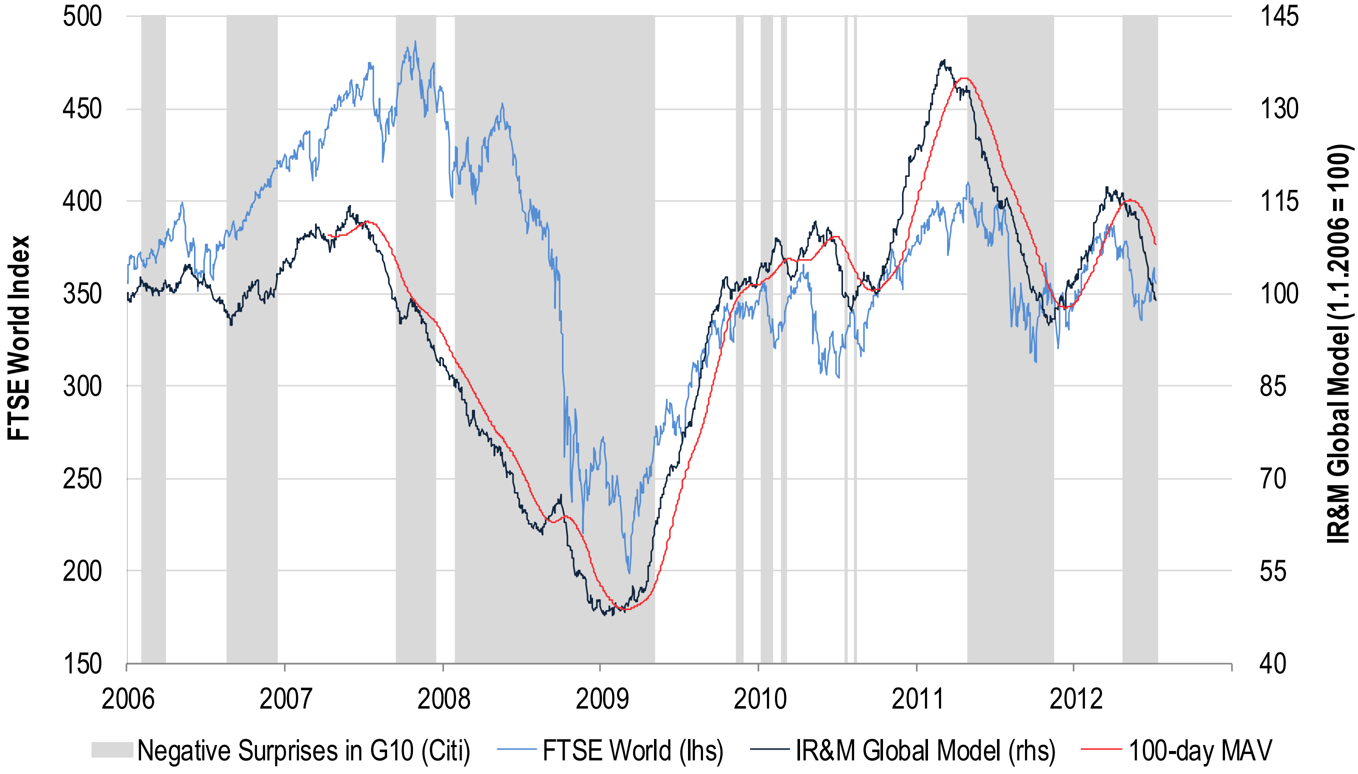
- Our interpretation of the summary above is that the economic trend is down. The practical relevance is that large drawdowns in equities typically occur not when things economic are improving but when they are deteriorating. We do not know for how long "things economic" will be deteriorating; no one does.

Economic trend vs global equity market

Chart 2 shows a model that was designed to give an indication of the economic trend nearly every day. The idea behind the model is that these indicators are not random but trend. Models such as these allow us to decide whether the global economy is expanding or things economic are deteriorating. The moving average is the trend. We then combine the trend with expectations. The shaded areas show periods where reality is "coming in" worse than economists and strategists are expecting, i.e., the economic data is below consensus.

Note here that these graphs (there are more below) do not in any way predict the future. Whether these variables turn tomorrow or keep falling for years to come, we do not know. The idea is simply to pick up the trend and its derivative, the surprises. We believe that being hedged when the trend is down and surprises are negative prevents experiencing long periods of negative compounding. Also, it seems to us, negative tail events do not normally happen out of the blue. They occur when things economic are not well and the red line in the graph below is declining.

Chart 2: IR&M global economic model vs FTSE World Index



Source: IR&M, Bloomberg. Note: Surprises are based on Citigroup Expectations indices. IR&M Global Model is based on 21 indicators, was designed to give a data point nearly every day, and remains work in progress.

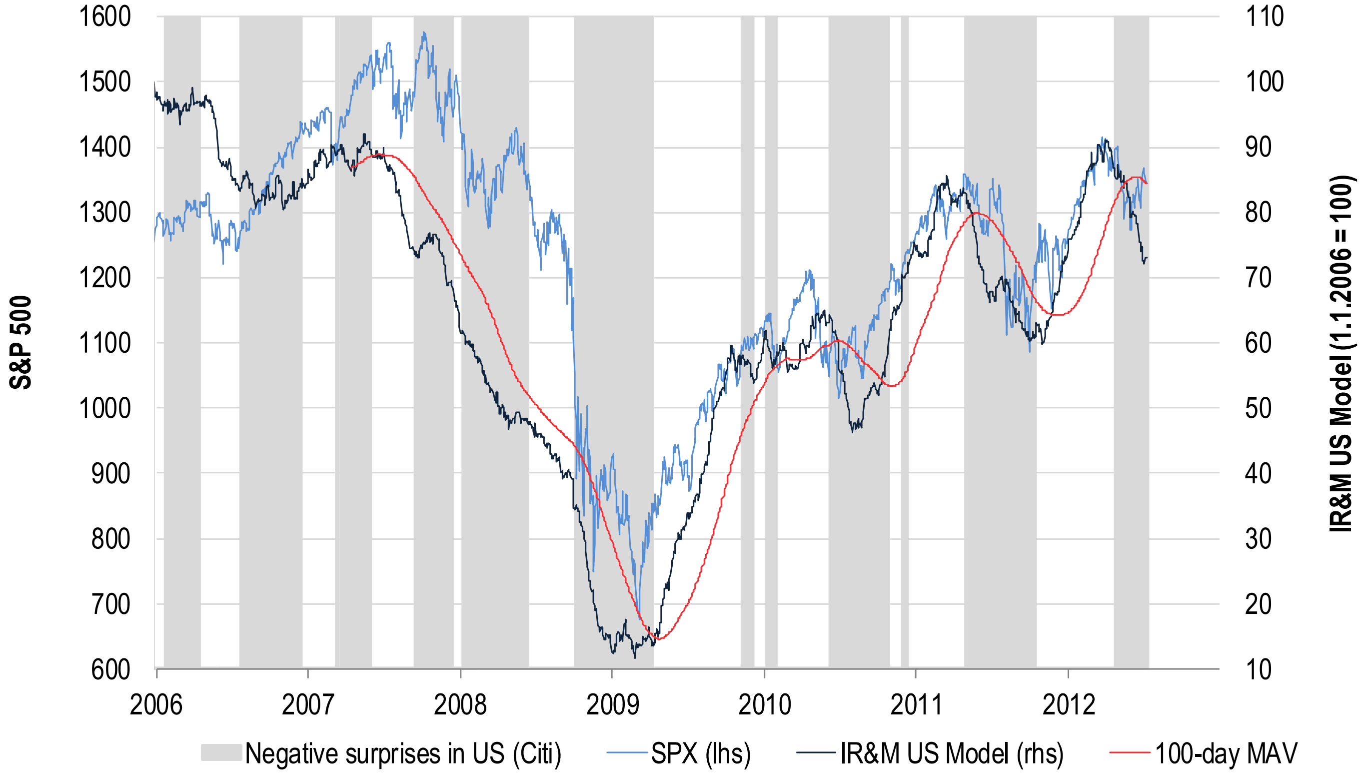
- Surprises turned negative on 23rd April 2012, around the same time when the model line crossed the moving average. The trend has been negative ever since.
- The idea behind exhibits such as this one is to help the investor regarding the decision whether to hedge risk or not. Large drawdowns in the equity market happen when surprises are negative and economy, represented here through a model, is deteriorating. This is currently the case.
- The reason why many investors find the current environment difficult is because of the introduction and effect of the various policy options. Both the timing as well as the impact of the remaining policy options is nearly impossible to predict.

United States: declining

Economic trend vs US stock market

Chart 3 shows a model based on economic variables relevant to the economy in the United States.

Chart 3: IR&M US economic model vs S&P 500



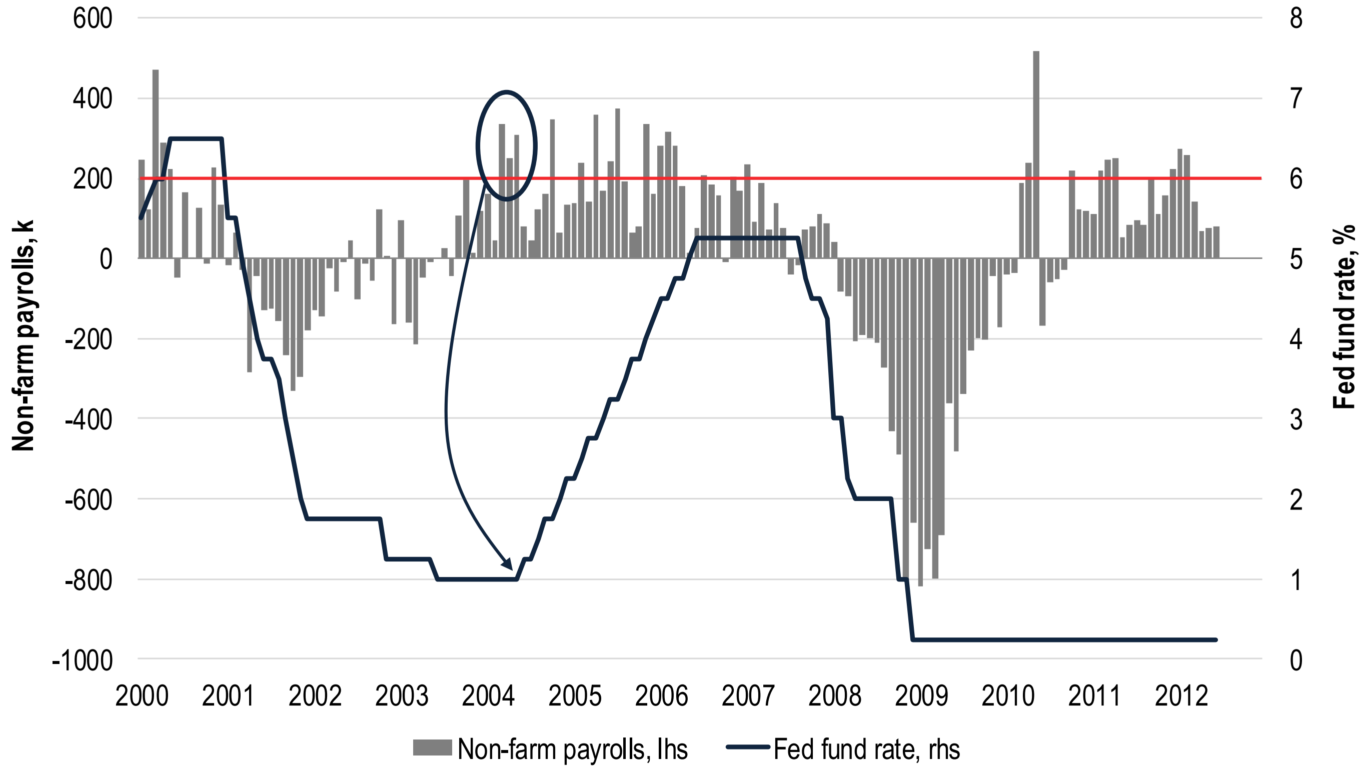
Source: IR&M, Bloomberg. Note: Surprises are based on Citigroup Expectations indices. IR&M US Model is based on 23 indicators, was designed to give a data point nearly every day, and remains work in progress.

- Economic surprises in the US have been negative since 25 April 2012 while our model crossed the moving average shortly thereafter. Our interpretation of these facts is that the US economy is deteriorating.
- In our last quarterly report, a gain of between 9.3% and 13.3% in the S&P 500 could have been locked in for the 2012 calendar year via the Dec 1375/1425 zero cost collar. At the close of 9 July, the index at 1,352, the Dec 1300/1360 zero cost collar would have allowed the investor to lock in a calendar year gain of between 3.3% and 8.1%. This means at the beginning of July, a positive absolute return could still be locked in for the calendar year. However, the possible locked in gain today is lower than three months ago.
- Our implicit recommendations in this report and its' updates is that when the economic conditions (represented through the dark blue and red lines) is deteriorating and surprises are falling, one ought to hedge. We currently do not know how long "things economic" will be deteriorating and how bad it might get.

Monetary policy stance

Chart 4 shows monthly non-farm payrolls and the Fed fund rate. Note that non-farm payrolls are subject to vast revisions many months after data release.

