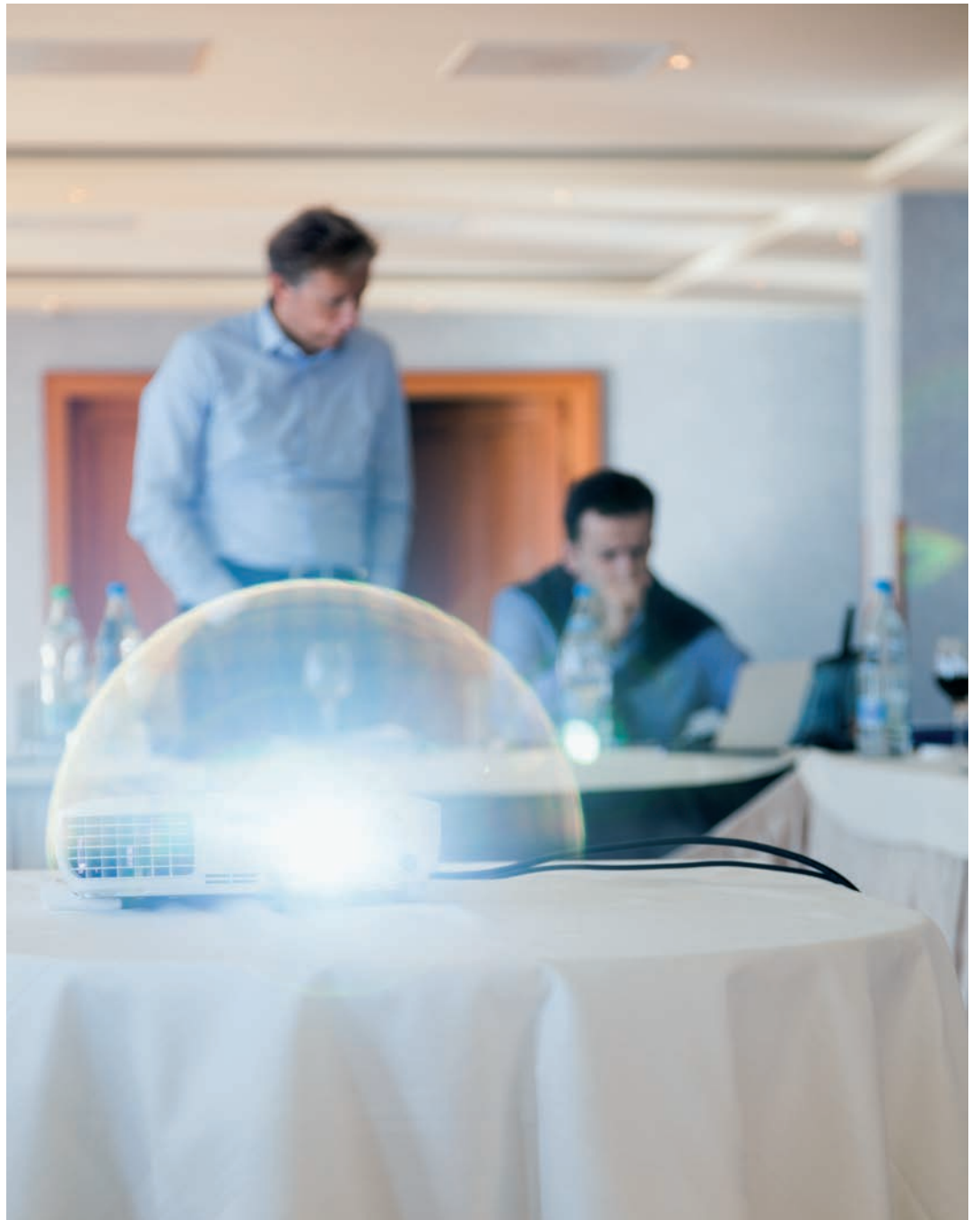


# Perspectives



## FOREWORD

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The world has changed dramatically since 2008. The initial financial crisis, rooted in housing-market bubbles, especially in the US, and all the toxic assets acquired lock, stock and barrel primarily by the world's leading investment banks, degenerated into a debilitating crisis of confidence worldwide with its epicentre in Europe: distrust initially of the banks, then of eurozone politicians who have been far too slow to come up with permanent and credible solutions to deal with the unsustainable levels of debt run up by certain member states.

The worsening economic and political situation in Greece is etched deeply into everyone's psyche, as is the speed at which the problems spread to other peripheral eurozone states. Financial markets have lost confidence in a steadily lengthening list of countries, including some regarded until now as among the safest havens in the world. At the time of writing, France is in danger of being stripped of its triple-A status and even Germany, for the first time in the modern era, has run into problems persuading investors to buy its 10-year Bunds, a turn of events that would have been unthinkable not all that long ago.

Against the backdrop of a double decoupling in growth and inflation between economies in the developed and emerging worlds, Pictet's Wealth Management Investment Committee met on 12-13 October, bringing together our own in-house investment experts with external specialists of world renown, to spend time reappraising and thoroughly analysing the whole situation and outlook. The key points and conclusions from our discussions have been presented in this inaugural *Special Edition* issue of *Perspectives*.

We hope that this new annual publication will provide relevant and instructive insights into the global economic and financial situation and outlook which, we are quite sure, will have a major bearing on your long-term investment decisions.

Philippe Bertherat  
*Partner, Pictet & Cie*

## **CONTENTS**

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- 2–3 **SECULAR OUTLOOK**  
Yves Bonzon, Chief Investment Officer, Pictet & Cie
- THE NEW PARADIGM OF INDEBTEDNESS**  
Christophe Donay, Head of Asset Allocation & Macro Research,  
Pictet & Cie
- 
- 4–6 MOVING FROM THE 'GREAT MODERATION' TO THE 'GREAT DIVERGENCE':  
THE VOLATILITY FACTOR ON FINANCIAL MARKETS
- 7–8 DEFLATION IS NOT A FATEFUL INEVITABILITY: A PARADIGM SHIFT IS CONCEIVABLE
- 9–11 CALCULATING EXPECTED LONG-TERM RETURNS ON ASSET CLASSES
- THE EUROPEAN FINANCIAL CRISIS**
- 
- 12–15 EUROPE NEEDS FISCAL ACTIVISM AND AN ACTIVIST ECB  
Avinash Persaud, Chairman, Intelligence Capital
- FISCAL DEFICITS**
- 
- 18–21 THE BEGINNING OF FINANCIAL REPRESSION  
Russell Napier, Consultant Global Macro Strategist, CLSA Asia-Pacific Markets
- EXCHANGE RATES**
- 
- 22–25 THE INTERNATIONAL MONETARY SYSTEM: WHO NEEDS A SYSTEM?  
Charles Wyplosz, Professor of Economics, University of Geneva
- FINANCIAL MARKETS**
- 
- 26–27 Viewpoints from Jonathan Wilmot, Chief Global Strategist, Credit Suisse
- HOW TO TAKE ADVANTAGE OF ASYMMETRIC PAY-OFFS**
- 
- 28–31 Viewpoints from Vinay Pande, Chief Investment Adviser, Deutsche Bank

# ***“The market plays back”* was the reply from Howard Marks, founder of Oaktree Capital Management, to a question at our annual Pictet Alternatives seminar in late September at The Dolder Grand Hotel in Zurich.**

**Yves Bonzon**

Chief Investment Officer, Pictet & Cie

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Howard Marks’ pithy assertion draws attention to a factor of paramount importance for the whole investment process. But, first, before pressing ‘play-back’, we need to ‘fast rewind’. Very early in my career in the late 1980s, I chanced upon Gary Shilling’s seminal book entitled *“Is Inflation Ending? Are You Ready?”*. In it, he described those mechanisms likely to result in a structural disinflationary trend in developed economies lasting several years, even decades, and explained why the rampant inflation of the 1970s was just a temporary spike.

I was particularly receptive to Shilling’s arguments and formed a firm belief that the monetary pattern for the next 10 to 20 years would involve a structural decline in inflation in the West. I was convinced that technological shocks could be a source of disinflation, even deflation, with the upshot that jobs would not be created at the same robust pace as productivity gains. At that time, most highly respected figures in the world of asset management had earned their stripes during the dramatic bear market for bonds which culminated in 1981 when yields on 10-year US Treasury bonds soared above 15%. Prices of many asset classes were still bearing the scars gouged by the accelerated inflation of the 1970s.

In the early 1990s, another influential work was published, this time by Bennett Stern III, who laid down the foundations of the Economic Value Added model which came to be known as EVA©. Then, in the mid-1990s, Deutsche Bank published its CROCI© model and Credit Suisse its CSFB-Holt© database, both drawing inspiration from EVA theory, and the market anomaly evaporated: *“The market plays back”*. As Howard Marks is a bottom-up investor, his assessment is applicable to stock-picking, but the principle is the same when deciding on asset allocations and macroeconomic investment management. The climate we are operating in has been evolving fast and radically in the aftermath of the severe shocks to the economic and financial system and in response to regulatory changes. Only those processes



that are re-engineered to keep up with shifts in the investment environment on markets can hope to add value over time. Comprehending how correlations between assets come together and become dismantled, understanding the shifting patterns of volatility, analysing the pools of capital that steer the pricing in asset classes and how these pools evolve are all fundamental to building a solid framework for reading the markets. Adopting this approach also provides the competitive edge in focusing on a time horizon slightly longer than the average for investors, who seem increasingly obsessed by short-term performance.