Chart 4: Fed fund rate with non-farm payrolls

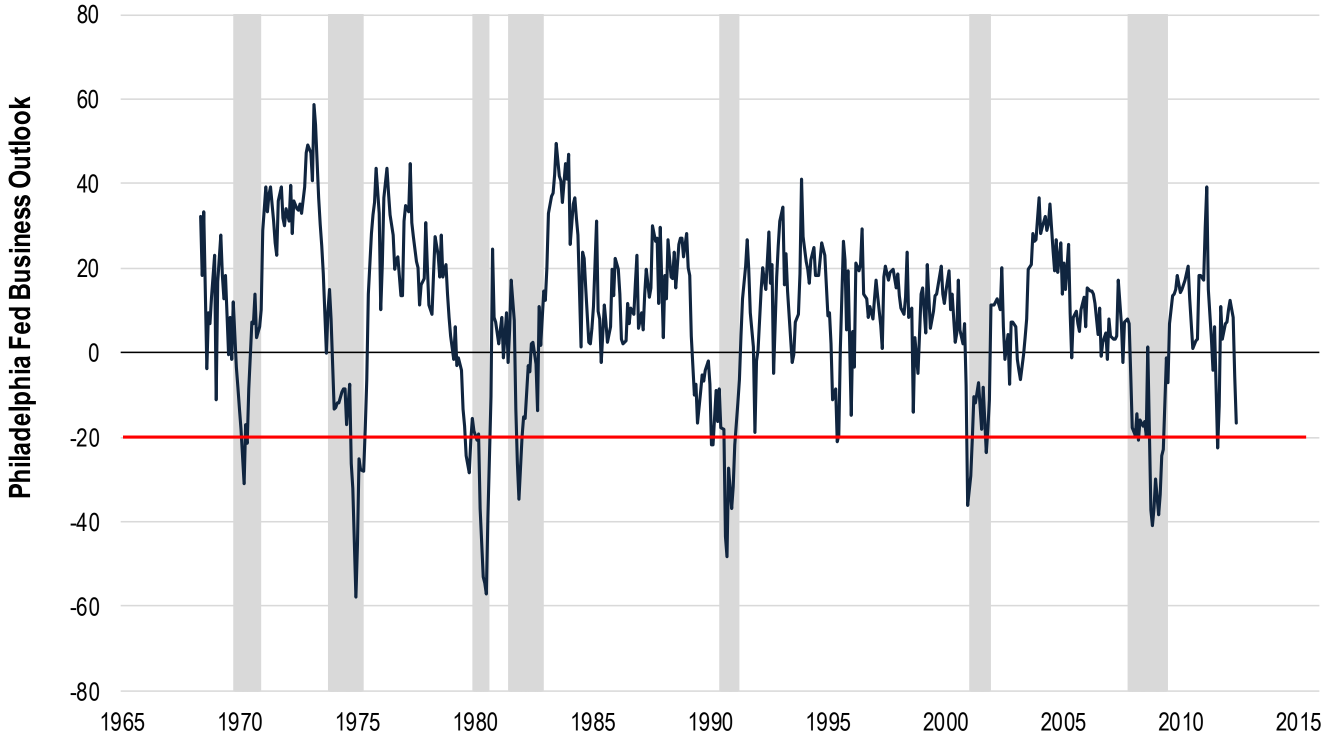


Source: IR&M, Bloomberg

- Fed tightening seems a non-issue at the moment. The last time the Fed started tightening was when non-farm payrolls were above 200,000 (red line) for three consecutive months. (The Fed also "promised" not to tighten until at least 2013; or was it 2014? We can't remember; hence the non-issue.)
- The Bureau of Labor Statistics surprised the market on Friday 6th July with a 80,000 new jobs being created; below the 100,000 that were estimated.
- Operation Twist 1 ended in June. On 20 June, the Fed announced a continuation of this intervention to the end of the year. Like its predecessors, this latest round of monetary easing was motivated by clear evidence the economy would not live up to the Fed's forecast. Members of the Federal Open Market Committee (FOMC), the Fed's main policymaking body, now expect growth of between 1.9% and 2.4% this year, down sharply from their April forecast of growth between 2.4% and 2.9%. This time a year ago, FOMC members were expecting growth of about 3.5% in 2012.
- There is an argument to be made that, given the Bernanke put, investors need not to hedge. The authorities are doing the hedging via monetary and fiscal policies. Assuming for a moment this can go one forever, no hedging is required; buy the dips. Caveat lector.

Business outlook

Chart 5: Philadelphia Fed Business Outlook



Source: IR&M, Bloomberg. Note: Shaded area show official US recessions.

- The Philly falling below -20 nearly guaranteed a recession in the past. However, in August 2011 it fell below 20 and the economy is not in a phase that could be described as an official recession. The indicator has been falling since April and was at -17 in June.

High frequency economic indicators

Table 10 shows eleven economic, high-frequency variables that are related to the business cycle in one way or another. The first line shows the average of the percentiles since 2007 of these indicators. The idea behind this table is to get a near real-time reading of the direction in which the economy is heading. Chart 6 graphs the average percentile compared to the S&P 500.

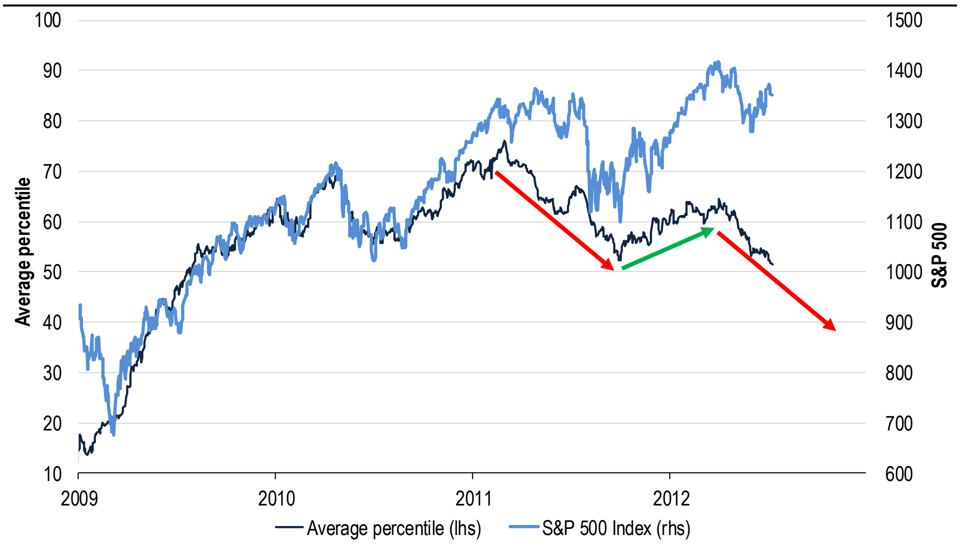
Table 10: High frequency indicators

2007-			March					April				May				June				July			
High	Low	Median	W9	W10	W11	W12	W13	W14	W15	W16	W17	W18	W19	W20	W21	W22	W23	W24	W25	W26	W27	Last	Economic proxy
76	9	61	61	60	62	63	62	64	63	61	61	61	59	57	57	53	54	54	54	54	52	52	Average percentile
98	-141	4	45	39	33	27	19	7	15	5	-8	-23	-24	-25	-25	-54	-50	-61	-64	-60	-63	-63	US Surprise Index
291	-19	183	170	171	194	188	188	174	172	170	168	162	158	143	145	121	137	131	137	134	128	125	US Yield curve (10-2Y)
28	-30	-1	-3.0	-2.5	-1.7	-0.6	0.3	1.3	1.8	1.2	0.6	0.1	0.0	0.4	0.1	-0.7	-2.1	-2.8	-3.2	-3.2	-2.9	-2.9	ECRI Leading (Growth)
2	-54	-43	-39	-37	-34	-35	-35	-31	-33	-31	-36	-38	-40	-44	-42	-39	-38	-36	-38	-36	-38	-38	Bloomberg Cons Comfort
1.16	0.57	0.93	1.01	1.01	1.01	1.02	1.01	1.01	1.02	1.00	1.03	1.01	1.00	0.96	0.98	0.96	0.98	0.97	0.98	0.96	0.96	0.95	Cons Discret vs. Staples
0.86	-4.03	-0.23	-0.32	-0.43	-0.47	-0.44	-0.34	-0.18	-0.06	0.01	0.02	-0.06	-0.13	-0.19	-0.23	-0.24	-0.25	-0.24	-0.22	-0.19	-0.19	-0.19	Aruoba Diebold Scotti
667	282	397	373	374	363	364	363	362	388	389	392	368	370	372	373	389	380	389	392	388	374	374	US Jobless claims
5.5	-2.5	2.6	2.7	1.7	2.3	3.3	2.7	4.2	4.5	3.2	3.6	4.2	3.3	4.5	3.8	2.9	2.8	2.9	3.6	2.7	1.4	1.4	US chain store sales, YoY
638	316	479	547	546	548	542	540	538	540	536	543	532	530	522	515	510	513	517	509	502	505	504	CRB RIND
463	127	336	390	386	388	381	383	380	363	370	382	372	365	347	345	331	329	338	331	349	341	341	Copper
1022	237	504	383	386	388	389	390	389	390	394	397	400	405	408	414	415	416	414	412	407	403	403	Container Ship Index

Source: IR&M, Bloomberg. Notes: US Surprise Index is from Citigroup. Bloomberg Consumer Comfort was previously from ABC News. Consumer Discretionary underperforms Consumer Staples during economic slowdown. The Aruoba Diebold Scotti Business Conditions Index (ADS BCI Index) is designed to track real business conditions at high frequency and is a daily index, published with a one week lag. CRB RIND is the Commodity Research Bureau/Reuters US Spot Raw Industrials Index consisting of raw industrial components with pre-cyclical characteristics. The prices of index constituents are not as much distorted through aggressive trading activity.

- The average percentile has been falling, slowly but gradually.
- Surprises have been falling materially since April. It is difficult to be bullish if reality is continuously worse than expectations.

Chart 6: Average percentile from high frequency indicators (Table 10) vs. S&P 500



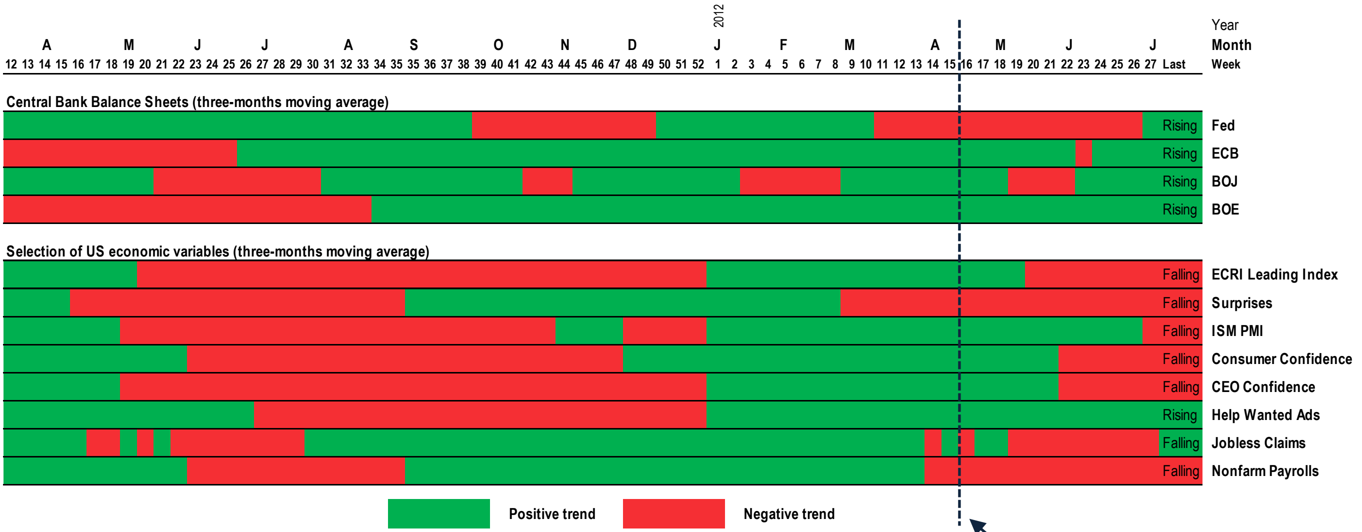
Source: IR&M, Bloomberg.

- The trend is down.

Economic health check

Table 11 shows three-month moving averages for four central bank balance sheets and eight economic indicators related to the business cycle. The table was designed for two reasons. First, during a trend this table allows us to tick a box every now and then with respect to the current trend. This should heighten conviction that the trend is the trend and nothing materially has changed. Second, the table should allow us to observe the trend reversal early.

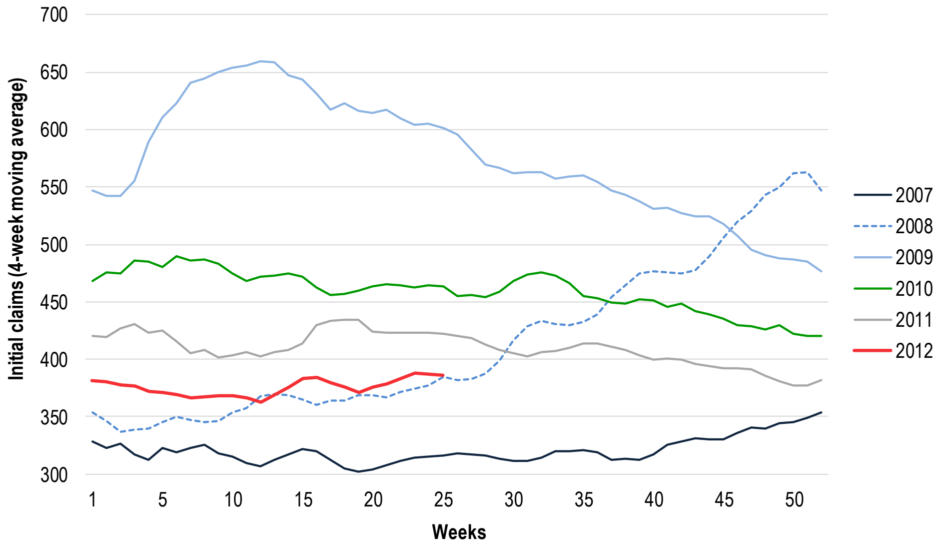
Table 11: Economic health check



Source: IR&M, Bloomberg
Notes: Surprises from Citigroup, Consumer Confidence and Help Wanted Ads from Conference Board, CEO Confidence from Chief Executive Magazine, US Initial Jobless Claims and US Employees on Nonfarm Payrolls from Department of Labor Statistics,

- All central bank balance sheets are rising again. We like to call this the *helping hand*, in contrast to Adam Smith's invisible one.
- This table allowed us to spot the "sell in May and go away" phenomenon early; both in 2011 as well as 2012.
- Our interpretation of the table is that the economy is deteriorating while the central banks are helping.

Chart 7: Jobless claims by year



Source: IR&M, Bloomberg

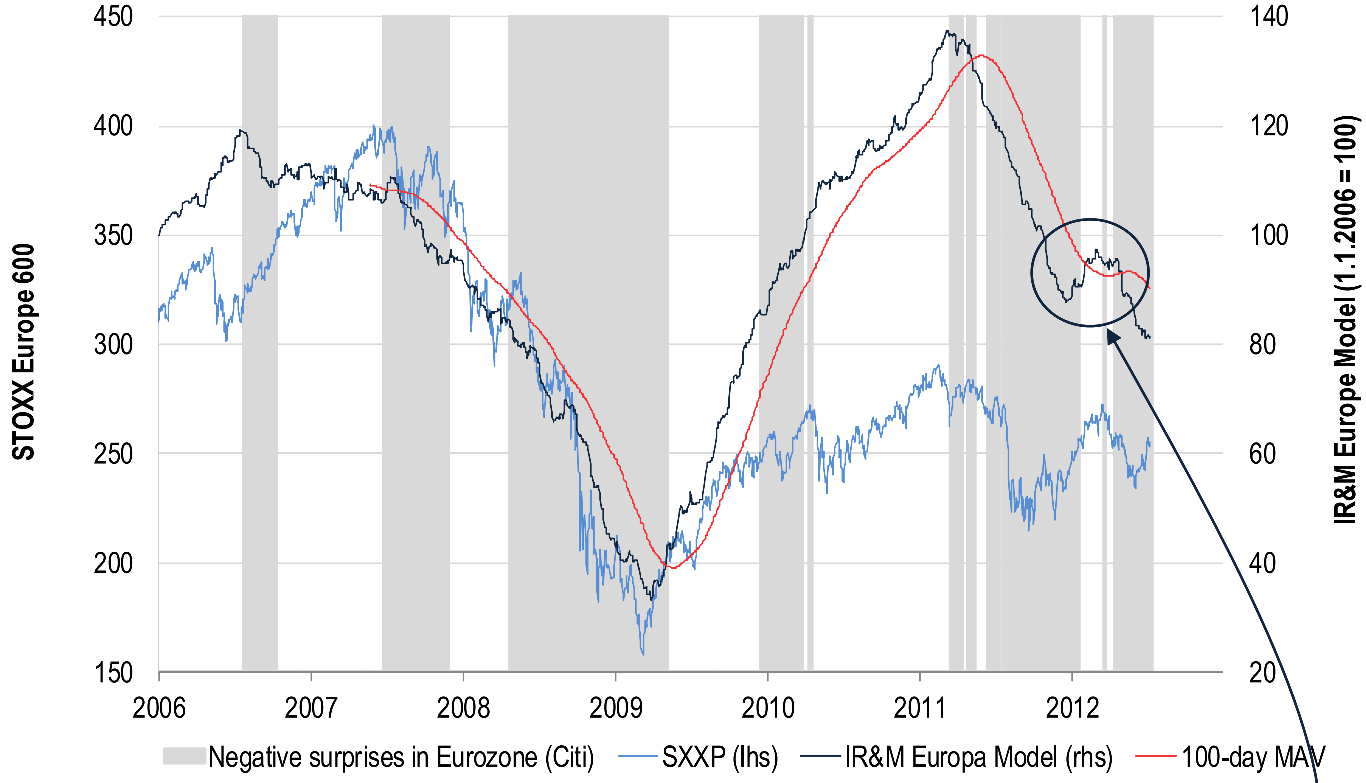
The more the 2012 jobless claims line resembles the 2008 line, the higher is the probability of a recession

Europe: declining

Economic trend vs stock market

Chart 8 shows a model based on economic variables relevant to the economy in Europe.

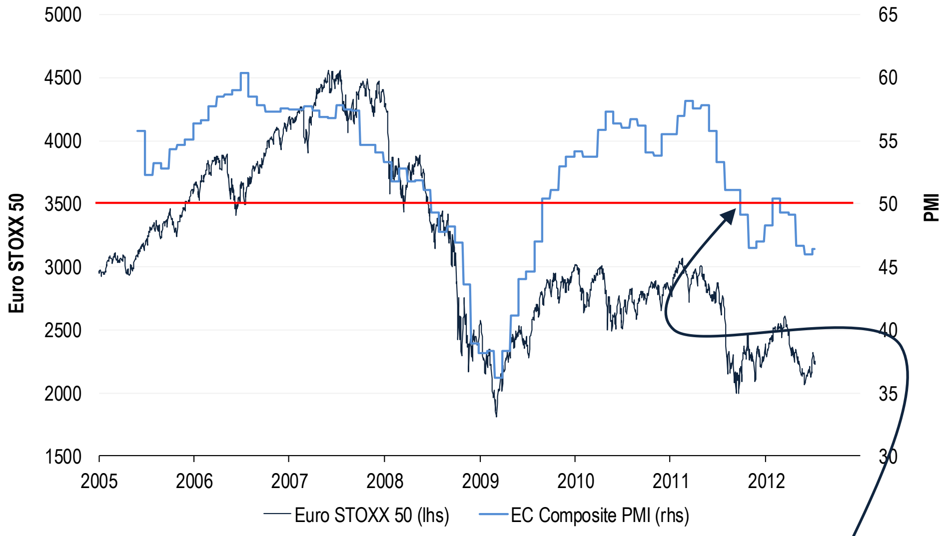
Chart 8: IR&M Europe economic model vs STOXX Europe 600



Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices for the Eurozone. IR&M Europe Model is based on 26 indicators, was designed to give a data point nearly every day, and remains work in progress.

- Surprises have been negative since 23rd April while our model fell through the moving average a couple of days later.
- The problems in Europe have not been solved. The uptick from autumn 2011, with the benefit of hindsight, can be regarded as a brief LTRO-induced blip.
- The cost at which large economies such as Italy and Spain have to roll their debt is prohibitive and rising.

Chart 9: Euro STOXX 50 and EC Composite PMI



Source: IR&M, Bloomberg.

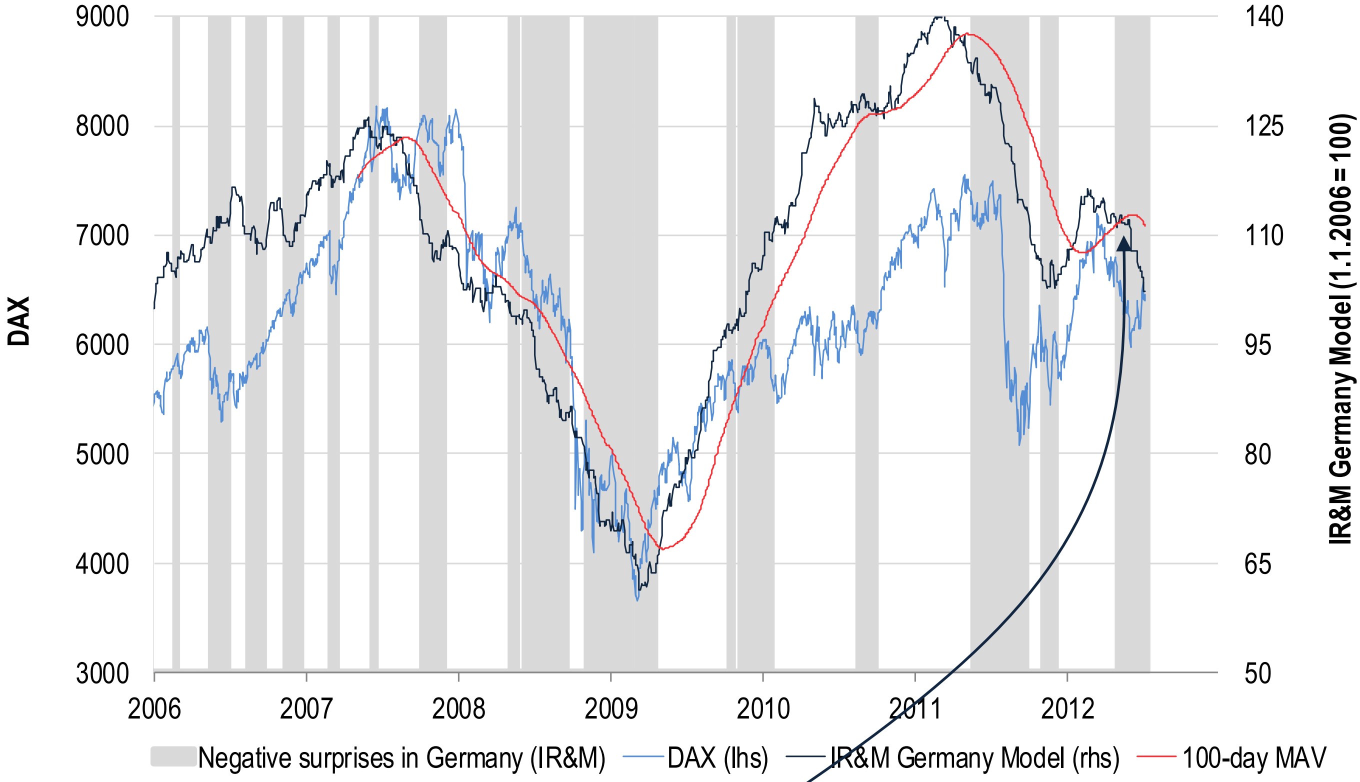
- The composite PMI for the Eurozone has been below 50 since September, part from a brief LTRO-induced holiday at 50.4 in December.
- A hedging rule that states: "be hedged Eurozone equity risk when PMI < 50" would have kept an investor out of the trouble of watching shares fall from 3500 to below 2000 during the financial crises.

Germany: declining

Economic trend vs stock market

Chart 10 shows a model based on economic variables relevant to the economy in Germany.

Chart 10: IR&M Germany economic model vs DAX

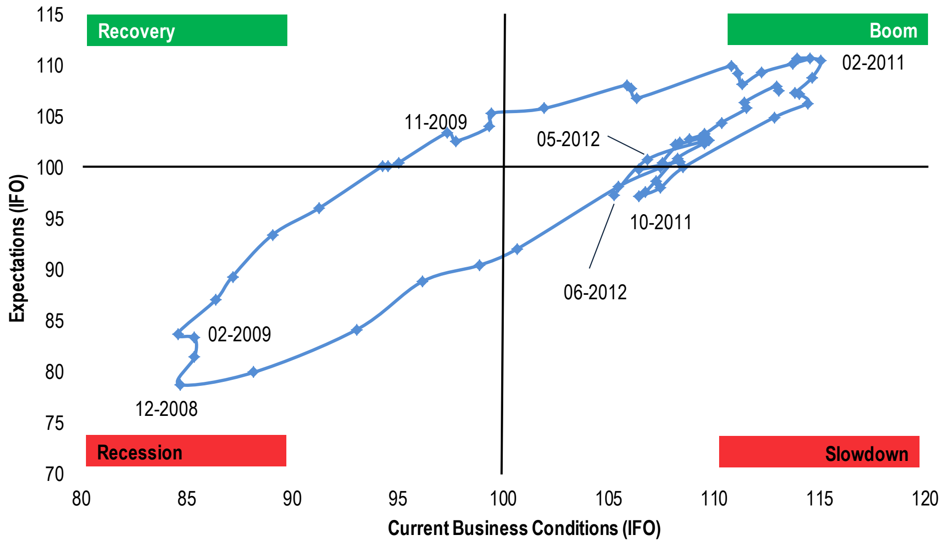


Source: IR&M, Bloomberg. Notes: IR&M Germany Model is based on 15 indicators, was designed to give a data point nearly every day, and remains work in progress.

- Surprises have been negative since mid-May, around the same time the model fell below its moving average. The economy is now deteriorating.
- Note that large drawdowns in the DAX occur when the trend is down. We believe paying attention to these crosses, therefore, makes sense. It gives the investor an opportunity to think about hedging.

Chart 11 shows the last and current business cycle based on IFO (Institut für Wirtschaftsforschung) climate indices. The horizontal axis shows current business climate whereas the vertical axis shows business climate expectations for the next six months. All is well in the upper right quadrant where current conditions as well as expectations are high. Then things economic start slowing down and the path goes from the upper right hand quadrant to the lower left hand quadrant. Once the nadir is reached, the path is from the lower left to the upper right again. Then the whole circle starts anew. The practical risk management relevance is that one ought to be hedged on the way from the upper right hand corner to the lower left hand corner. It is in those periods where the DAX experiences its losses. Chart 12 shows the DAX with PMI.

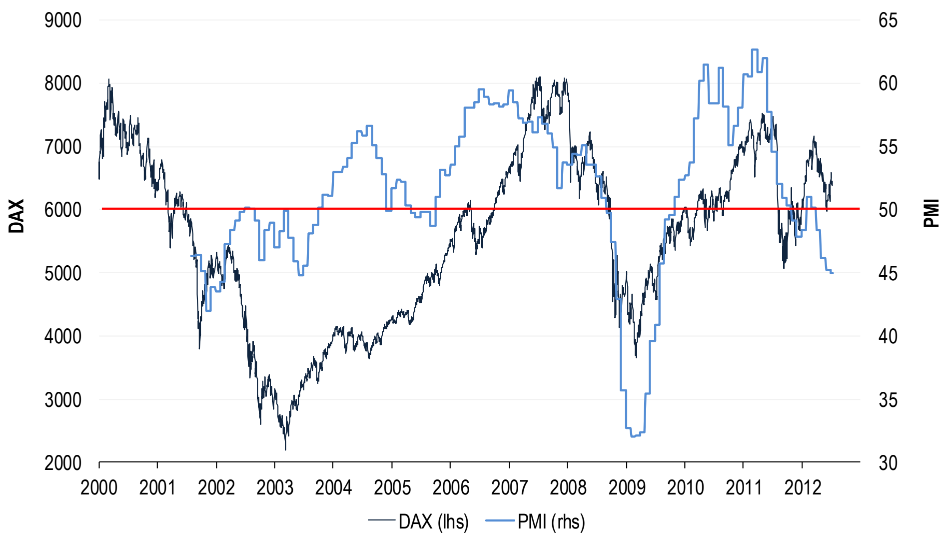
Chart 11: IFO Pan Germany Business Conditions and Expectations



Source: IR&M, Bloomberg

- The latest indication puts the German economy in the slowdown quadrant; i.e. the trend is from the upper right hand corner towards the lower left. Our interpretation of this is that financial conservatism is superior to financial aggression.

Chart 12: DAX and PMI



Source: IR&M, Bloomberg

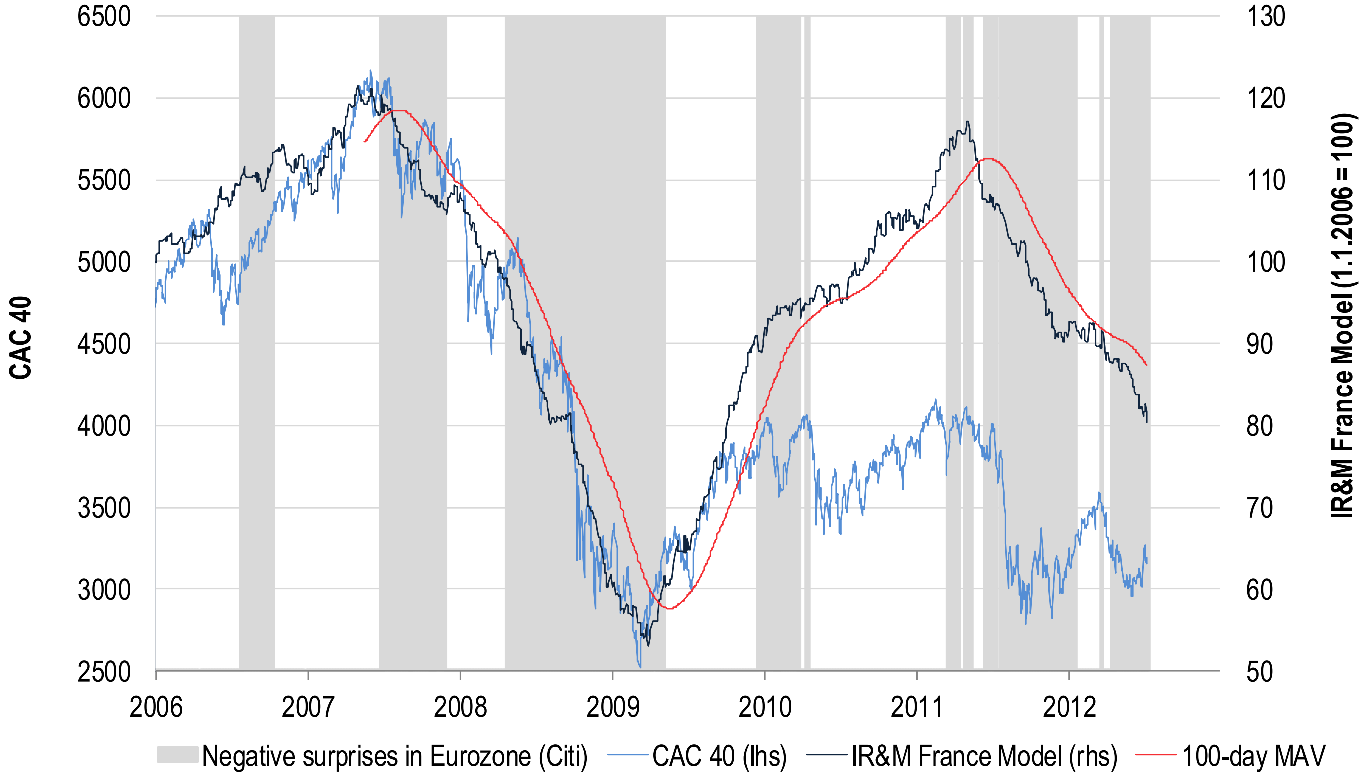
- German PMI has fallen below 50 in March and has been continuously falling ever since.