The purpose behind this *Special Edition* of Pictet & Cie's *Perspectives* can be summarised as follows: understanding and identifying the structural forces at work in the global economy and on financial markets; knowing in which direction monetary gravity is pulling; anticipating what governments' and economic policymakers' responses might be to such forces.

For the last three years, we have been pinpointing deflation as the number one risk hanging over Western economies. When it comes to monetary policy, there are widespread fears the European Central Bank, the Bundesbank's true heir, will persevere with its war on inflation in today's changed climate. Only a few days ago, Philipp Hildebrand, current Chairman of the Swiss National Bank's Governing Board, told a sizeable audience in Geneva: "If anything, we face strong deflationary dynamics", underscoring his thesis with the statement that "inflation is no issue". We can but hope that our eurozone neighbours will come to understand pretty soon the concept of balance-sheet recession and a disorderly liquidation of assets, and will share the SNB's assessment.

Time is of the essence for solving this debt crisis that began in the private sector and is now centred on sovereign debt. The authorities must make strenuous efforts to stipulate how losses incurred from the excess debt are to be spread using the normal methods: printing money; transferring wealth from creditors to debtors; restructuring debt. As yet, not much progress is being made on this front owing to the clash of interests among the various parties. The constant pendulum swings from deflation scares to reflationary attempts and back have led to what some have dubbed the 'new normal', basically a 'non-normal' or 'bimodal' distribution of returns on assets. Very few investment processes seem to have effectively made allowance for this radically different investment environment.

Furthermore, in many cases, statutory regulations are driving the transition towards an investment approach adapted to this new paradigm. But, rather than moaning about the glass being half-empty, I prefer to view it as an opportunity for differentiation by managing both risks and the resultant opportunities in such a way that distinguishes us clearly from the consensus. This belief has persuaded us today to construct asset allocations for our portfolios founded on diversification through strategies and risk factors rather than via the more conventional route of diversification by asset class, a concept with its roots more in legal considerations than economic rationale.

Gary Shilling's latest book is entitled "The Age of Deleveraging". The reflationary battle has barely begun. ●

**KEY TRENDS FOR THE 2010S**

	1960s	1970s	1980s	1990s	2000s	2010s
ECONOMIC ENVIRONMENT	Bretton Woods	Floating FX	Disinflation	Fall of Berlin Wall	EMU	Managed Western deleveraging
		Oil shock	Plaza	Globalisation	Great global imbalance	Emerging market discrimination
		Inflation	Arbitrage	Internet E-trading	China's rise Structured credit	Smart grid Asset-price targeting End of \$ paper standard?
INVESTMENT ENVIRONMENT	US Nifty Fifty stocks	Small caps	Government bonds	Indexing	Hedge funds	TAA
		Oil stocks	Nikkei	Nasdaq	EM equities	Gold
		Gold, CHF and JPY	Hang Seng	SMI	Commodities	EM local debt
				USD	EUR	Oil services Developed quality blue chips

Every decade is characterised by a different economic and investing environment.

Since 2008, the 'Great Moderation' has given way to the 'Great Divergence'. But new economic thinking and technological shocks could well call it into question. We take these paradigm shifts into consideration in calculating our long-term expected returns.

**Christophe Donay**

Head of Asset Allocation & Macro Research, Pictet & Cie

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### **MOVING FROM THE 'GREAT MODERATION' TO THE 'GREAT DIVERGENCE': THE VOLATILITY FACTOR ON FINANCIAL MARKETS**

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The volatility of assets, especially equities, increased steeply following the sub-prime crisis. Implied volatility for the S&P 500 index averaged 16% between 2003 and mid-2007, but that average has climbed to 25.7% for the period since then. Shifts in the volatility regime reflect a rise or fall in risks which can be divided into fundamental and market risks. In this article, we will be focusing on fundamental risks (shifts in volatility and market risks form the subject of our Topic of the Month article in our December 2011 issue of *Perspectives*).

The 2008 economic and financial crisis signalled a distinctive break in the regime, bringing about a paradigm shift for economies in the West. The macroeconomic environment has become far more unstable, with the crisis of mushrooming debt in European countries only accentuating the violent swings between up-trends and downtrends on financial markets.

This tearing of the macroeconomic backcloth is all the more worrying as economies in the West were coming out of a 25-year period from 1982 to 2007 during which volatility in economic growth had radically diminished: recessions that occurred were half as long and half as deep as those in previous decades. Likewise, inflation volatility had dropped by 66% over the same 25 years. The steadily declining volatility of macroeconomic variables between 1980 and 2008 can be explained by the economic concept of the 'Great Moderation', a theory first expounded in the late 1990s, which argued that diminishing volatility of macroeconomic variables could be attributed to a combination of three factors.

#### **How the Great Moderation came about**

The first of these factors is associated with the effectiveness of monetary policy. Adoption of monetary policy guided by the precept of inflation targeting

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— first implemented by the US Federal Reserve and then by most of the world’s central banks — had helped to exorcise the demon of inflation. Core inflation in the US dropped from 12% to 2% between 1980 and 2003. With inflation kept steady at around 2%, it became much easier for businesses to have reliable inflationary expectations in making capital-spending plans, for households to make decisions on whether to save or spend, and for governments to form budgeting policy.

The second factor is connected to institutional changes in the way economies were regulated. One of the most significant was the Reagan administration’s 2Ds policy of ‘deregulation’ and ‘decompartmentalisation’, which unleashed financial innovation and led to the demise of the Glass-Steagall Act.

The third, which does not sit at odds with the first despite what some economists claim, relates to the so-called ‘Good Luck’ theory. This covers a whole range of factors that contributed towards lowering volatility in the economic environment, but which are attributed to serendipity or happy coincidence. Such factors include the absence of oil crises, technological breakthroughs and innovations (petrochemicals, microprocessors, etc.) and geopolitical stability.

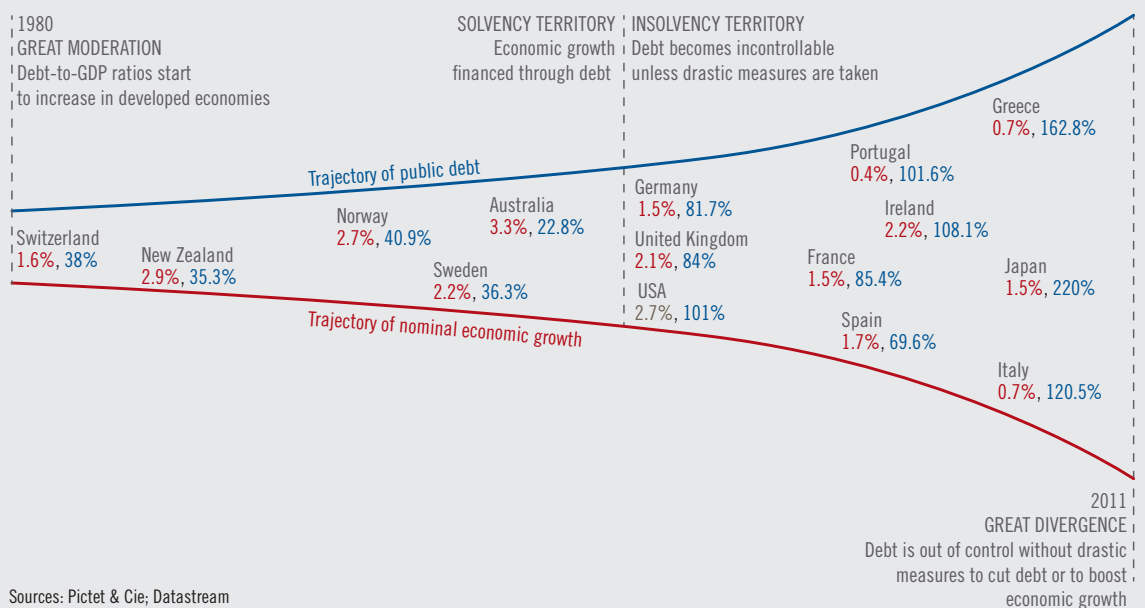
The Great Moderation had one essential virtue for investors: it created considerable stability in GDP growth and inflation, improving visibility quite noticeably. These are precisely the two factors that dictate levels of long-term returns from the various asset classes (see the article entitled “Calculating expected long-term returns on asset classes” on page 9). These two factors are the indispensable foundations of a strategic asset allocation.

**The new ‘Great Divergence’ paradigm**

The Great Moderation has now, however, given way to a new paradigm: the ‘Great Divergence’, as we shall call it. This relates to the mountains of government debt amassed as a result of the divergent growth trajectories taken since the early 1980s by public borrowing and economies: government borrowing has been expanding far too fast for economic growth, culminating in crippling debt overruns. The US total outstanding debt/GDP ratio stood at 170% in 1980 whereas it is now almost up to 350%. If we look solely at sovereign debt, the public debt/GDP ratio was running at 35% in 1980 whereas today it is up at 101%. On the other side of the equation, the US economy generated real GDP growth of 3.3% p.a. between 1980 and 2001, whereas it has averaged half that (+1.6%) since 2001. In other words, in the last few years the effectiveness of debt accumulation in generating economic growth has been dwindling. As a result, financial market operators consider that Western countries could, sooner or later, default and that these enormous public debt mountains are a serious systemic risk for the world as a whole. In the case of eurozone countries alone, borrowings of over 3,000 billion euro would need to be cleared to bring public debt ratios down to 60% of GDP, the level regarded as the key threshold for the long-term viability and sustainability of budget deficits. This trio of factors that had previously ensured economic stability in the ‘Great Moderation’ world have each crumbled away for different specific reasons and are now turning into generators of economic instability.

Monetary policies have abandoned the realms of inflation targeting to venture into the uncharted and hazardous territory of quantitative easing. What impact will QE have on inflation? How will the value of currencies of countries practising this extreme form of monetary easing be affected? These questions

**SINCE 2008, DEVELOPED ECONOMIES HAVE ENTERED AN OVER-INDEBTEDNESS REGIME**



Sources: Pictet & Cie; Datastream

remain unanswered at present. In any event, the monetary conditions that vouchsafed the stable inflation regime are no longer in place. Even the very effectiveness of monetary policy in regulating the economic cycle is being called into question.

Over-indebtedness is also casting serious doubts on governments' abilities to regulate the economic cycle effectively. The Western world has learned its Keynesian lessons by heart: if a recession bites, stimulating ailing economies by increasing public spending will be an effective remedy. However, judicious application of Keynesian budget policy presupposes that governments possess adequate borrowing capabilities to finance deepening public deficits. As we alluded to above, this room to manoeuvre has vanished. What's more, the Keynesian approach has been supplanted by austerity fiscal policies. Instead of regulating the economic cycle, these programmes are deepening and prolonging recessions.

Lastly, the relatively stable state of international relations is a thing of the past; the cards are now being re-dealt between East and West. Asia's emergence as a global economic powerhouse has destabilised the delicate balance of the international currency system founded on, initially, the gold standard and, at present, the US dollar. The solidity of the dollar's status is at times called into question while the jury is still out on the renminbi's likely status. The euro, hailed as a new reserve currency a decade ago, today accounts for over 25% of central bank foreign-exchange reserves worldwide. The uncertain fates of both the eurozone and the euro itself have injected an extra element of instability into the international monetary regime (see the articles by Avinash Persaud and Charles Wyplosz on pages 12 and 22, respectively).

### **Great Divergence and asset classes**

The unsettled economic climate is significantly heightening uncertainty and distorting those risk factors that influence the risk premiums priced into assets. This is having two major implications for asset allocation.

The Great Divergence has altered the traditional respective statuses of asset classes. Bonds issued by Western countries are no longer regarded as ideal safe havens because soaring public debt has increased the risk of defaults. As a result, the risk premium priced into bonds is steadily rising, altering the ranking for investment purposes of some sovereign debt, including those deemed until quite recently to be solid, such as French OATs. The intensifying crisis in Europe during summer 2011 even led to a negative risk premium on German Bunds even as they continued to benefit from their safe-haven status. However, this might well soon be questioned. Financial markets' persistent and well founded doubts about European governments' ability to solve the eurozone debt crisis are mounting

steadily, so even the impeccable standing of German Bunds may be challenged. The German government's trouble in placing bonds for 6 billion euro with investors on 23 November 2011 sent a warning signal which will need to be heeded. So far, only US Treasury bonds appear to have been spared, but they too may soon be affected by mounting anxieties of financial markets over ballooning public debt. The US is not immune, as its public debt ratio at the end of 2011 is the same as for France and Germany, i.e. close to 85%. Moreover, the interlocking of the European and American banking systems could easily see the contamination from one continent to the other.

Lastly, price volatilities of the various asset classes have been rising in this world of the Great Divergence. This points towards increasing chances of tail risks. It is broadly accepted that increasing implied volatility (as measured by the VIX Index) coincides with declines on stock markets. Experience of the last few decades has, however, cast doubt over this rule of thumb, as, for instance, when the dotcom bubble burst. A world of structurally higher volatility would suggest that returns from risk-based assets, notably equities, are likely to be lastingly low. High volatility feeds through into hybrid assets as well, such as corporate bonds both of investment grade and, even more noticeably, those classified in the high-yield segment, explaining the high degree of correlation between asset classes. The benefits of applying the time-honoured principle of ensuring broad portfolio diversification to provide stability to the overall return on investments will be gravely jeopardised by high volatilities spreading throughout asset classes.

It would, however, be misguided to believe that the Great Divergence in Western economies is inevitably destined to drag on for years. Further paradigm shifts are quite conceivable as shocks occur. As the room to influence demand through fiscal and monetary manoeuvres has become limited, it is instructive to look at possible paradigm shifts that could have a direct impact on supply and which might occur before too long. We will look at these in the following article. ●

## DEFLATION IS NOT A FATEFUL INEVITABILITY: A PARADIGM SHIFT IS CONCEIVABLE



The economic and financial crises following each other in ever quicker succession and turning ever more serious, from the initial sub-prime crisis in the US to the current euro debacle, have resulted in severe over-indebtedness throughout economies in the developed world just when they are no longer generating strong enough growth. As governments have taken a proportion of private-sector debt onto public-sector books, public debt is running at well over 60% of GDP, but economies are registering nominal GDP growth below 5%. In such circumstances, the level of debt is ballooning uncontrollably in several European states. Even big powers such as the US and Japan are not safe from the maelstrom of spiralling debt.

As a result, the prevailing economic winds are deflationary and the risk of debt deflation is grave indeed.

Measures adopted so far to solve the debt crisis have solved nothing. In fact, they have had the opposite effect. The austerity programmes involving a mix of tax rises and public-spending cuts implemented by several countries have just caused economies to slow even more worryingly. As a result, tax revenues are falling and indebtedness is rising, producing exactly the opposite of the desired outcome.

### What are the exit routes from this over-indebtedness?

The economic paradigm for developed economies offers little hope of a rapid exit from the indebtedness into which governments are currently locked. Breaking out of the debt impasse presupposes that the huge quantities of debt can be dealt with using methods other than those chosen so far. Stimulating economic growth through reflation is regarded as the most virtuous route to take. How could growth in the developed world be revitalised? What fresh economic policy approach could be implemented to pull countries out of the vicious downward spiral of 'declining tax income ==> spending cuts ==> rising

government debt', the consequence of Keynesian responses designed to drag economies out of recession?

Answering these questions is neither a straightforward exercise nor a pious hope as coming up with answers to such questions is part of the process of solving the debt crisis. Moreover, the answers will be decisive in seeking to calculate expected returns from asset classes. Before trying to find answers, we should bear in mind that every decade brings with it unexpected surprises and shocks, so we should perhaps begin with yet another question: what would we have predicted in 2000 when the US economy was expanding so impressively on the back of all the new information and communications technologies? At that time, one line of thinking maintained economic cycles would come to an end as a result of constantly rising productivity. The atmosphere of optimism in the US could see no obstacles to prevent this from feeding through in various ways: business investment; aggressive, but selective immigration; households' vigorous consumer spending.

Perhaps we might have suggested the telecom, media and technology sector was overheating and some correction was overdue? However, we would have been accused of being absurd if we had floated the idea that we might be heading for a structural growth downturn in developed economies, a full-blown collapse of the US housing market, a far-reaching euro crisis, doubts being cast over the solvency of countries as wealthy as the US or France, the adoption of zero interest-rate policies and several rounds of quantitative easing by central banks, serious deflationary risks or, finally, dislocations in the West's industrial and social fabric.

### Plausible structural shocks for the coming 10 years

Structural shocks are hard to predict, let alone imagine what form they might take. This unpredictability derives from the fact that, by their very nature, they run counter to the economic mechanisms generally at work at the time. Just as an attitude of gloom and doom in the first decade of this century would have been regarded as out of place early in the period when economies were expanding so strongly, so optimism is off the agenda today when economic mechanisms and indecisiveness among policymakers have paralysed economies in the developed world. Consequently, the most obvious approach to take would just involve projecting those mega-trends in play for the last few years forward into the next decade. If we were to go down that road, economies in the developed world would be heading for a period of punishment, pain and abnegation, leading to debt deflation.

However, the asset allocator has to throw off this straitjacket on thinking and try to identify and assess those phenomena that might reasonably be expected to cause breaks in the underlying trend over the long term. As forces are currently predominantly deflationary, searching for possible rupture points involves detecting sources of positive shocks liable to reverse these deflationary economic pressures. Identifying what these shocks might be is vital when it comes to long-term strategic asset allocations. Such shocks and rupture points tend to be at the root of shifts in regime affecting real economic growth and/or inflation (see the article on the roles of growth and inflation in expectations for long-term returns on assets on page 9).

We envisage five different types of conceivable shocks over the decade ahead. Some could provide stimulus to economic growth whereas others would apply a harsh brake. Future political choices and the direction and nature of economic policy will enable each country to prepare the ground for a positive shock to happen or not.