France: going Venezuela

Economic trend vs stock market

Chart 13 shows a model based on economic variables relevant to the economy in France.

Chart 13: IR&M France economic model vs CAC 40

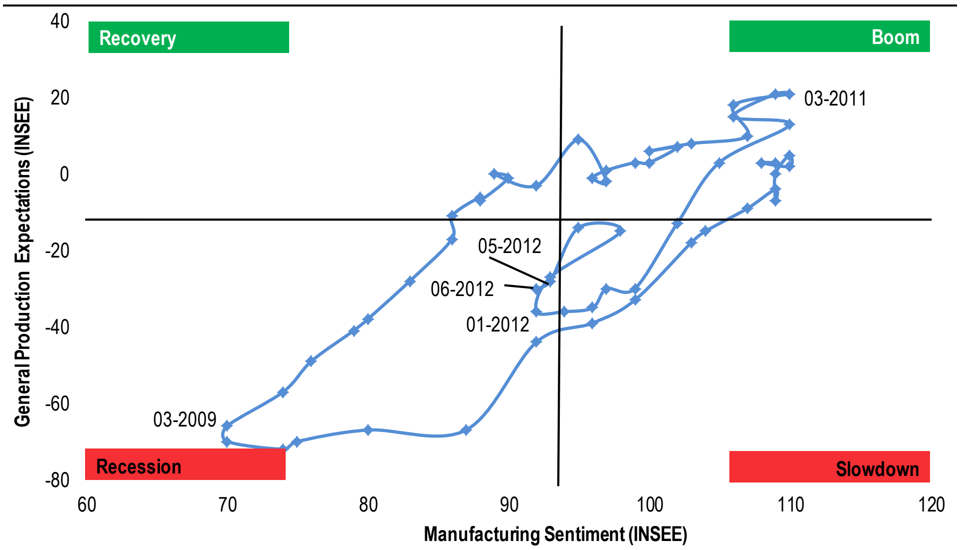


Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices for the Eurozone. IR&M France Model is based on 15 monthly indicators, was designed to give a data point nearly every day, and remains work in progress.

- Going socialist is probably not very helpful; see main section of this report.

Chart 14: INSEE Manufacturing Sentiment and General Production Expectations

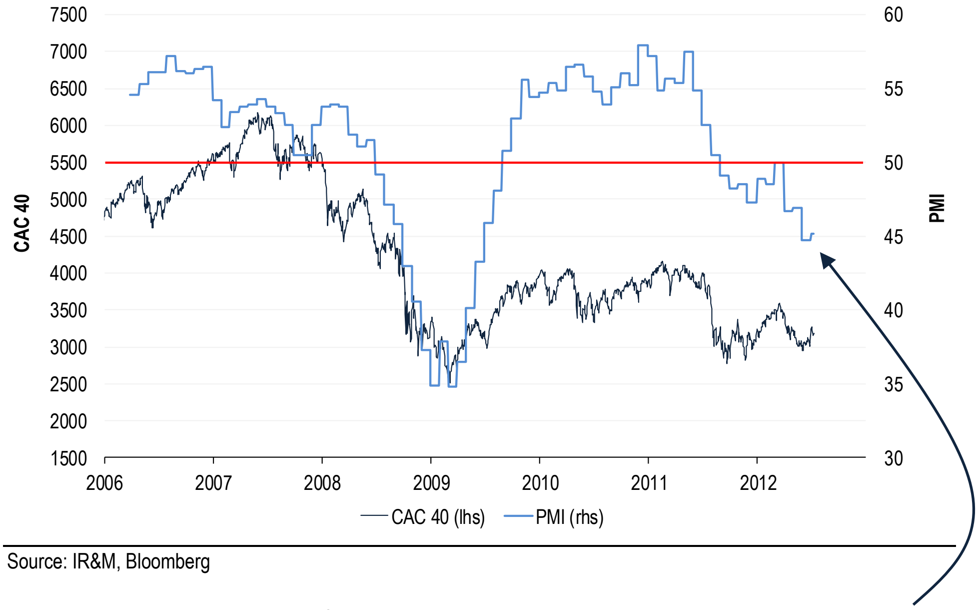
Chart 14 is analogous to Chart 11.



Source: IR&M, Bloomberg

- Our interpretation of this chart is that the economy is heading the wrong way.

Chart 15: CAC 40 and PMI



Source: IR&M, Bloomberg

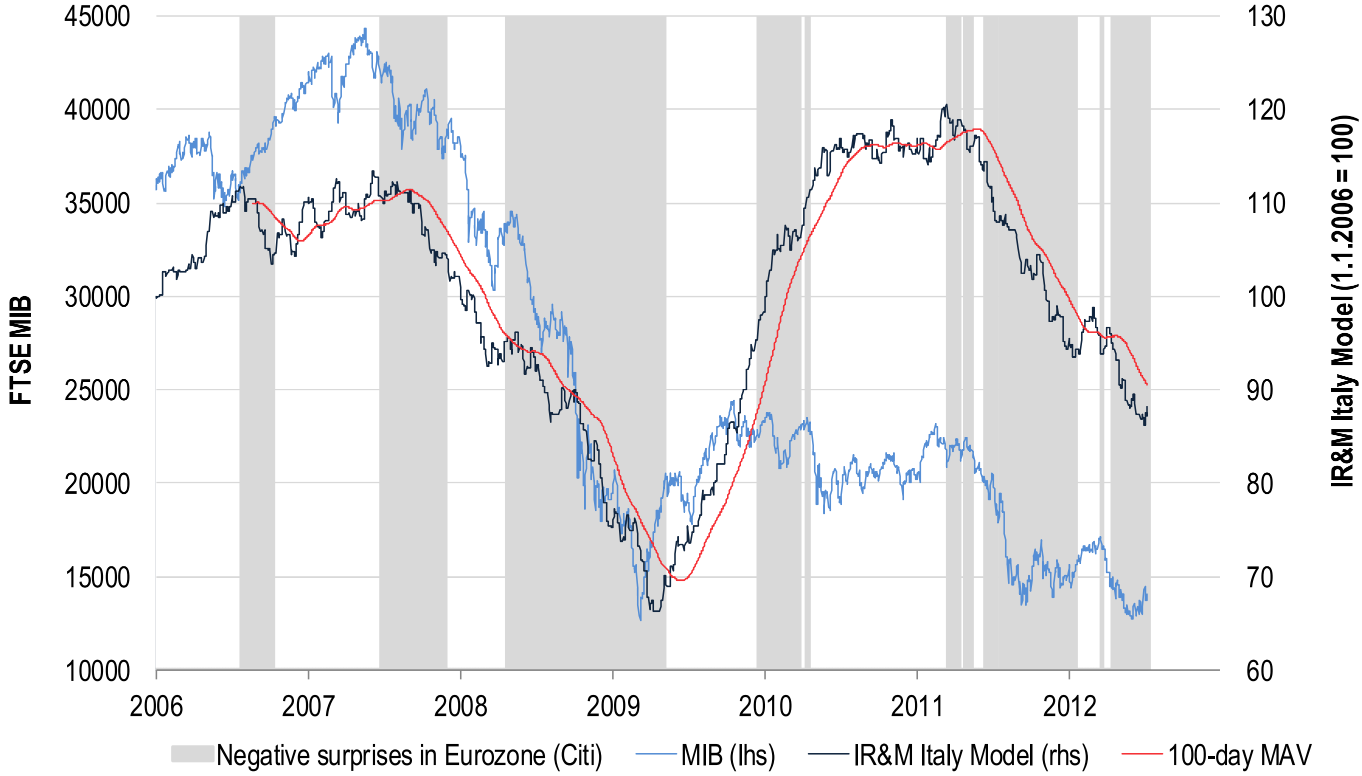
- Judging by PMI, most of Europe, the Eurozone and France are contracting economically.

Italy: declining

Economic trend vs stock market

Chart 16 shows a model based on economic variables relevant to the economy in Italy. Chart 17 shows consumer sentiment.

Chart 16: IR&M Italy economic model vs FTSE MIB



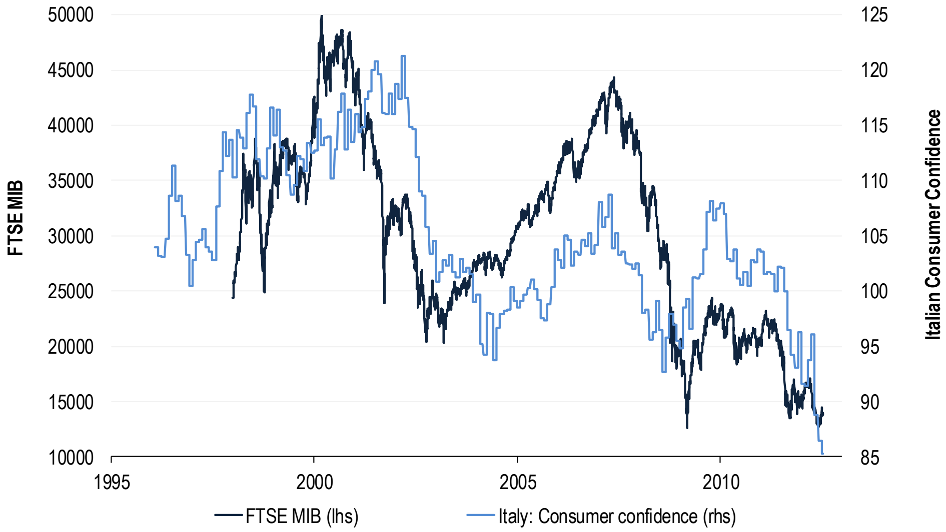
Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices for the Eurozone. IR&M Italy Model is based on 13 indicators, was designed to give a data point nearly every day, and remains work in progress.

- The steady decline of "things economic" in Italy has prevented the investor from becoming overtly bullish on Italian risk assets. However, many of Italy's problems are not shown by economic models, as pointed out in the first section of this document. And we haven't even mentioned the horrid demographics in Italy.

- Yes, we do indeed hear the contrarians sing in chorus "buy when you hear the canons, and sell when you hear the violins." We understand that logic. However, it seems wiser to wait until the canons fall silent a bit. There most likely will be an interval between the canon fire and one hears violins in Italy. (Given that Berlusconi wants to come back—thereby not lifting the rank of Italy in the *Perceived Corruption Index* all too much—there might be a satirical comedy prior to the violins.)

"Buy when the cannons are thundering and sell when the violins are playing."
—N.M. Rothschild (Nathan Mayer Rothschild)

Chart 17: Italian consumer sentiment and FTSE MIB



Source: IR&M, Bloomberg

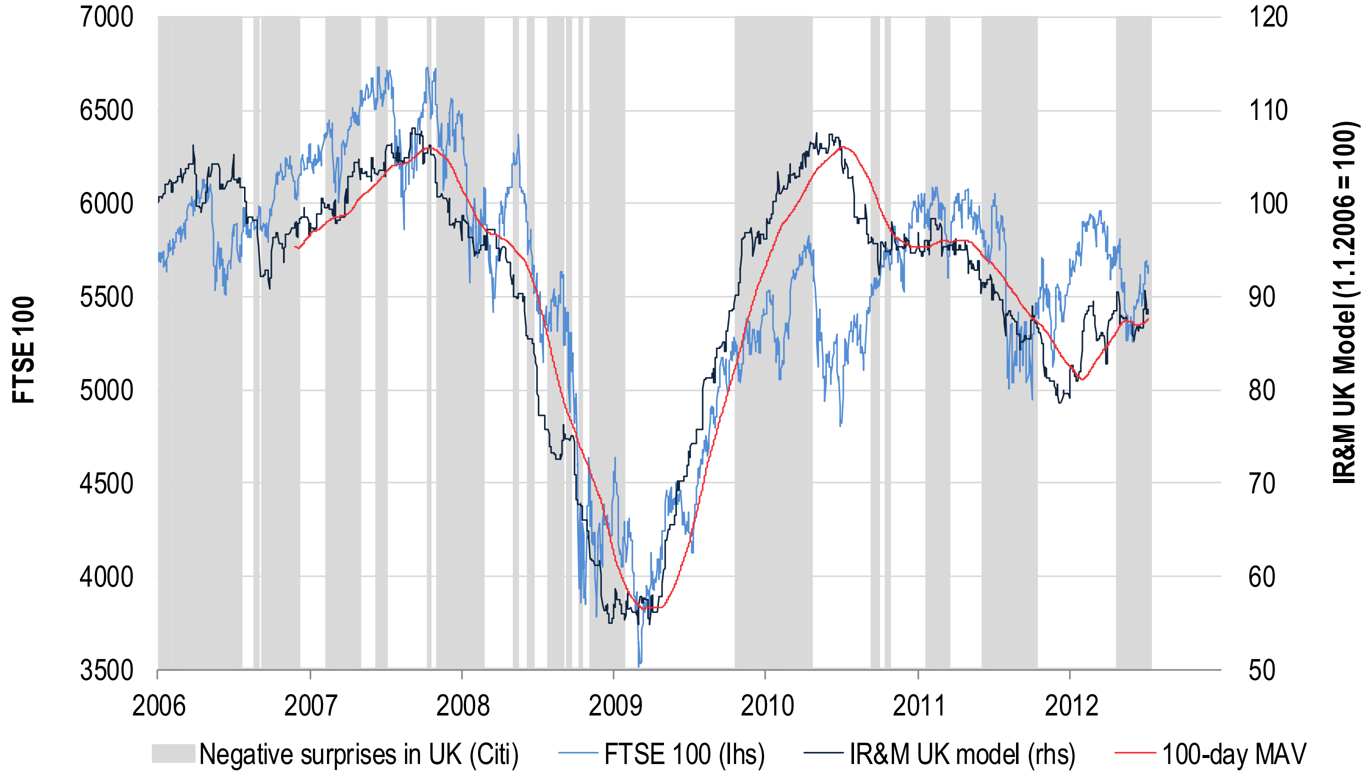
- Consumer sentiment is at a multi-year low.

UK: at inflection point

Economic trend vs stock market

Chart 18 shows a model based on economic variables relevant to the economy in the UK. Chart 19 examines GDP and business sentiment.