- 1. Shocks of a demographic nature.** These have been in evidence for some time. The ageing of populations not just in the developed world, but also in several emerging economies like China, is an inevitable process. This shock, by nature, is negative. According to estimates, it slices roughly one percentage point a year off potential economic growth. It would be hard for countries facing the problem of a greying population to alter this trajectory — the only real way would be a deliberate pro-immigration policy.
- 2. Currency shocks.** We would primarily suggest the risk of debasement of paper currencies (chiefly the US dollar and euro).
- 3. Legal and institutional shocks.** These could involve a whole range of aspects such as a much freer spirit of entrepreneurship throughout the world, especially in emerging economies. Institutionalising and respecting rights to private property form key ingredients of this shock and are, moreover, vital prerequisites for further expansion in emerging economies.
- 4. Shocks down to new economic knowledge/thinking.** We would include mainly changes in the style of monetary and fiscal policies under this heading. In particular, central banks could switch their monetary stances from being geared to inflation targeting towards price level targeting or even asset price targeting. Moreover, fiscal policy could evolve away from the Keynesian approach to a new form of supply-side economies so as to favour research and development, the fount of innovation. This would fuel robust growth in investment in capacity. Capital spending to expand production capacity is different from investment in productivity

and replacement spending on account of the job creation that comes with it.

- 5. Shocks caused by radical innovations and breakthroughs in technology.** This could cover the areas of nanotechnologies, neuroscience, biotechnology, not to mention new information and communications technology, such as the quantum computer.

Western economies stand at a crossroads with two highways opening up ahead. If there is no paradigm shift, no positive shock, they will crumple under the sheer weight of debt, lose ground steadily against emerging economies before, ultimately, becoming impoverished. On the other hand, they could seize the initiative again to relaunch their economies. There is no better driver of sustainable and sustained growth than innovation (approach posited by the theory of endogenous growth). This could take over from Keynesian economic policies applied by governments deprived by top-heavy debt from being able to wield the reflationary levers. Of course, innovation cannot be decreed into existence, but its dynamics follow a well understood historical path. A mix of supply-side economic policies geared towards putting in place conditions to encourage research — the source of all inventions — would ultimately increase the chances of seeing innovation germinate and stimulate fresh, sustainable growth.

Calculating long-term returns expected from asset classes over a 10-year period and constructing strategic asset allocations for the long term are as much an art as they are a science. They also necessitate being grounded in realism as well as looking forward to what might happen. Realism obliges us to contemplate the likelihood that, until one of the positive shocks does materialise, then developed-world economies will continue to be controlled by the forces of excess public debt, under-utilised production capacities and lacklustre demand as a result of stunted growth in income, exacerbated by a credit crunch. The poisonous cocktail of these three forces will see Western economies subjected to the yoke of debt deflation. A defensive strategic asset allocation, built on low-volatility and quality assets backed by solid balance sheets and geared towards capital protection, would be what is needed. On the other hand, if one or more of the positive shocks outlined earlier were to materialise, it would significantly alter the rules of the game for the strategic asset allocation: it would need to be reshaped to increase its sensitivity to economic growth.

For this reason, it is crucial we take due account of potential materialisation of such shocks in our models for calculating expected long-term returns on asset classes. That is one good reason to continue reading through this *Special Edition of Perspectives* as the following article investigates this topic in greater depth. ●

## CALCULATING EXPECTED LONG-TERM RETURNS ON ASSET CLASSES AND THE IMPORTANCE OF IDENTIFYING REGIME SHIFTS



Portfolio construction is founded on expectations of returns and the assumption of risk. Calculating the likely levels of returns from asset classes is a peculiar exercise as it has a bearing on how successful the performance of a strategic asset allocation will be over a long period.

In evaluating expected returns from asset classes it is vital that proper allowance is made for all economic and financial factors that might influence investment returns. Our analysis is based on an investment time-frame of seven to ten years. That investment horizon matches the needs of long-term asset managers seeking to arrive at a strategic asset allocation. We are not referring here to more tactical asset allocations which, by definition, have shorter time horizons of less than 12 months.

Many empirical models for calculating expected returns are predicated on the hypothesis of mean reversion or a more or less naïve projection of historical rates of return. These straightforward approaches have ensured that such models have become popular in the investment community. For instance, many pension funds are known to use the working hypothesis that a portfolio comprising 60% in bonds and 40% in equities, historically, has delivered an average annual return of 8% over the long run. This is based on bonds providing historical nominal returns of 5%. Expected returns on equities, by extrapolation, work out at 12%. However, as

yields on long-dated US Treasury bonds have sunk below 2%, such projections are obviously completely unrealistic today. This example shows that investors seeking to calculate expected returns from asset classes must not be blind to current circumstances nor blinded by past performance.

It became clear we needed to formulate our own proprietary model for calculating projected returns to avoid these pitfalls and maintain vital flexibility in shaping asset allocations to take account of any shocks that might cause major shifts in trends in economies and on financial markets. Our purpose here is to present the broad outlines of our approach to the calculations and provide an illustration of it applied to equity markets in the developed world.

### **What parameters need to be taken into consideration to calculate expected returns?**

Our model is built on two fundamental hypotheses. First, market pricing is dictated by the laws of supply and demand. For instance, if governments or central banks intervene directly in bond markets (this topic is covered in Russell Napier's article, "The beginning of financial repression" on page 18), expected returns from various asset classes will be significantly altered and calculating will become that much more awkward. Fears on this score are not being blown out of proportion judging by the recent example of the ban imposed by European countries on holding 'naked' credit default swaps, i.e. without having, in paral-



lel, the underlying sovereign bonds. Second, it must be feasible to calculate expected returns using non-complex and observable economic and financial data that can be formalised and reasonably forecast in a top-down scenario.

Construction of the Pictet-WM model offers three advantages over models of the ‘mean-reversion’ type. First, our model takes into consideration all the major trends featuring in our long-run macroeconomic scenario. In the model, we have consistently and comprehensively factored in parameters as diverse and as significant as the monetary and fiscal policy mix, economic growth prospects, the inflation outlook, exchange-rate developments, technology/innovation shocks, deflation, debt levels, etc. The modelling exercise boils down to translating and reworking key predicted economic trends into expected returns from asset classes.

Second, our model enables us to simulate expected returns according to various hypotheses concerning how a number of key macroeconomic variables might behave. Third, we model shifts in regime liable to have an impact on economies and be transmitted into financial markets. We have to accept that, in the longer run, the chances of there being a paradigm shift are high. Over a long period, our approach makes it possible to combine two successive regimes: the regime in place at the outset of the decade, which we could describe as the ‘deflation mode’ (see the opening article “Secular Outlook” on page 2), and the possibility of a shift to a different regime during the

course of the decade. We have outlined some of the potential shocks that might lead to a paradigm shift over the coming decade in the article entitled, “Deflation is not a fateful inevitability: a paradigm shift is conceivable” on page 7).

The real challenge in the modelling exercise is how to integrate macroeconomic fundamentals into our calculations of expected returns straightforwardly, comprehensively and consistently. Fortunately, we have pinpointed two key common parameters for determining expected long-term returns from equities, government bonds, corporate bonds, commodities and currencies. The two variables are the regimes governing (1) real economic growth rates and (2) prices. Each regime can take three different forms. The interplay of one regime with the other enables us to characterise the economic environment overall.

**THE STATE OF THE ECONOMY CHARACTERISED BY TWO VARIABLES**

Price regime	Regime of real economic growth
Disinflation: inflation close to 0%	Deflation: growth of around 1%
Standard inflation at 2%	Standard: growth running at potential (3% in the US case)
High inflation at 4%	Robust growth running noticeably above potential (4% in the US case)

As we move into the second decade of the 21<sup>st</sup> century, prices and growth in the developed world are in deflation mode. In contrast, underlying inflation in emerging economies is running above targets set by central banks and real economic growth is close to potential. Emerging economies are, therefore, in sustained growth mode.

**The significance of these two regimes**

The model described above can be applied to most asset classes. We have used it for money-market instruments, government bonds, equities in developed markets, currencies and commodities.

The instability witnessed on historical returns suggests the role played by shifts in the inflation and growth regimes are crucial. US equities delivered a total real average return of 6.6% p.a. between 1926 and 2011, signifying equities outperformed bonds by around 4 percentage points a year. If we break that down into shorter periods, we soon see that the excess return varies quite dramatically: for instance, it rose as high as 12% between 1924 and 1959, but has been limited to just 1.5% since 1969. If we break down these shorter periods even further, we can detect a robust link between returns on the various assets in the different permutations of price and economic growth modes.

In the table below, we have presented simulated expected returns for US equities (S&P 500) according to the various inflation and growth regimes.

Cells in the table with no percentage correspond to economic scenarios that would be unrealistic: for example, we are highly unlikely to experience a combination of robust economic growth and widespread disinflation at the same time.

Under the deflation regime, expected returns calculated for equities on developed-world markets over the next 10 years look no more encouraging than the meagre returns generated over the past decade. With a total expected nominal return of just 2.7%, an investor in equities would in effect be expecting to gain little more than the yield provided by dividends being paid out. On a brighter note, if we take the scenario envisaging an innovation shock fuelling accelerated

**Under the deflation regime, expected returns calculated for equities on developed-world markets over the next 10 years look no more encouraging than the meagre returns generated over the past decade.**

economic growth of 4% and stable inflation running at 2%, the annual average expected long-run return from equities would amount to 13%. The gap is huge: a compound return of 13% on capital of 100 over 10 years would see that capital expand to 340, compared to just 130 in the case of a meagre 2.7% compound return.