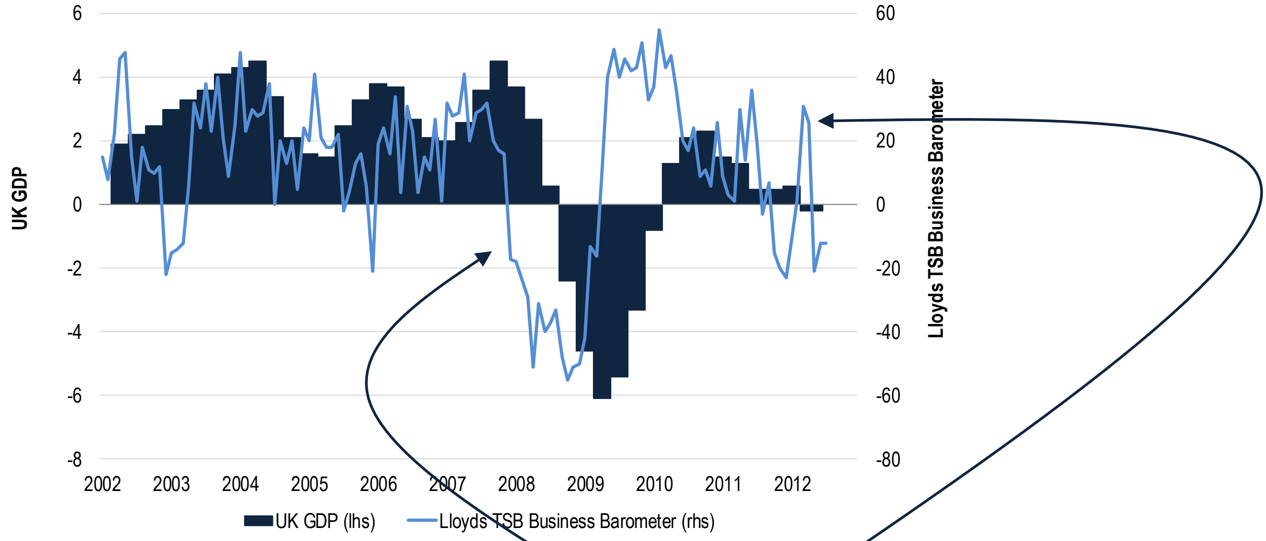
Chart 18: IR&M UK economic model vs FTSE 100



Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices for the UK. IR&M UK Model is based on 19 indicators, was designed to give a data point nearly every day, and remains work in progress.

- Surprises have been negative since 27 April. Our model shown in the graph has been moving erratically. Some indicators were very good and surprising massively on the upside, while others were the exact opposite. We don't have a very good interpretation of Chart 18 unfortunately. It is possible that the Queen's jubilee and the summer Olympics are having an impact on some of the sentiment indicators we look at.

Chart 19: UK GDP and business sentiment



Source: IR&M, Bloomberg.

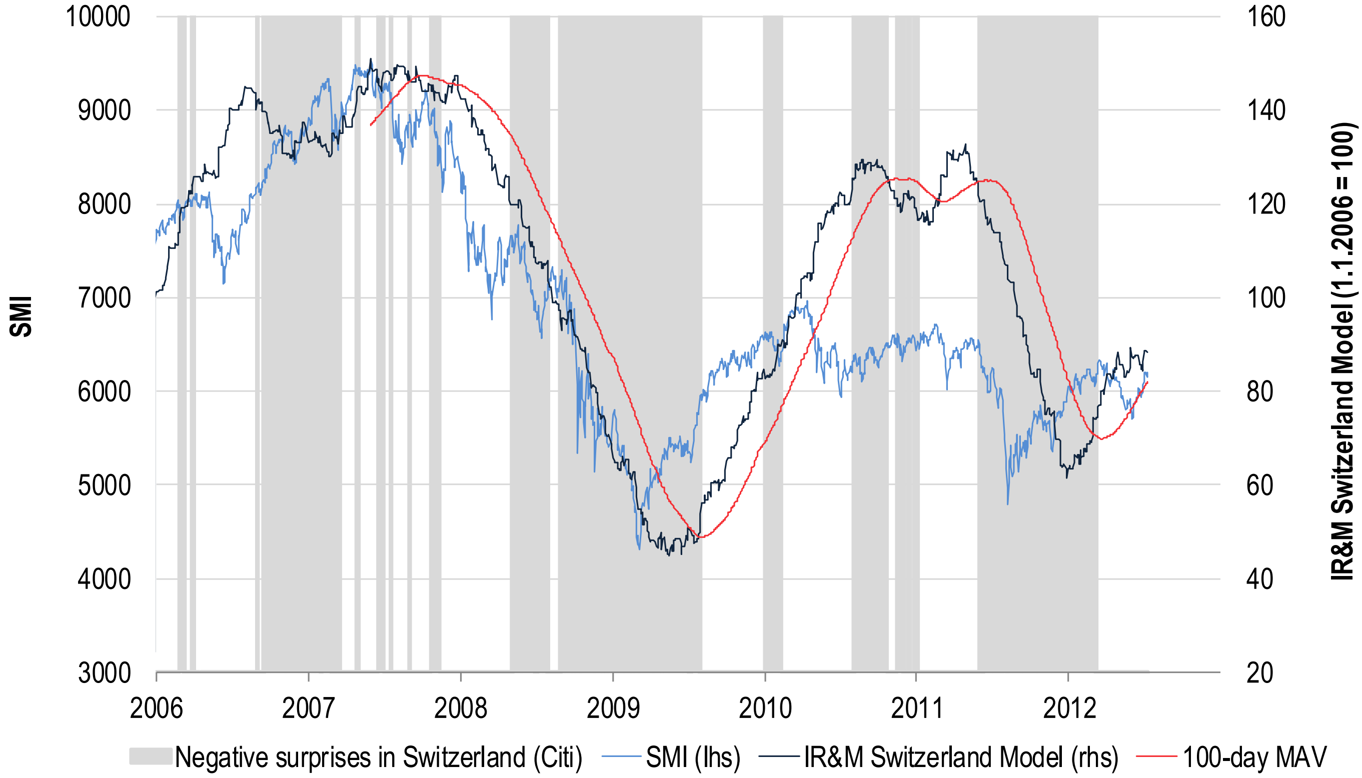
- The Lloyds TSB Business Barometer was an early indicator last time around.
- The spike in March and April had us a bit confused.
- Our current interpretation of the information we look at is that the UK is in recession but potentially at an inflection point. It seems that the UK was well-advised to stay out of the Eurozone. Furthermore, we get the impression that the current administration understands Wriston's Law of Capital. In Europe, that's quite a differentiator.

Switzerland: Safe harbour

Economic trend vs stock market

Chart 20 shows a model based on economic variables relevant to the economy in Switzerland.

Chart 20: IR&M Switzerland economic model vs SMI



Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices for Switzerland. IR&M Switzerland Model is based on 16 indicators, was designed to give a data point nearly every day, and remains work in progress.

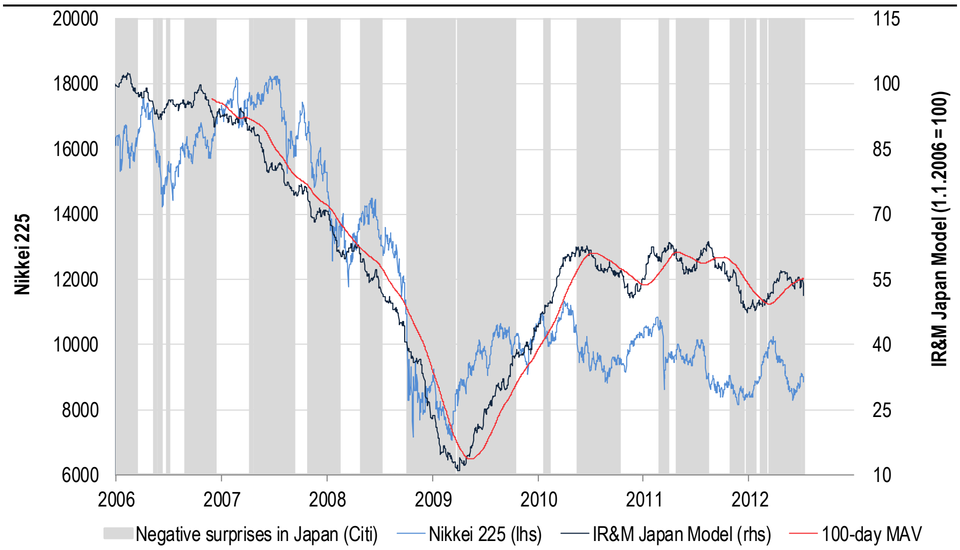
- Surprises have been positive since 8 March 2012. Our interpretation of the chart shown here is that the trend is up. However, Switzerland is not an island. Switzerland's PMI for example is strongly correlated with the Eurozone which is Switzerland's main trading partner.
- The long-term implications of the currency peg are unknown. Intuitively one would assume pegging a strong currency to a failed experiment is unwise; but then who knows?

Japan: at inflection point

Economic trend vs stock market

Chart 21 shows a model based on economic variables relevant to the economy in Japan. Chart 22 compares the Nikkei 225 with the Tankan Business Conditions Large Enterprises Manufacturing Index.

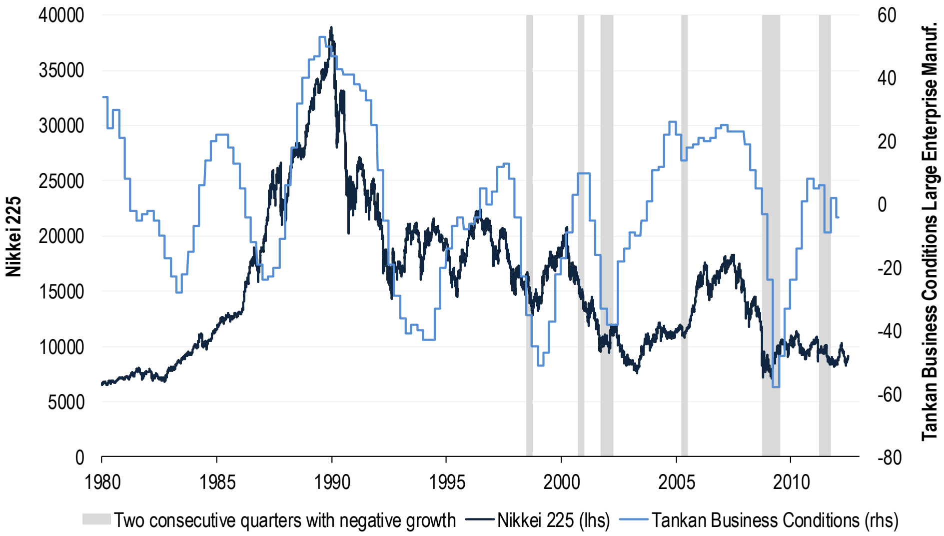
Chart 21: IR&M Japan economic model vs Nikkei 225



Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices. IR&M Japan Model is based on 22 indicators, one quarterly survey (Tankan), was designed to give a data point every day, and remains work in progress.

- The trend is not up. Surprises have been negative for a long while with only brief interruptions. The JPY is too strong for the economy to take off.

Chart 22: Nikkei 225 vs Tankan



Source: IR&M, Bloomberg

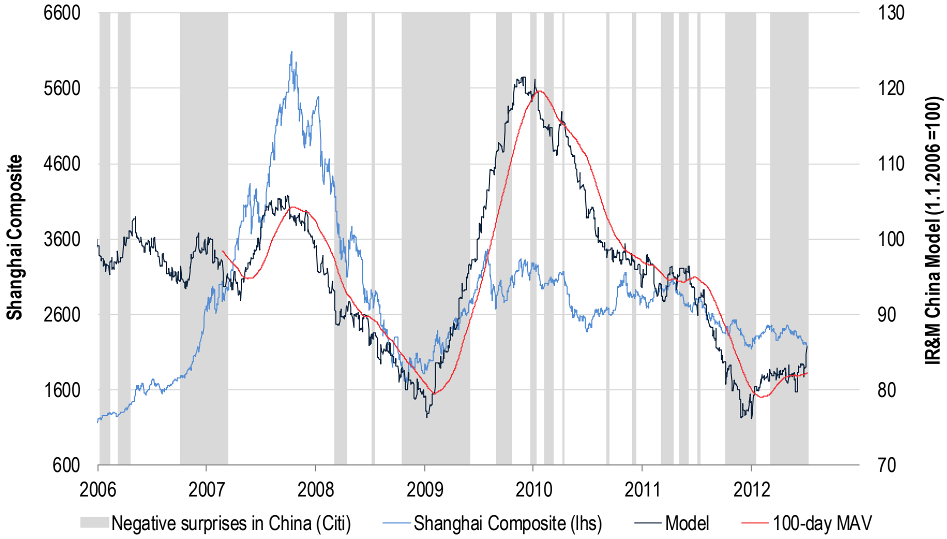
- The latest Tankan report was mixed at best.
- We are aware that "at inflection point" is a cheap shot. Ideally, we'd know exactly where Japan was heading. But we don't, hence the cheap shot. Valuation is low but political gridlock and demographics are not encouraging.

China: at inflection point

Economic trend vs stock market

Chart 23 shows a model based on economic variables relevant to the economy in China.

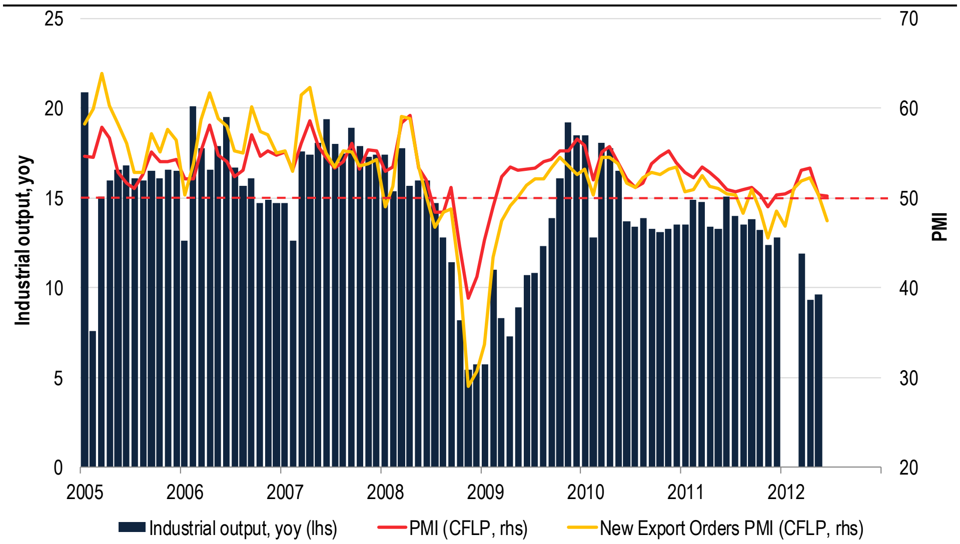
Chart 23: IR&M China economic model vs Shanghai Composite



Source: IR&M, Bloomberg. Notes: Surprises are based on Citigroup Expectations indices. IR&M China Model is based on 19 indicators, includes a daily read of relative performance between property stocks and a market index, was designed to give a data point every day, and remains work in progress. Note that we had issues with data on China in the past.

- The debate between hard and soft landing is not going away. Our interpretation of the data is that China is at an inflection point. Surprises have been negative since mid-March though.

Chart 24: PMI vs industrial output



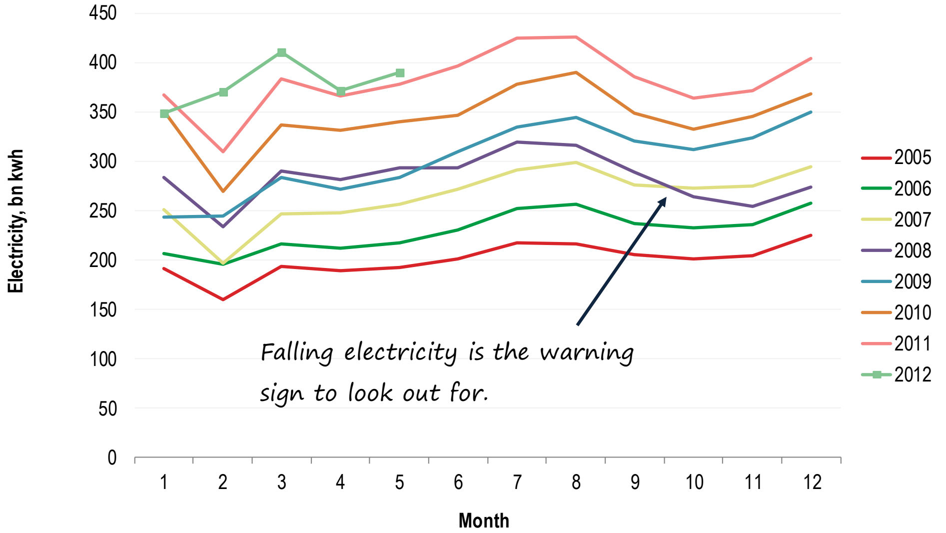
Source: IR&M, Bloomberg

- Official PMI was at 50.2 in June; exactly the middle between the economy contracting and expanding; hence the term "inflection point". New orders dipped below 50. Industrial output is contracting but not collapsing.

Economic health check

Thanks to WikiLeaks we know what politburo member Li Keqiang thinks are important and incorruptible measures for China's economic speed. Given China's high level of perceived corruption, it makes sense to look for incorruptible proxies. Li Keqiang is the First-ranking Vice-Premier and deputy Party secretary of the State Council of the People's Republic of China, the seventh ranked member of the Politburo Standing Committee, the People's Republic of China's de facto highest decision-making body. Most official statistics are "for reference only" he once confide—smiling, apparently—to the US ambassador. The three variables he looks at are electricity consumption, rail cargo volume, and bank lending. We look at electricity and rail cargo volume as a form of economic health check. Note that some researchers suggest that electricity data is corrupted too.

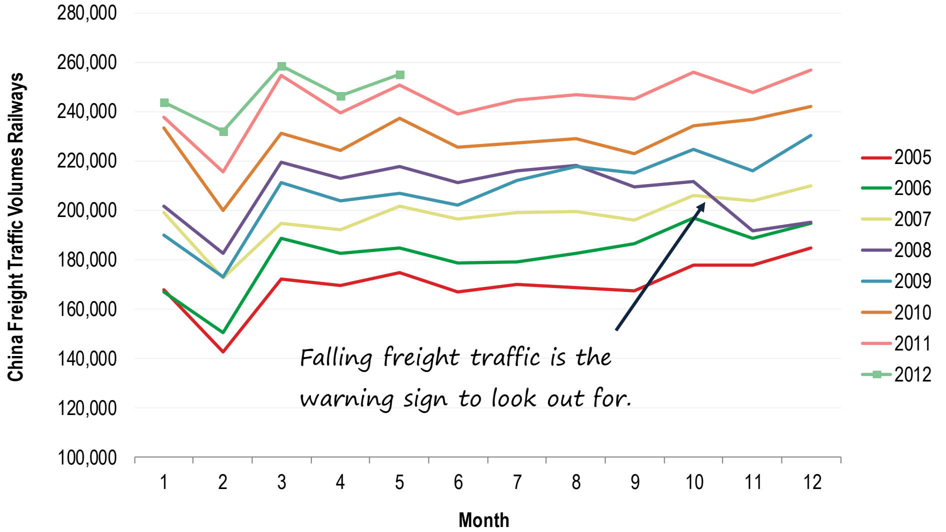
Chart 25: Electricity



Source: IR&M, Bloomberg

- Electricity remains above the previous year.

Chart 26: Freight traffic volume



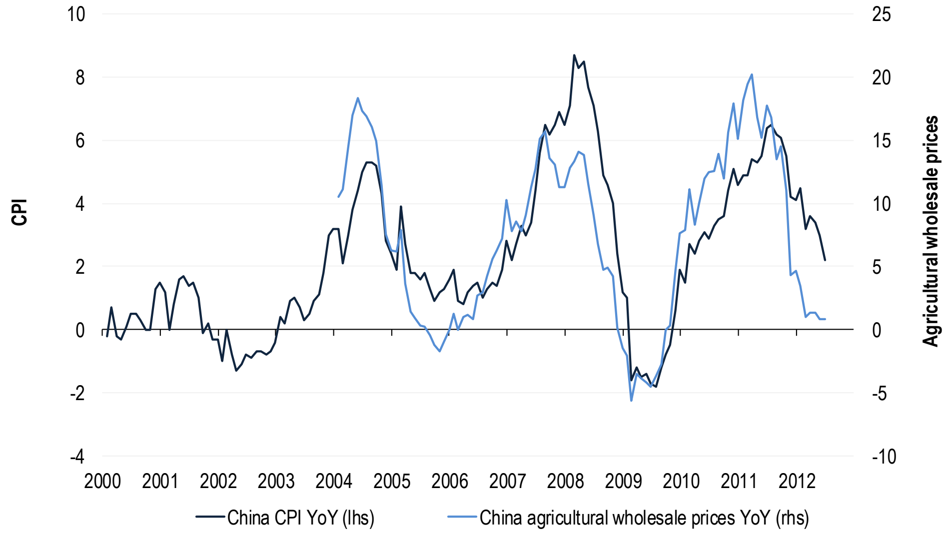
Source: IR&M, Bloomberg

- Freight traffic has been higher than in the previous year. We can tick these two boxes and move on.

Inflation

The spectre of inflation is not only an issue for China. One could argue inflation in China, or any negative surprises out of China, economic or geopolitical, are akin to a sword of Damocles bumbling over the global economy. The following graph shows CPI with agricultural wholesale prices. The reason inflation is important from a risk assessment standpoint is that food inflation spiralling out of control would not only bear the risk of economic weakness but also heighten the risk of intra-national tensions.

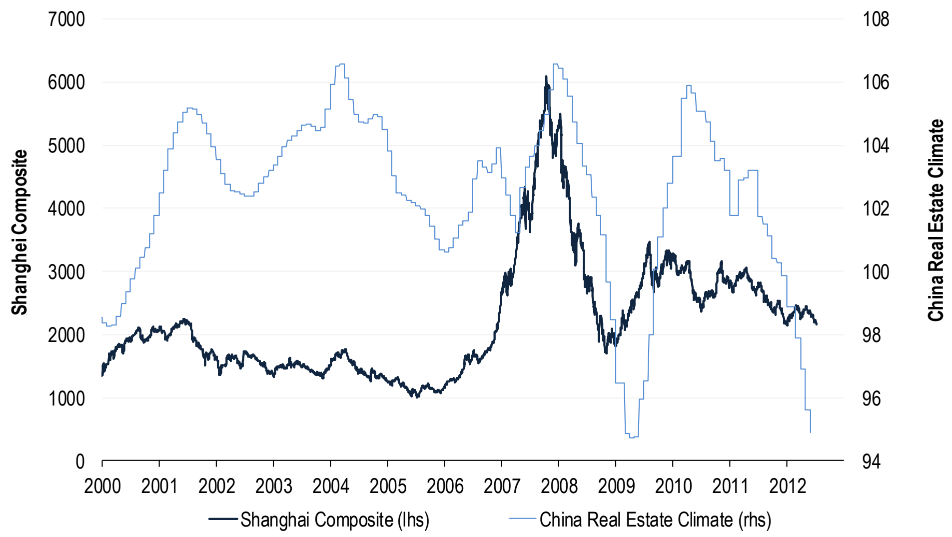
Chart 27: China CPI



Source: IR&M, Bloomberg

- Inflation seems under control. However, falling inflation has been interpreted by the market both positively as well as negatively. Good, giving the authorities more options to intervene; bad; because the authorities need to intervene again.

Chart 28: China Real Estate Climate



Source: IR&M, Bloomberg

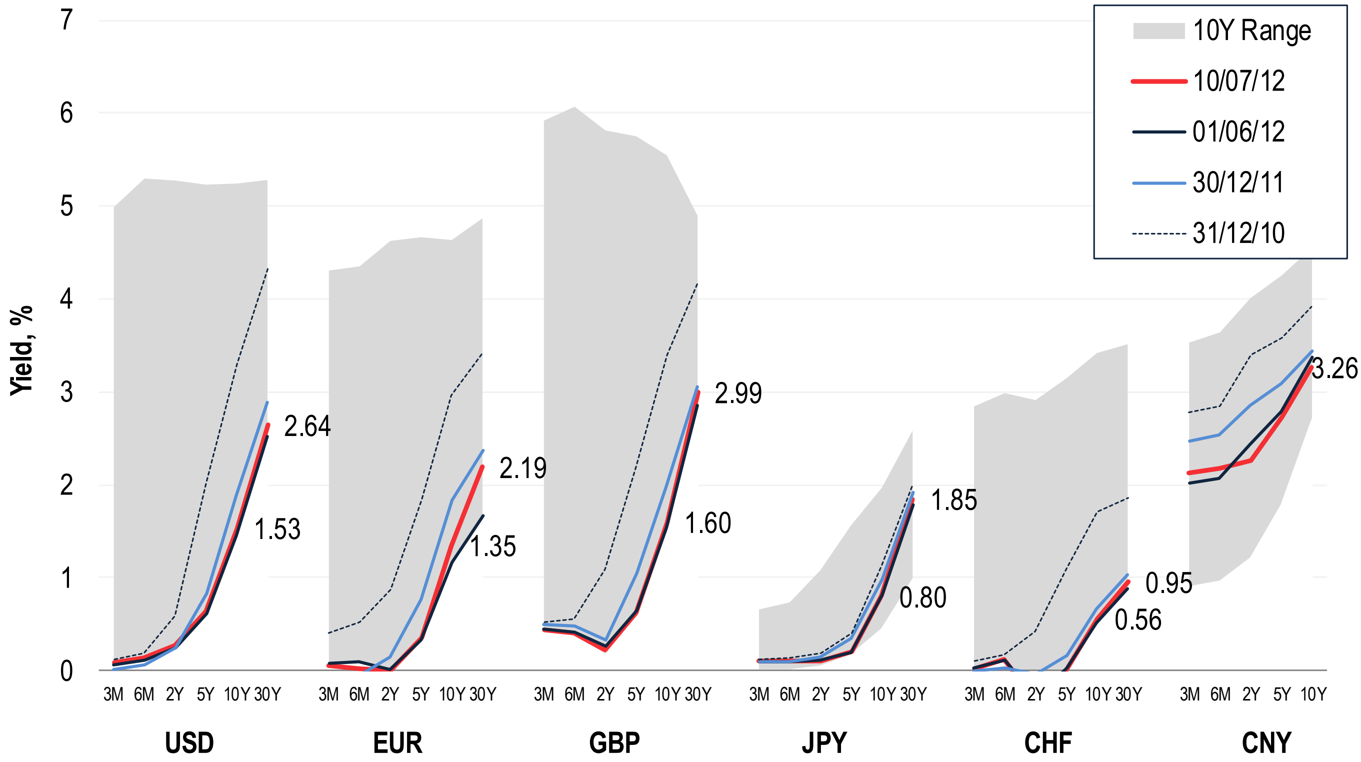
- Real estate prices as well as real estate sentiment has been falling. However, the stock market has not crashed. It is not entirely unthinkable that the local private investor soon will regard the stock market as the least unattractive option.

Risk

Yield curves

Table 12 shows six yield curves, the changes over one week, one month, and year-to-date, as well as the 10-year range.

Table 12: Yield curves



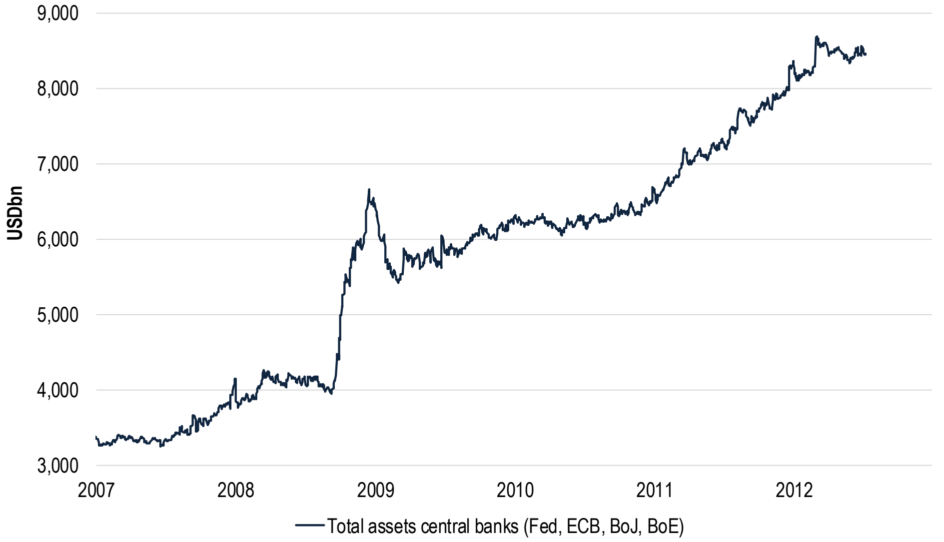
Source: IR&M, Bloomberg
Note: Numbers in graph stand for 10-year and 30-year yields. Short end of CHF yield curve "disappears" because yields are negative.

- We call the fall and flattening of the yield curve "Japanisation". The first three yield curves seem to be continuously moving to resemble the yield curve of Japan (or Switzerland).
- We expect this chart to warn us early when these curves start to move northwards. This will be relevant for bond risk as well as assessments of currencies. It is not entirely unthinkable that inflation will be an issue during most people's life time. Speaking of inflation:

Central banks

Chart 29 shows the sum of four central bank balance sheets.

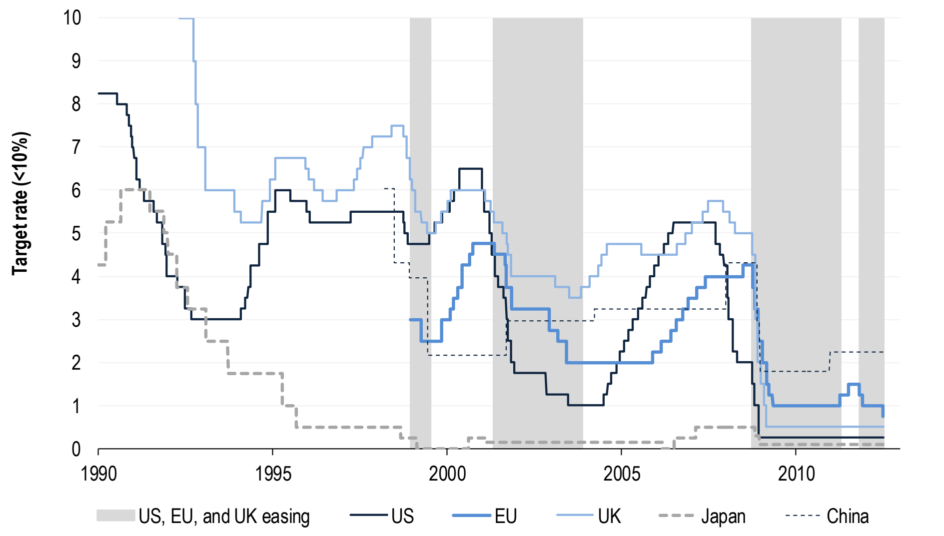
Chart 29: Total assets central banks



Source: IR&M, Bloomberg

- The trend is unmistakably from the lower left to the upper right. This is a "helping hand" rather than an invisible one. The cost to society from this "help" is yet unknown. However, history suggests that the help is not entirely "free of charge".