There are plenty of risk factors exerting an influence over long-term returns on asset classes. This would take us down entire new avenues of research and analysis. If we look beyond our two selected growth and inflation modes, we could incorporate factors such as liquidity, volatility and correlation modes, return asymmetries or behavioural biases in investors (derived from financial behavioural research). Integrating all these risk factors into the model would fine-tune and improve the estimates of expected long-term returns. However, the cornerstone of successful investment in the long run is built on capabilities and expertise in anticipating possible regime shifts. ●

**RESULTS FROM PICTET MODEL FOR ANNUAL EXPECTED RETURNS OVER 7 YEARS FOR US EQUITIES (S&P 500)**

	Anaemic growth G <sub>R</sub> = 1%	Standard growth G <sub>R</sub> = 2.5%	Innovation shock G <sub>R</sub> = 4%
Disinflation π = 0.5%	2.7%	–	–
Standard inflation π = 2%	–	5.6%	13%
High inflation π = 4%	3.8%	6.6%	9.7%

Source : Pictet & Cie

### EUROPE NEEDS FISCAL ACTIVISM AND AN ACTIVIST ECB

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**A policy response to recapitalise the banks and promote economic growth is required to break out of a vicious spiral of decline. Expelling Greece from the euro, default or inflation will not do the trick.**

**Avinash Persaud**

Chairman, Intelligence Capital

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The present train of events in European markets began with what was essentially a liquidity crisis. But capital has been destroyed and there are institutions that are short of capital. Getting out of this crisis requires Europe to deal with the capital problem.

The European Central Bank can help with the liquidity crisis, but that just kicks the can down the road for a while. To solve the capital problem, the fiscal authorities have to be involved and it requires courageous politicians to take bold decisions. Until there is a policy response to the capital problem, the crisis will continue and Europe will keep on muddling through.

I am an optimist, however: I believe there will be a policy response because there is no alternative. The path will be political — full of fudges, with lots of complications and lots of relief rallies. But while there are no magic bullets, there are solutions to the policy problem and I want to offer some thoughts about what they could be.

The first step is to identify what the problem is that we are trying to solve. Financial crises ought to be periods of great learning, because the perceived wisdom on issues such as financial innovation and securitisation has been shot out of the water. But crises are not occasions for great learning because they are so complex that everybody can pick out one aspect that reinforces their previous prejudices about what the solution should be. As a result, there are lots of solutions in search of a problem.

My view of the problem is that we are in a vicious spiral. There is a global recession, there are weak economies, and there is a lack of fiscal credibility. As a result, governments are unable to deliver a big fiscal stimulus to stimulate growth, and it is very hard for the private sector to be the risk-taking motor of growth during recessions. So low growth is entrenched, which further undermines fiscal credibility. The challenge is to break this vicious spiral.

That is the problem facing Greece, and there is no way that it can get out of this spiral of decline with zero to negative growth for the next five years. Some people have concluded that they should let someone else deal with the problem, let someone else deal with the fiscal credibility, let someone else deal with global growth, let someone else deal with the banking issues. But kicking Greece out of the euro is not the solution — it is a punishment. You've done wrong, you have to take the consequences, and the best consequence I can think of is kicking you out of the club.

Having begun my career as a currency strategist, I was a rather unlikely person to conclude that the euro was a really good idea when it was launched. But in my discussions with governments, especially in small emerging markets, I saw how the best brains in their central banks were struggling to work out where their currencies should be. Exchange rate volatility preoccupied those countries when they





**Guaranteeing all the debt of European governments will not solve the problem of trying to create fiscally sustainable growth out of a recession. Nor will holding down the debt to some level, say 60% of GDP — a country with debt at or below 60% of GDP does not need that guarantee.**

should have been focused on the real drivers of growth in their economies such as giving their country the skills needed to compete internationally.

The US and the UK adamantly defend the right to devalue their exchange rates, but where has it got them? Manufacturing exports in the UK are just a fraction of 10% of GDP, and it is the same in the US. Total manufacturing output in the UK is below 14%, and at a similar level in the US. I think we know why: using the exchange rate to boost competitiveness is a sop, a distraction which stops countries doing the real things they need to do. So when the US was struggling to sell gas-guzzling pickup trucks with the steering wheel on the wrong side to the Japanese, they concluded that the problem was that the yen was too weak.

That is why I thought the euro was a good idea. And it is why many Germans thought the same and did what you are supposed to do in a fixed currency. Having joined with an overvalued Deutschmark, they focused on productivity and are now hugely competitive — unlike other countries in Southern Europe. So the solution to the failure to do what is needed to get the economy growing is not to opt out of the euro and devalue. If a country's debts are in the euro, leaving the single currency means defaulting, which is not going to drive growth. The devaluation route is a punishment, not a solution.

Issuing common bonds for the eurozone does not solve the problem either — it certainly does not solve the problem of fiscal discipline. Maybe there will be a time when Europe moves to fiscal union, but politically this is not the time for a common bond. On the contrary, there is a very worrying rise in nationalism across Europe.

The problem we are trying to solve is to create growth in Europe — fiscally sustainable growth

out of a recession. Guaranteeing all the debt of European governments will not do that. Nor will holding down the debt to some level, say 60% of GDP — a country with debt at or below 60% of GDP does not need that guarantee. We need to find a way that supports growth fiscally without adding to the burdens of national economies.

And inflation is not an easy way out. The balance sheet of the US Federal Reserve has exploded with quantitative easing, but the money is not getting through to the economy. Governments can try to inflate their way out of the debt, but in the middle of a recession it is hard: monetary policy is working full steam ahead, but it is pushing a brick with string.

Finally, default is no solution either. It could undermine European banks which are heavily exposed to sovereign debt (encouraged by flawed banking regulation which allowed every sovereign to be the safest risk in capital adequacy ratios). If banks default as countries default, that will not solve the growth problem.

In fact the banks may have to be recapitalised to avoid a collapse in the financial system. Bank lending would not necessarily pick up, because there are no borrowers. We are in a balance-sheet recession, where borrowers faced with the lowest interest rates of a lifetime are choosing to repay debt. But even if the banks will not be a source of great lending, we should make sure they do not cause a complete collapse of the financial system.

So we need to find a way of recapitalising the banks — one that hurts the shareholders, sending the right signals to improve behaviour in the future. My proposal would be for the ECB to issue a 20-year zero coupon bond, using its better credit rating to print the cash. The proceeds would go into a fund to put capital into the banks in the form of

## THE EUROPEAN FINANCIAL CRISIS

community preference shares. So although the banks are not making money, they would be recapitalised without having to pay interest. When things turned round, however, the first share of profits would go back to the fund and repay the ECB's zero coupon bond with interest.

Meanwhile, spurring growth without a political union could be achieved by a much expanded European Investment Bank. The EIB has a role in building infrastructure around Europe with funding that is very modest in relation to European GDP. Its role could be made much greater by raising its funding to 3% of European GDP, weighting its investments towards countries suffering most in the recession.

The advantage of my proposals is that they do not bail out Greece, but they also do not allow the banks to fail. And while Greece would have defaulted on 50% of its debt, there would be massive infrastructure spending from a central European Investment Bank to support growth and jobs. All the member states would put up capital for the EIB to support growth and the banks would be recapitalised in a way where the ECB gets its money back when those banks recover.

The point I want to make is that there are solutions to the capital problem. It requires an activist ECB and it requires fiscal activism. There was a time we were trying to create a Europe on automatic pilot — with monetary policy on automatic pilot and with fiscal policy effectively on automatic pilot. But in the long run, that approach cannot generate the response to global shocks and create the growth that is needed. We need greater activism in the system.

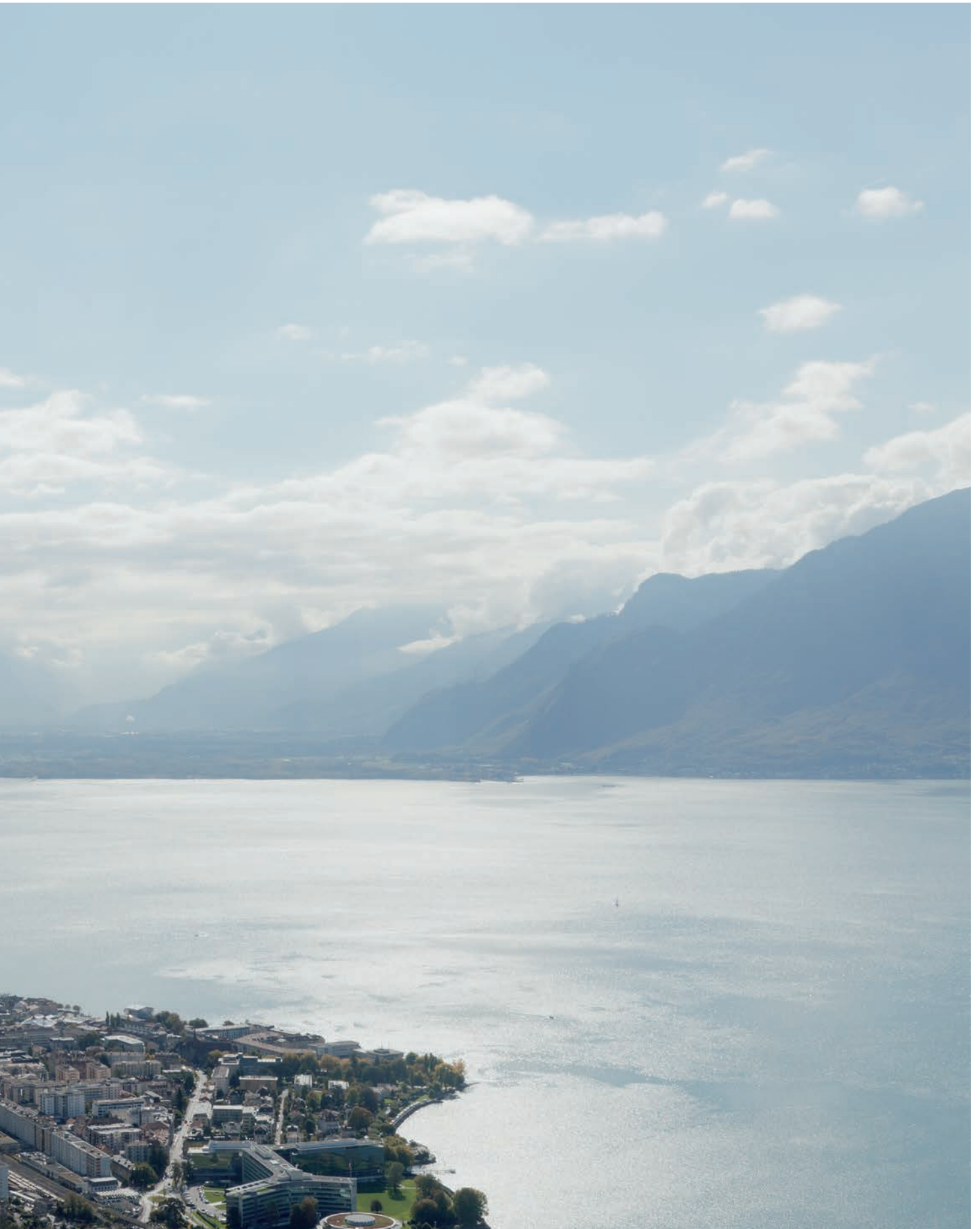
I think that our politicians will fumble their way towards the solutions. And I think, sadly, they need crises to be the fire behind them, to push them to do something which they do not have the courage to do now, and to do it right. But I do think that ultimately a solution will be found. ●

**My proposal would be for the ECB to issue a 20-year zero coupon bond, using its better credit rating to print the cash. The proceeds would go into a fund to put capital into the banks in the form of community preference shares.**









### THE BEGINNING OF FINANCIAL REPRESSION

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**As the fiscal deficit rises, the US government is finding it harder to fund its spending. With foreign central banks reducing purchases of US Treasuries, financial repression will fill the gap by forcing the private sector to buy government debt.**

**Russell Napier**

Consultant Global Macro Strategist, CLSA Asia-Pacific Markets

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In this presentation, I will be pessimistic about the stock market going down, but unfortunately I will be even more pessimistic than that because I see the government's role in markets going up. My bearish forecast is that governments are coming back into the markets and interfering with our business — and that they will be around for a very long time.

I want to start with the ownership of US Treasuries by foreign central banks. The US government has been issuing large amounts of Treasuries since the end of the Clinton presidency, and foreign central banks have been buying much of it. The People's Bank of China simply prints renminbi in the morning and in return gets dollars to buy Treasuries — it's free funding. And it is not just the People's Bank of China, it is Saudi Arabia, Taiwan, Korea, Hong Kong, Brazil and even Switzerland until recently.

But foreign central bank funding of the deficit has peaked. Because China has been undervaluing its currency, it in effect provides finance to the USA which buys Chinese goods. But an exchange rate does not remain undervalued forever, because the increase in the supply of renminbi feeds through to domestic inflation and higher wages. Combined with demographic change, China's competitiveness is eroding and its surplus is falling. And the day that China no longer has a surplus, it will not buy any more Treasuries.

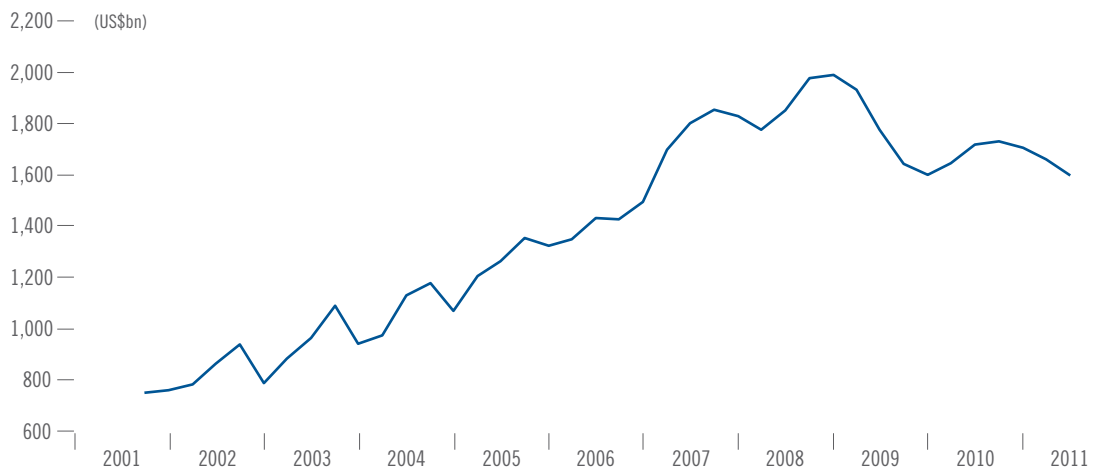
In fact, it will start selling them to keep its exchange rate competitive since the alternative of devaluation would be unacceptable politically. So China will sell Treasuries and buy back renminbi to hold its exchange rate down. That would push up the risk-free interest rate in the US and reduce the supply of

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#### FOREIGNERS' FAITH IN US RESTRAINS THE FED

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Net private-sector lending to the USA



Source: Datastream



**China will sell Treasuries and buy back renminbi to hold its exchange rate down. That would push up the risk-free interest rate in the US and reduce the supply of money in China. That is deflation — and it could come to pass less than three years.**

money in China. That is deflation — and it could come to pass in less than three years.

The question for the US is how it will then fund the government, since 40 cents in every dollar of spending is currently borrowed. It can simply print the money which will generate inflation, or it can ask US citizens to buy it.

The challenge is magnified by the growth in federal debt. Government figures forecast that it will rise to 100% of GDP by 2021 and then plateau. But the calculations assume that GDP grows by 3.5% in real terms for the whole ten years. If inflation never gets above 2.4% throughout the entire period, if there are no recessions and if the long bond yield is never above 4.5%, public debt still remains at 100% of GDP. For the country to reduce the debt level, its economy will have to grow much faster — at rates not seen since the Second World War.

So how will the government fund its growing deficit? The last time when debt climbed so much was the Second World War, and that led to 80% of all bank loans going to the government. The only way that America ever supported this amount of debt in its history was by massively squeezing out the private sector.

The debt was subsequently reduced by trashing bond investors through inflation. This was also helped by strong economic growth, fuelled by a postwar explosion of consumption after the end of rationing and price controls. But a consumer boom is not an option now with current levels of consumer debt. If some new technology comes along that can

push real economic growth to 5% for the next ten years, the problem would be solved — but it would have to be a major technological breakthrough, a new form of growth to make the federal debt level a non-issue.

The US can only fund the growing federal debt if it makes the purchase of government debt compulsory. And one way that it can do this is through the new vogue for macro-prudential regulation, which sounds like motherhood and apple pie but is a way to force debt into the private sector. As a result of tougher international capital adequacy rules designed to avoid another financial crisis, financial institutions will be required to hold more government debt.

Another strategy used after the war was to mandate bank deposit rates with the rationale of avoiding destabilising competition for savings. The rates were consistently set below inflation, helping governments to fund themselves at negative real interest rates. A variant has just been introduced by the Italian government in a new fiscal package which imposes higher taxes on all financial instruments apart from government bonds. Whether it is through the stick or the carrot, the financial sector has to be forced into the government debt market.

However, one further condition is needed if government debt is to be forced on the private sector. The average maturity of US government debt is about four and a half years, so bond investors will take their money out of the country if the government is creating inflation while paying negative rates. Since I think it is inevitable that western democracies will

## FISCAL DEFICITS

get into the business of inflating away their government debt, there will have to be exchange controls to restrict the free movement of capital.

We can already see that the Greeks cannot stand by while capital is leaving, because it is creating deflation. And the Swiss cannot live with the capital arriving because it either raises the exchange rate or boosts inflation. Sooner or later, the politicians will say that they should just stop it from moving — rather than adjusting to capital, capital should adjust to us. After a period that peaked in the 1980s when many politicians decided that the market was superior to government, we have reached a tipping point where they are now moving in the opposite direction.

So after the banking crisis comes the fiscal crisis and then financial repression where governments force investors to buy their debt. The public sector has bailed out the private sector, but now the private sector must bail out the public sector. And that will be a nasty surprise.

If central banks print more money for the bail-out, the stock market will rise. But as financial repression increases, the markets will realise who will actually pay in the long run. It will be the private sector, and corporations will be attractive targets. President Obama has already identified “big companies” for higher taxes: and the amount of corporate tax as a

percentage of GDP is one of the lowest ever at a time when corporate profits are close to a post-war high. This is a good time to sell US equities!