Chart 30: Target rates



Source: IR&M, Bloomberg

- Central banks, including China, are easing. Money was, is, and remains cheap. And is hoarded.

- EUR rates fell below 1% for the first time on 5th July.

Financial risk monitor

Table 13 is a risk monitor. The idea is to show heightened risk or stress very early on. We update this frequently in our on-screen updates.

Table 13: Financial risk monitor

		10-year*			2010		2011												2012						
Market	Risk proxy	High	Low	Median	11	12	01	02	03	04	05	06	07	08	09	10	11	12	01	02	03	04	05	06	Last
Composite	St. Louis Fed Stress	5.5	-1.3	0.1	0.2	0.1	-0.1	-0.1	-0.1	-0.3	-0.1	0.1	0.0	0.8	1.1	0.7	1.0	0.7	0.5	0.3	0.1	0.2	0.4	0.3	0.3
	BB Financial Conditions	1.3	-12.7	-0.1	-0.3	0.2	0.1	0.4	0.4	0.6	0.5	0.5	0.0	-0.9	-1.8	-1.0	-1.0	-1.0	-0.5	-0.1	0.1	0.0	-0.7	-0.1	-0.1
	Citi Macro Risk	0.99	0.0	0.42	0.51	0.28	0.33	0.32	0.32	0.31	0.44	0.40	0.68	0.90	0.97	0.82	0.85	0.79	0.59	0.47	0.36	0.35	0.72	0.36	0.40
Liquidity	LIBOR 1M OIS Spread	338	1	9	7	8	9	11	12	10	9	8	8	13	15	16	18	22	17	13	12	10	8	8	8
	Euro Libor-OIS Spread	196	-2	27	33	41	21	25	21	16	28	20	35	64	81	81	98	97	77	63	42	39	39	42	39
	Euro Basis Swap Spread	-3	-300	-38	-56	-60	-31	-33	-21	-8	-26	-28	-46	-80	-105	-92	-131	-114	-72	-67	-51	-45	-50	-54	-57
Credit	TED Spread	464	9	31	15	18	16	17	21	24	21	24	16	32	35	44	53	57	49	41	40	37	40	38	37
	EmMa Spread	1037	111	278	277	241	246	237	227	234	247	239	256	336	462	376	418	425	398	338	314	330	413	378	372
	CDX.NA.IG	279	29	95	100	85	84	82	96	88	89	91	96	115	144	121	128	120	101	94	91	95	123	112	111
	iTraxx 5Y Europe	217	20	88	117	105	98	98	102	97	102	106	117	153	202	162	185	173	143	129	125	140	180	166	173
	iTraxx 5Y E. Crossover	1150	150	410	522	437	416	386	384	353	370	395	438	646	839	660	757	755	620	568	613	650	719	662	678
Sovereign	iTraxx 5Y E. Sovereign	386	47	183	203	210	176	179	174	187	197	217	270	293	339	304	327	357	338	343	269	275	326	282	285
(5Y CDS)	Greece	5047	5	36	976	1074	869	941	1003	1350	1420	1952	1722	2261	3536	>5000				essentially default					
	Ireland	1192	5	222	611	615	596	585	642	661	669	769	790	769	700	694	711	726	621	603	572	566	726	553	547
	Portugal	1527	4	32	543	500	433	465	580	653	679	745	924	918	1110	970	1060	1093	1484	1175	1076	961	1185	805	841
	Spain	621	3	35	365	350	249	249	233	237	251	270	363	358	382	340	408	394	376	368	437	476	599	531	587
	Italy	592	6	27	269	238	180	183	151	148	164	171	310	361	470	445	487	503	416	381	397	445	563	488	522
	Belgium	406	2	8	201	218	173	174	139	143	151	143	199	230	260	269	304	316	245	238	233	252	282	240	224
	France	250	2	11	105	101	99	91	74	74	73	80	122	154	187	176	200	222	181	176	169	193	219	189	184
Rates	BBOX (swaption volat.)	138	68	91	96	101	100	97	99	96	96	98	98	93	94	96	97	94	86	91	89	86	82	80	79
Bonds	MOVE (bond volat.)	265	51	96	102	110	96	91	91	77	72	89	88	98	101	107	100	91	72	76	79	63	74	73	63
Equities	VIX (equity volat.)	81	10	19	24	18	20	18	18	15	15	17	25	32	43	30	28	23	19	18	16	17	24	17	18
	Skew Index (CBOE)	142	106	119	117	121	130	129	125	127	124	122	121	120	115	121	117	116	122	125	125	120	119	119	120
FX	VXY (G7 FX volat.)	24	6	10	13	13	11	10	11	11	11	11	12	12	14	12	13	12	11	10	10	9	11	10	9

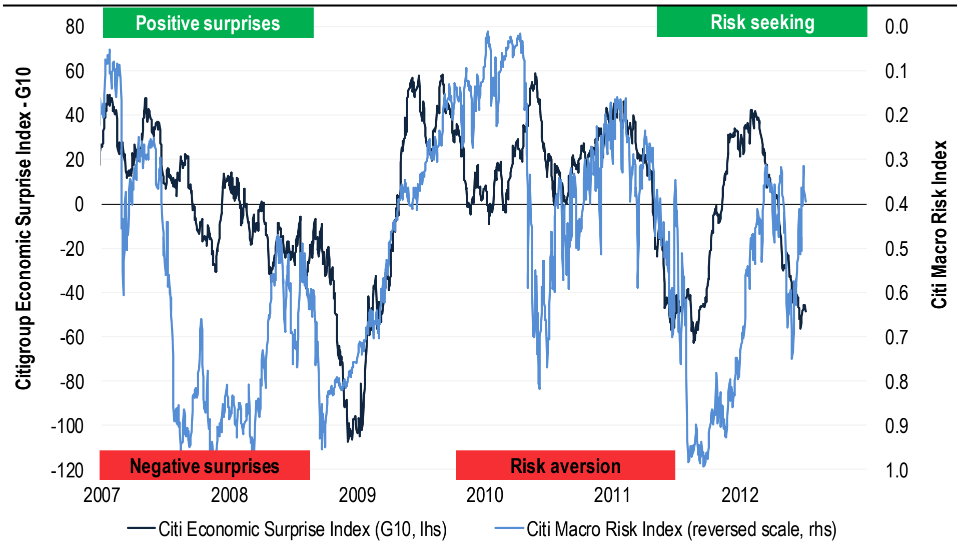
Source: IR&M, Bloomberg
Note: *10-year period or since data is available.

- The colour coding allows to spot where the issues are at a brief glance.
- The bone of contention in the Eurozone crisis is the sovereign risk of Italy and Spain. They're too big to fail, but doing exactly that.
- Default insurance for Italy and Spain has been rising during July.

Macro and geopolitical uncertainty

Chart 31 combines the Citigroup Macro risk index with the Citigroup G10 Economic Surprise Index. All is well when these indices are rising, surprises rising above the zero line.

Chart 31: Macro risk and financial conditions



Source: IR&M, Bloomberg

- Many risks that investors face today are beyond "macro" as the first section of this report tries to bring across.

Table 14 shows the IR&M bubble monitor that we update quarterly. It's a tick-the-box approach to six characteristics that are typically associated with a building bubble. Note that the box ticking is only semi-factual, i.e., some ticks are open to debate.

Table 14: IR&M bubble monitor

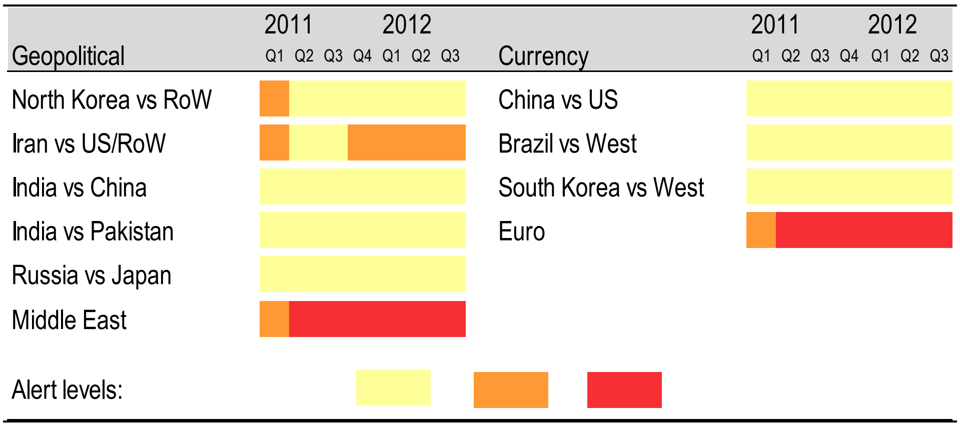
	Gold	US Treas.	China real estate	China stocks	EmMa stocks
Prices at or close to all-time-high	☒	☑	☒	☒	☒
Very strong recent price rise	☒	☒	☒	☒	☒
Money too cheap for too long	☑	☑	☑	☑	☑
Excessive use of leverage	☒	☒	☑	☒	☒
Retail participation	☑	☒	☑	☒	☒
Front-page news (TV, Mags, etc.)	☒	☒	☑	☒	☒
	☒	No	☑	Yes, be alert!	

Source: IR&M
Note: changes to previous quarterly report are marked with grey.

- Chinese real estate bubble seems to be deflating in an orderly fashion.
- The deflating of the welfare state bubble might not be as orderly.

Table 15 shows the IR&M conflict monitor that we update quarterly. It's a tick-the-box approach to a selection of geopolitical as well as currency (war) conflict zones.

Table 15: IR&M conflict monitor



Source: IR&M

"Amazingly, some people refuse to acknowledge that Iran's goal is to develop nuclear weapons. You see, Iran claims that it's enriching uranium to develop medical research. Yeah, right. If it looks like a duck, walks like a duck, and quacks like a duck, then what is it? That's right, it's a duck. But this duck is a nuclear duck and it's time the world started calling a duck a duck.

Fortunately, President Obama and most world leaders understand that the idea that Iran's goal is not to develop nuclear weapons is ridiculous."

—Binyamin Netanyahu[1]

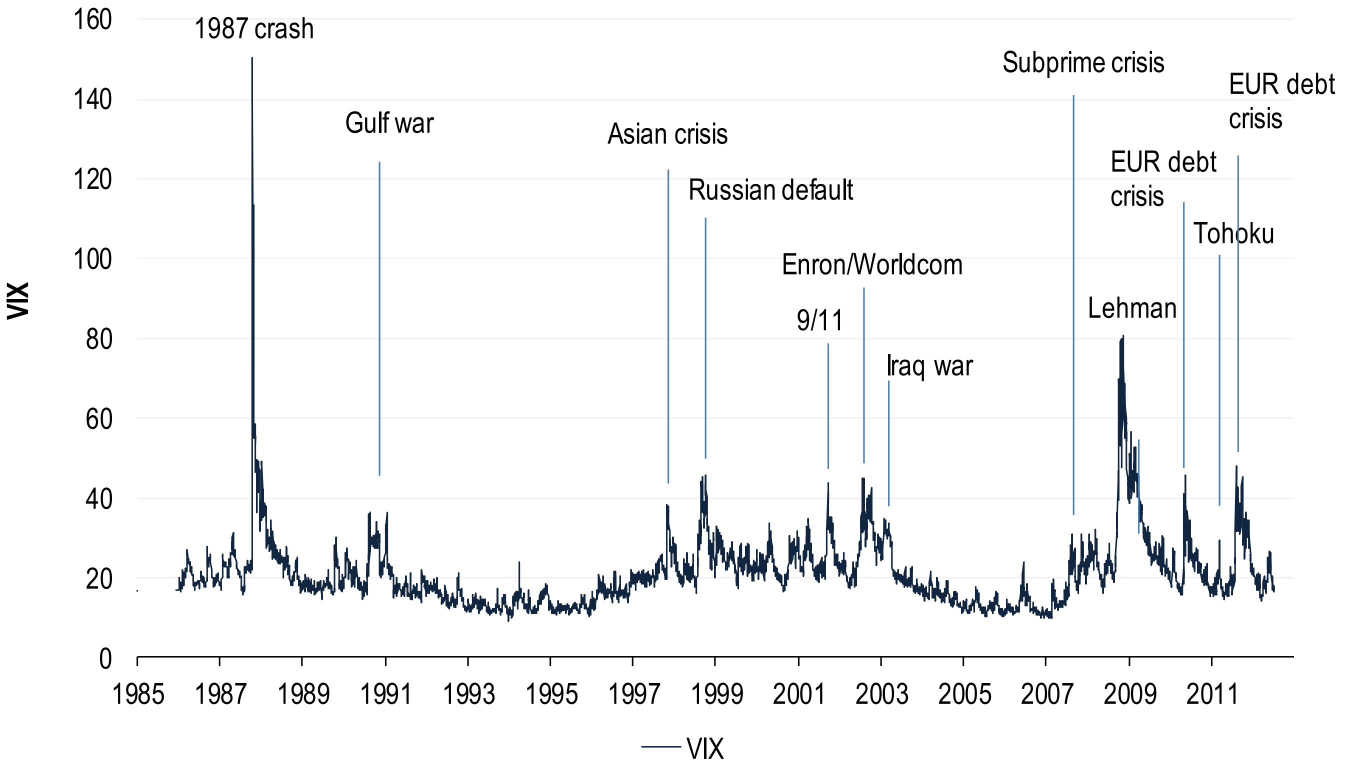
- Binyamin Netanyahu, the Israeli prime minister, has been to Washington DC. Whether he got the sign off to attack Iran or whether was asked to hold back, indefinitely or until after the US elections, we don't know.
- The Middle East and the Eurozone remain in turmoil.
- Note that this table is also an indication for the impact of Wriston's Law of Capital. The migration of capital and the flight of capital currently have its origin in areas in turmoil.

[1] The Guardian, Netanyahu on Iran: 'None of us can afford to wait much longer', 6 March 2012

Fear gauge

Chart 32 shows the most prominent risk/fear gauge, the legendary VIX.

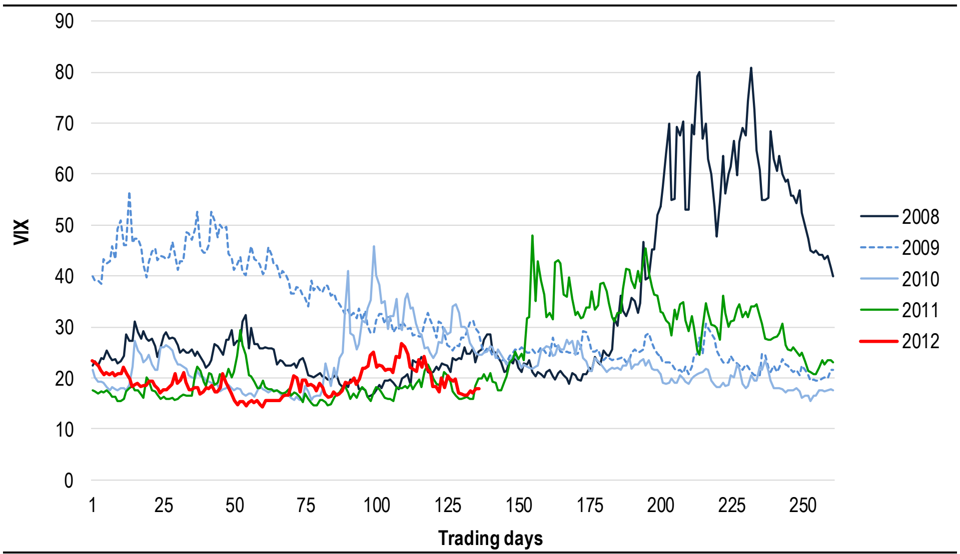
Chart 32: VIX



Source: IR&M, Bloomberg

- VIX has risen from the abnormally low levels of 15% at the end of March pointed out in our last quarterly report. However, the average for 2012 is 19.1% which compares to 24.1% in 2011, 22.5% in 2010, 31.5% in 2009 and 32.6% in 2008. Somehow Chart 33 suggests that the calendar year is not over yet.