Many people see equities as an asset, but they are not: they are the fine sliver of hope between assets and liabilities. And in the modern world, it's a finer sliver of hope than ever before because of gearing. In periods of deflation, bankruptcy risk rises sharply because revenues fall while fixed costs do not or fall more slowly. But whether we have a big deflationary shock, or inflation which ends in deflation, stock prices fall.

What positive developments could make my prognosis wrong? I can see four possibilities:

- A surprise recovery in US residential real estate. It is a very cheap market relative to earnings and finance is cheap if you can get it. At some stage the market will clear and a stable to rising housing market would make people a lot more excited.
- Growth in commercial bank balance sheets. It is hard to see how the economy can grow strongly without growth in bank credit and growth in the money created by expanding bank balance sheets. If the banks start working again in the US, there will be reason for optimism.

**President Obama has already identified “big companies” for higher taxes: and the amount of corporate tax as a percentage of GDP is one of the lowest ever at a time when corporate profits are close to a post-war high.**



- Rebalancing of sectors. As Chinese wages rise, manufacturing in the West is becoming very competitive, very quickly. Tourism is also coming back quickly, driven by tourism from mainland China.
- Game-changing technological developments such as an incredibly cheap source of energy would raise the non-inflationary growth rate.

But these are uncertain and I predict that China will be running a deficit within three years, selling Treasuries and buying renminbi. That would provide the deflationary shock, which would be followed by falling equities and then government measures of financial repression to sell the debt. Manipulating the bond market, forcing banks and insurance companies to buy government debt and capital controls will be the response to fuel high levels of nominal growth.

The funding of US government faces an enormous crisis. The foreign central bankers are doing less of it, so the American people will have to step in. And the resulting deflationary consequences will be bad for growth and for equities. ●



### THE INTERNATIONAL MONETARY SYSTEM: WHO NEEDS A SYSTEM?

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**The international monetary system is blamed for exchange-rate volatility, currency wars, global imbalances, the domination of the dollar and recurrent financial crises. But the present arrangements usually produce outcomes that reflect underlying economic reality.**

**Charles Wyplosz,**

Professor of Economics, University of Geneva

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We live in a world where there is no recommended exchange-rate regime. Every country is free to do what it wants: most developed countries let their exchange rates float, while most developing countries effectively have fixed or managed exchange rates.

There are agreed rules of conduct within this non-system, under the surveillance of the International Monetary Fund which has to certify that countries are not manipulating their exchange rates. And after the start of the financial crisis, the G20 agreed to coordinate policy more deeply, moving away from a free-for-all. But member countries are not willing to enter into any remotely binding agreements.

The question is whether there is anything wrong with this. Those who wish to create a new international system put forward five main criticisms of the non-system which I will deal with one by one.

The first is that the non-system generates too much exchange-rate volatility. It is certainly true that there was zero volatility under the Bretton Woods fixed exchange-rate regime, which tied currencies to the US dollar which was convertible into gold. But that was before globalisation, when there were capital controls and financial markets were smaller. The world has changed considerably since 1971 when the US ended the convertibility of the dollar to gold, and we cannot return to fixed exchange rates globally.

What we now have is periods when nothing much happens on exchange rates, followed by bursts of excitement when exchange-rates move a lot. But there are good reasons for the volatility, which reflect changes in the structure of economies. In other words, there is exchange rate volatility and there are good reasons for it — so there is very little that we can do about it.

The second criticism is that the non-system leads to currency wars, when countries are accused of hold-

ing down their exchange rates which makes other countries' exports less competitive. There is a constant debate on this between the Chinese and the Americans which resembles the debate between the US and Japan 30 years ago. Switzerland has this year intervened to hold down its exchange rate which had appreciated as a safe haven amid turmoil on the markets. Brazil says that US monetary policy through quantitative easing is pushing up the real against the dollar.

Yet these movements reflect underlying economic performance. The dollar has been weak because the US economy took a terrible hit in 2008, and the exchange rate movement is part of the adjustment process. Brazil's economy is booming and overheating is leading to inflation, so letting the real appreciate is the best thing for the world. Exchange rates often misbehave, but in the last four or five years they have been doing what you would expect them to do to spread the burden: countries that have current-account surpluses have exchange-rate appreciation, and the converse is true.

Third, critics say that the international monetary non-system generates global imbalances. The huge surpluses in China and huge deficits in the USA inevitably lead to financial crises, they say, that will require a considerable fall in the dollar to restore US competitiveness. Yet it is fascinating that after the US housing bubble burst and house prices collapsed, there was not very much depreciation in the dollar. And it is very clear that that when the US economy got into trouble in 2007-08, it had nothing to do with the dollar — it was the bursting of the housing bubble which built up through the actions of the US mortgage industry.

In my view, it is very not clear that there is anything wrong with the US running deficits and China running surpluses. They are at different stages of development and have different ways of operating. China has huge savings that sometimes exceed 50%

of GDP for reasons that are well understood; household saving is zero in the USA because of its bizarre financial system. If there's something wrong with the US mortgage industry, that is not a global problem. And I find it hard to believe that appreciation of the renminbi would cut savings rates in China: indeed, the renminbi has appreciated 30% over the last two years and there is still a current-account surplus.

As China is becoming rich, it is a huge saver — and it is much better to have 1.5 billion people becoming rich and saving rather than being extremely poor and not saving anything. This enormous pool of savings will reduce long-term interest rates, and although that makes borrowing cheaper in the USA, that is a great opportunity to borrow and invest in productive capacity.

Fourth, there is a perennial discussion about whether the domination of the dollar in world markets is desirable. I think there is nothing wrong with it — though since it is a competitive market, it may not last. But for now, while the percentage of foreign reserves held in dollars rises and falls, it is largely stable overall. The euro has not increased its market share over the constituent currencies since monetary union, while the Japanese yen has been going down after its years of glory.

Everyone is now looking at the renminbi, and maybe one day it will become a world currency. But for now it is not convertible and China still has a cen-

trally planned economy. And while there is always talk of expanding Special Drawing Rights (SDRs), the international reserve asset created by the IMF, they are not money. A few billion people use dollars, but SDRs are used by just 187 central banks. Right now, there is no challenger to the dollar, which is here for many years to come.

The fifth and last criticism is that the international exchange-rate non-system is crisis-prone. There have been enormous, devastating crises constantly over the last 30 years or so — Latin America in the 1980s, Asia in the late 1990s, the US in 2001 and 2007-08, and now Europe. But my view is that we cannot ascribe these crises to exchange rates. Each crisis can be explained through domestic policy mistakes.

In Latin America during the 1980s, countries were fixing their exchange rates and stoking inflation through excessive monetary creation. There were huge currency mistakes in Asia, where countries were borrowing in US dollars creating an enormous weakness that eventually exploded. The US subprime crisis could have been averted with proper regulation supervision and consumer protection.

The IMF may have made mistakes in Latin America and Asia and failed to warn of the pressures building up. But even when it did have concerns, its warnings went unheeded. The functioning of the IMF has been less than glorious, but does that mean we need a new international monetary system?

**Everyone is now looking at the renminbi, and maybe one day it will become a world currency. But for now it is not convertible and China still has a centrally planned economy.**





Europe's crisis is home-made — the result of fiscal indiscipline with poorly thought-out governance in the eurozone. Levels of public debt have risen by 30% of GDP on average since the financial crisis, which was the correct response to avoid a remake of the Great Depression. But many countries had already built up debts before 2007 that were very high for no very good reason. Many European countries ran budget deficits every or almost every year — Greece last had a surplus in 1972 and France in 1974.

You cannot operate a monetary union with member states not committed to fiscal discipline, and this deep weakness in the eurozone is the reason for the current crisis. Meanwhile, the European Central Bank has never seen its role as being to backstop the crisis. And the crisis has suffered from extreme politicisation, with France and Germany meeting regularly to come up with communiqués that show they have no grasp of the situation. Resolving a financial crisis is a technical issue, but they bring politics into it and as a result every country is pulling in its own direction.

My view is that there is no clear case that the non-system we have is not working, and I do not see any alternative in any case. The big issues are national policy mistakes, and while we would like to have a benevolent dictator telling countries to stop making mistakes, they are sovereign entities that cannot be forced to do anything they do not want to do.

The world balance of power is clearly moving towards Asia, and as a consequence the international financial organisation that oversees the system will have to change. But this will take decades. What I foresee is evolution, rather than suddenly overthrowing the existing non-system and replacing it with a new one. ●



**“If the world is going to survive, we will end up in a situation where the long-term legacy of the debt crisis is an understanding by politicians that if a fiscal authority wants to be solvent it has to run primary budget surpluses in perpetuity.”**

**Viewpoints from Jonathan Wilmot**  
Chief Global Strategist, Credit Suisse



*Q: How do you see asset values?*

Some interesting things are happening on asset valuations. US house prices, measured in terms of gold, are at a secular low only seen once before in the last 100-odd years. US equities are pretty low also when measured in terms of gold, nearly as cheap as they were in 1979.

In outright terms, equities are not so cheap at the moment and bonds are extremely expensive. So equities are very cheap relative to bonds. This reflects an all-time low in risk appetite, which is an almost 180° reversal of the situation in March 2000 — which makes me feel that we may be at some sort of turning point. Perhaps people are far too gloomy about equity returns over the next decade, when bonds will very soon not be the place to be.