Chart 33: VIX by calendar year



Source: IR&M, Bloomberg

Appendix

Government expenditure and corruption

Table 16: Government expenditure and corruption, all 168 countries, sorted by last column, good to bad

	Tax burden % GDP (1)	Govt. expend. % GDP (2)	Perc. Corruption Index (3)	Rank of (2) from 168	Rank of (3) from 168	Average rank from 168
Singapore	13.4	17.0	9.2	9	5	7
Hong Kong	13.9	17.3	8.4	12	12	12
Bahamas	15.3	22.2	7.3	30	21	26
Costa Rica	13.8	17.5	4.8	14	47	31
Macau	27.4	19.9	5.2	20	42	31
Chile	16.1	24.4	7.2	40	22	31
United Arab Emirates	1.8	25.8	6.8	45	28	37
Mauritius	18.9	23.5	5.2	35	42	39
Qatar	5.6	29.7	7.2	63	22	43
El Salvador	14.0	17.2	3.4	10	77	44
Australia	27.1	33.1	8.8	79	8	44
Peru	15.2	17.4	3.4	13	77	45
Switzerland	30.3	33.7	8.8	85	8	47
Rwanda	12.3	26.8	5.0	49	46	48
Madagascar	10.5	14.6	3.0	3	95	49
Uruguay	25.1	32.3	7.0	74	25	50
Thailand	14.9	20.4	3.4	23	77	50
Saint Lucia	28.1	32.8	7.0	76	25	51
Gambia	13.6	22.0	3.5	27	74	51
Panama	17.0	19.8	3.3	19	83	51
Indonesia	11.4	16.7	3.0	7	95	51
China	17.5	23.0	3.6	33	72	53
Bahrain	4.0	30.4	5.2	67	42	55
Guatemala	10.7	14.3	2.7	1	114	58
Bangladesh	8.6	14.3	2.7	1	114	58
Zambia	15.0	22.4	3.2	31	87	59
Namibia	28.9	30.0	4.4	64	55	60
South Korea	25.6	33.1	5.4	79	41	60
Vanuatu	17.2	25.9	3.5	46	74	60
Malaysia	15.7	30.3	4.3	66	57	62
New Zealand	31.0	42.8	9.5	123	1	62
Ethiopia	8.6	17.2	2.7	10	114	62
Sri Lanka	12.8	24.9	3.3	42	83	63
Burkina Faso	12.6	23.1	3.0	34	95	65
South Africa	23.4	30.6	4.1	69	61	65
Dominican Republic	13.1	16.9	2.6	8	123	66
Luxembourg	37.5	42.2	8.5	121	11	66
Japan	28.1	42.0	8.0	120	14	67
Saint Vincent and the Grenadines	27.1	36.2	5.8	99	35	67
Morocco	23.0	29.0	3.4	58	77	68
Jordan	16.2	33.2	4.5	81	54	68
Cape Verde	20.6	35.7	5.5	97	39	68
Gabon	14.3	24.8	3.0	41	95	68
Canada	31.1	44.1	8.7	129	10	70
Colombia	15.0	29.4	3.4	62	77	70
Tanzania	15.3	25.7	3.0	44	95	70
Philippines	12.8	18.5	2.6	17	123	70
Tunisia	19.9	30.8	3.8	71	70	71
Benin	16.1	25.9	3.0	46	95	71
Uganda	12.5	15.3	2.4	5	136	71
Botswana	30.4	39.3	6.1	109	32	71
Cameroon	10.3	17.5	2.5	14	128	71
Bhutan	9.9	38.6	5.7	106	37	72
United States	24.0	42.2	7.1	121	24	73
Liberia	22.1	29.0	3.2	58	87	73
Norway	41.0	46.4	9.0	141	6	74
Mexico	17.5	26.9	3.0	52	95	74
Seychelles	30.9	36.7	4.8	100	47	74
Pakistan	9.3	19.9	2.5	20	128	74
Macedonia	26.1	33.3	3.9	82	66	74
Barbados	32.3	44.7	7.8	133	16	75
India	16.8	29.0	3.1	58	91	75
Kazakhstan	21.5	23.5	2.7	35	114	75
Central African Republic	8.7	15.4	2.2	6	146	76
Oman	4.2	39.3	4.8	109	47	78
Senegal	18.3	26.8	2.9	49	107	78
Germany	37.0	47.5	8.0	143	14	79
Mali	16.4	25.9	2.8	46	112	79
Honduras	15.7	23.5	2.6	35	123	79
Turkey	24.6	37.2	4.2	102	58	80
Sierra Leone	10.4	22.9	2.5	32	128	80
Togo	14.5	21.9	2.4	26	136	81
Estonia	34.7	45.2	6.4	134	29	82
Netherlands	39.1	51.4	8.9	156	7	82
Albania	25.7	31.9	3.1	72	91	82
Malta	27.8	43.3	5.6	125	38	82
Paraguay	14.5	19.6	2.2	18	146	82
Ireland	27.8	48.2	7.5	145	19	82
Samoa	22.7	35.9	3.9	98	66	82
Comoros	10.4	22.1	2.4	28	136	82
Finland	43.1	56.2	9.4	163	2	83
Sweden	46.4	55.2	9.3	162	4	83
Georgia	24.4	38.5	4.1	105	61	83
Nepal	12.2	19.9	2.2	20	146	83
Israel	31.4	44.3	5.8	131	35	83
Nicaragua	22.2	23.8	2.5	38	128	83
Denmark	48.2	58.4	9.4	165	2	84
Dominica	31.6	43.3	5.2	125	42	84
Iceland	34.1	51.0	8.3	154	13	84
Iran	9.3	27.8	2.7	53	114	84
Cyprus	25.8	45.8	6.3	138	30	84
Spain	30.7	45.8	6.2	138	31	85
Laos	13.1	21.1	2.2	24	146	85
Côte d'Ivoire	16.5	21.1	2.2	24	146	85
Kuwait	1.5	41.9	4.6	119	52	86
Cambodia	9.4	18.3	2.1	16	155	86
United Kingdom	34.3	51.2	7.8	155	16	86
Turkmenistan	21.8	14.7	1.6	4	167	86
Niger	13.6	25.5	2.5	43	128	86
Poland	34.3	44.6	5.5	132	39	86
Suriname	30.6	32.9	3.0	77	95	86
Syria	11.5	26.8	2.6	49	123	86
Trinidad and Tobago	14.1	34.1	3.2	86	87	87
Lithuania	13.8	44.1	4.8	129	47	88
Austria	42.8	53.1	7.8	160	16	88
Brazil	34.3	38.8	3.8	108	70	89
Slovakia	29.3	41.5	4.0	116	63	90
Romania	27.4	38.7	3.6	107	72	90
Armenia	16.4	28.9	2.6	57	123	90
Belgium	43.2	54.1	7.5	161	19	90
Slovenia	37.9	49.0	5.9	148	34	91
Portugal	35.2	49.8	6.1	150	32	91
Ghana	23.7	41.5	3.9	116	66	91
Latvia	26.9	43.3	4.2	125	58	92
Jamaica	26.7	37.1	3.3	101	83	92
Tonga	19.5	35.5	3.1	94	91	93
Croatia	19.1	42.8	4.0	123	63	93
Mozambique	15.4	32.0	2.7	73	114	94
Saudi Arabia	5.4	45.7	4.7	137	51	94
France	41.9	56.2	7.0	163	25	94
Malawi	16.5	35.5	3.0	94	95	95
Vietnam	22.3	33.4	2.9	83	107	95
Guinea	15.8	24.1	2.1	39	155	97
Haiti	11.7	22.1	1.8	28	166	97
Swaziland	35.9	38.1	3.1	104	91	98
Czech Republic	34.8	45.9	4.4	140	55	98
Bulgaria	25.7	40.7	3.3	113	83	98
Egypt	15.3	34.6	2.9	89	107	98
Argentina	31.6	37.9	3.0	103	95	99
Tajikistan	17.6	28.6	2.3	55	144	100
Kenya	20.7	28.7	2.2	56	146	101
Ecuador	17.9	34.5	2.7	88	114	101
Hungary	39.1	50.2	4.6	151	52	102
Nigeria	6.9	30.4	2.4	67	136	102
Lebanon	17.2	32.5	2.5	75	128	102
Mauritania	15.2	30.6	2.4	69	136	103
Bolivia	22.6	35.5	2.8	94	112	103
Mongolia	20.6	35.2	2.7	92	114	103
Montenegro	26.7	47.7	4.0	144	63	104
São Tomé and Príncipe	16.7	41.2	3.0	114	95	105
Papua New Guinea	22.4	30.2	2.2	65	146	106
Democratic Republic of the Congo	15.9	28.2	2.0	54	159	107
Chad	7.1	29.3	2.0	61	159	110
Djibouti	21.0	43.8	3.0	128	95	112
Italy	43.5	51.8	3.9	157	66	112
Algeria	11.1	41.7	2.9	118	107	113
Azerbaijan	14.4	34.8	2.4	90	136	113
Cuba	21.2	75.2	4.2	168	58	113
Greece	29.4	52.9	3.4	159	77	118
Guinea-Bissau	10.2	35.0	2.2	91	146	119
Kyrgyzstan	22.2	33.4	2.1	83	155	119
Bosnia and Herzegovina	37.0	50.2	3.2	151	87	119
Guyana	21.6	40.0	2.5	112	128	120
Lesotho	56.9	65.5	3.5	167	74	121
Moldova	32.0	45.2	2.9	134	107	121
Venezuela	14.5	33.0	1.9	78	163	121
Yemen	8.0	35.2	2.1	92	155	124
Russia	34.4	41.4	2.4	115	136	126
Uzbekistan	20.8	34.2	1.6	87	167	127
Solomon Islands	23.8	48.2	2.7	145	114	130
Angola	9.0	39.5	2.0	111	159	135
Belarus	24.9	46.6	2.4	142	136	139
Zimbabwe	39.0	45.2	2.2	134	146	140
Ukraine	36.9	48.5	2.3	147	144	146
Maldives	14.1	64.9	2.5	166	128	147
Equatorial Guinea	2.2	49.0	1.9	148	163	156
Burundi	18.1	50.7	1.9	153	163	158
Libya	5.4	52.3	2.0	158	159	159

Source: IR&M, Heritage foundation, transparency.org

The first two columns are for 2012, the Perceived Corruption Index is from 2011.

The Laffer curve

Refresher from Wikipedia

The Laffer curve was coined by journalist Jude Wanniski in the 1970s, with Wanniski naming the curve after an idea sketched on a napkin in a restaurant by Arthur Laffer. Laffer later pointed out that the concept was not original, noting similar ideas in the writings of both 14th century Muslim philosopher Ibn Khaldun (who discussed the idea in his 1377 Muqaddimah) and John Maynard Keynes. Numerous other historical precedents also exist.

The Laffer Curve is a theoretical representation of the relationship between government revenue raised by taxation and all possible rates of taxation. It is used to illustrate the concept of taxable income elasticity (that taxable income will change in response to changes in the rate of taxation). The curve is constructed by thought experiment. First, the amount of tax revenue raised at the extreme tax rates of 0% and 100% is considered. It is clear that a 0% tax rate raises no revenue, but the Laffer curve hypothesis is that a 100% tax rate will also generate no revenue because at such a rate there is no longer any incentive for a rational taxpayer to earn any income, thus the revenue raised will be 100% of nothing. If both a 0% rate and 100% rate of taxation generate no revenue, it follows from the extreme value theorem that there must exist at least one rate in between where tax revenue would be a maximum. The Laffer curve is typically represented as a graph which starts at 0% tax, zero revenue, rises to a maximum rate of revenue raised at an intermediate rate of taxation and then falls again to zero revenue at a 100% tax rate. One potential result of the Laffer curve is that increasing tax rates beyond a certain point will become counterproductive for raising further tax revenue.

Based on economic analysis John Keynes father of Keynesian economics and his followers recommended "pump-priming" the economy to avoid recession: cutting taxes, increasing government borrowing, and spending during economic down-turns.

Supply-side economics is a school of macroeconomic thought that argues that economic growth can be most effectively created by lowering barriers for people to produce (supply) goods and services, such as adjusting income tax and capital gains tax rates, and by allowing greater flexibility by reducing regulation. Consumers will then benefit from a greater supply of goods and services at lower prices.

Typical policy recommendations of supply-side economics are lower marginal tax rates and less regulation. Maximum benefits from taxation policy are achieved by optimizing the marginal tax rates to spur growth, although it is a common misunderstanding that supply side economics is concerned only with taxation policy when it is about removing barriers to production more generally.

Publications

Risk management research (subscription based)

Pompous meddling continues	2 July 2012
Empty monetary bag of tricks	22 June 2012
Helping hand rather than an invisible one	15 June 2012
Fed recommends to hedge too	8 June 2012
Waiting for the next fix	1 June 2012
Hopium running low	25 May 2012
Euro area tearing itself apart	18 May 2012
PMIs make for horrid reading	7 May 2012
Just in the middle of the river	2 May 2012
Risky fragility	19 April 2012
What makes bears blush (Q2 2012 report)	11 April 2012
Conditionally well but subject to revision	4 April 2012
Not yet out of the woods	22 March 2012
Eerily unchanged	15 March 2012
Ltroveneous double liquidity whammy	2 March 2012
Bullish middle-game: an intermezzo?	17 February 2012
Shooting the economic lights out	3 February 2012
Confidence rally	27 January 2012
Relatively difficult (Q1 2012 report)	**16 January 2012**
Global economy stabilises a bit	22 December 2011
Santa put	8 December 2011
Europe in the tails	28 November 2011
Gap between US and Europe opening	16 November 2011
October looks like a short sigh of relief	3 November 2011
On can kicking and bouncing dead cats	25 October 2011
Kicked can cause dead cat to bounce	16 October 2011
Beware of lights at the end of tunnel	7 October 2011
Europe doubling down (inaugural quarterly report, available on www.ineichen-rm.com)	**3 October 2011**
Europe is levering up, ie, doubling down	30 September 2011
Summer of 2008 revisited	23 September 2011
Depression rather than recession	16 September 2011
Déjà vu	9 September 2011
Global economy arguably in recession	2 September 2011
Risk levels in Europe have risen strongly	26 August 2011
US recession a sure thing	19 August 2011
PIIGSF?	12 August 2011
Early indications continue to deteriorate	5 August 2011

Free six months trials available. (No gmail, hotmail, yahoo, etc. accounts)

Absolute returns research (available on www.ineichen-rm.com)

Diversification? What diversification?	June 2012
Regulomics	May 2011
Equity hedge revisited	September 2010
Absolute returns revisited	April 2010

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