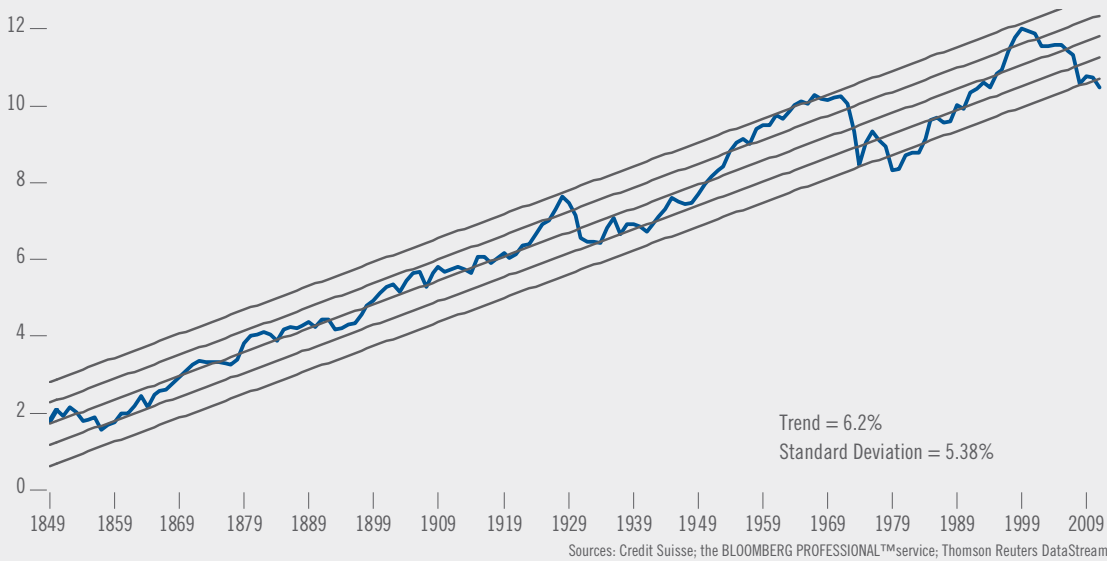
*Q: Are you optimistic or pessimistic about the economic outlook?*

I look at this in the context of my own account of the evolution of the world economy, which has been my framework for the last 20 years or more. The structure of the world economy is becoming more and more like that in the 19th century: lots of innovation, new markets, new sources of labour, new sources of supply, international capital flows on a huge scale, oscillation between confidence and growth in the emerging markets, financial shocks, bubbles and capital flowing back to the core again.

That sort of oscillation took place very often in the 19th century but two things have changed now. First, the role of government is very different. And the role of central banks is very different — banking panics were two a penny in the 19<sup>th</sup> century, but we hadn't had one since the Second World War until 2008, which was the first proper banking panic since the Great Depression.

The point, though, is that if the world is going to survive, we will end up in a situation where the long-term legacy of the debt crisis is an understanding by politicians that if a fiscal authority wants to be solvent it has to run primary budget surpluses in perpetuity—and the more debt you have now the bigger the primary surplus that you have to run. It is

## LONG-RUN EQUITY RETURNS, MEASURED IN GOLD



difficult to be sure about that they will in practice do this, but it would take us back to the ideal of 19<sup>th</sup> century governments and banks.

Second, the banking system in the 19<sup>th</sup> century had to hold a lot of capital and operate with a lot of liquidity because it was not underwritten by the state to the same extent as now. Let me just make clear that that did not stop bubbles. It did not stop people from getting overexcited by the latest investment fashion and it did not lead to stability. In fact, it was pretty inefficient, in many ways, to have a situation like that. But in an odd way, we are now trying to move the banking system back towards that model.

Now what were the economic consequences between 1850 and around 1907 of operating on the 19<sup>th</sup> century model? We got, for the most part, deflationary growth, massive and brutal structural change, and lots of volatility. So 20 years ago, I made a rather bold prediction that long-bond yields would go to 3% everywhere, on the grounds that if that was how the economy was going to work, we would end up in that sort of deflationary growth — despite central bank inflation targets, despite all the things that move the political system to be biased towards inflation in the money system.

I was wrong in one respect because after each bubble, we have ended up fighting deflation with more and more monetary

stimulus, to the point where we have driven real bond yields down to avoid deflation. The question now is whether we can survive the latest crisis and have another ten years of the same system operating effectively through gently accelerating inflation to reflation, without a great deflationary bust.

*Q: Is this a good time to invest?*

From an investor point of view, the world that we now live in is a paradox because my valuation indicators suggest that if we avoid systemic collapse, this could be an extreme decade for equity returns. So maybe gold is not the place to be, for example.

It is clearly the case that the global financial system faces a number of very specific threats of which the eurozone crisis is the greatest. It could drive us not just into recession but into something much, much worse and that is the fear that haunts investors. On top of that, there is the huge inequality of wealth and income in both the Western world and the developing world, which is a source of potential political unrest, failure or even break-down. That means there is a political uncertainty on top of more generic uncertainty about how the system is going to evolve and operate.

In my judgement, those uncertainties are greater than any time since I started working 30 years ago. Investors hate un-

certainty and it is hard to see a middle way through it. Either the world ends up in depression and that will be the end of globalisation. Or it will end up in a surprisingly good place, although getting there will feel horrible. Managing money in that sort of environment is not a picnic, even if you're bullish. ●

**“The political justification for the euro was an attempt to unify a continent where people had an incredibly bad record of internecine warfare in the 20th century, an unquestionably laudable objective. But the worst way to try to achieve political unification or a meeting of minds is through money.”**

**Viewpoints from Vinay Pande,**  
Chief Investment Adviser, Deutsche Bank

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*Q: How will the euro crisis play out?*

I recently asked our economists this very question — what was going to happen to the euro? They said there were three possibilities. The first could be characterised as “muddle, muddle, muddle” — they gave this a roughly 70% chance of being the outcome. Europe’s leaders come up with a wonderful insurance scheme now, but there’ll be another scheme after three weeks and another three months later. If it were possible to postpone a comprehensive solution long enough, perhaps partial solutions could buy time until a return of world growth could rescue the euro. Think of policymakers with a pail full of meat running away from a pack of wolves (the impatient market), throwing pieces of meat out at regular intervals to distract the wolves, until the policymakers are rescued. And who knows? Some good may eventually come of this if it results in more mobile labour markets in

Europe and more responsible fiscal policy in each country.

The second possibility (to which they gave a roughly 20% probability) is that the wolves come so close that the entire pail of meat needs to be emptied in an instant. That would be a common euro bond, or a vast amount of QE by the ECB — from the point of view of the conservative core of Europe a cheque written on a piece of elastic that stretches from planet Earth to Mars, and they fear what the ‘profligate’ periphery would do with that. (Of course, in the periphery it is not viewed this way and is considered the most obvious solution.) Third is a disorderly breakdown, with a small 10% probability. Countries like Greece are pushed against a wall; they find the process unbearable and default. The consequences could be extraordinarily bad not just for the eurozone, but for the whole world economy. They gave a zero probability to a fourth possibility: a negotiated, orderly dissolution of the euro such as could possibly be achieved by a dual currency route being adopted by either the core or the periphery.

Speaking purely for myself, I don’t believe the risks are quite that skewed to the first outcome and away from the others, but, yes, I agree it is the preponderant possibility.

*Q: What went wrong with the euro?*

There was a crack in the wall from the start, a set of weaknesses which were well flagged by, for example, US economists in the 1990s. Whether they were liberal or conservative, they said the project was flawed in its design and construction and would lead to something like the present crisis. There was also, of course, political objection by Conservatives in the UK. The periphery of the euro area has since experienced a relative loss of competitiveness vs. the core in some eurozone economies of the order of 15%, 20% or even more. This is obviously a bad situation but, in the past, would not necessarily have been the end of the world. The problem was that the crack in the wall proved a disaster when the malevolent aspects of globalisation led to an earthquake. Over the last decade, the enormous trade deficits recorded by the US took the dollar from parity vs. the euro to 1.60; that is the earthquake I am referring to. Overlay the 20% loss of



## HOW TO TAKE ADVANTAGE OF ASYMMETRIC PAY-OFFS

competitiveness on this 60% dollar move and you begin to appreciate that these countries would struggle against almost any competitor, never mind Germany. The key therefore is to see the problem in context. The context is globalisation and the risks and opportunities it has created. In that sense the euro crisis is like the earlier sub-prime crisis. Something similar happened in the US during the 1960s and 1970s when it racked up enormous deficits for the same reasons it has done so more recently. Except the US dollar currently seems to have no difficulty, as we speak, in finding foreigners to fund a current-account deficit that dwarfs that of the euro area. Are the Chinese and Americans brothers, in a sense that Greeks and Germans are not? The political justification for the euro was an attempt to unify a continent where people had an incredibly bad record of internecine warfare in the 20<sup>th</sup> century, an unquestionably laudable objective. But the worst way to try to achieve political unification or a meeting of minds is through money. In my experience you cannot unite over money; you fight over it. There is a fundamental danger in trying to achieve unification through “a bureaucratic compromise hashed out in smoke-filled corridors”. That seems to be the perception of Eurosceptics. Note that I am not suggesting it can't happen, of course, but that there are great vulnerabilities created in this process.

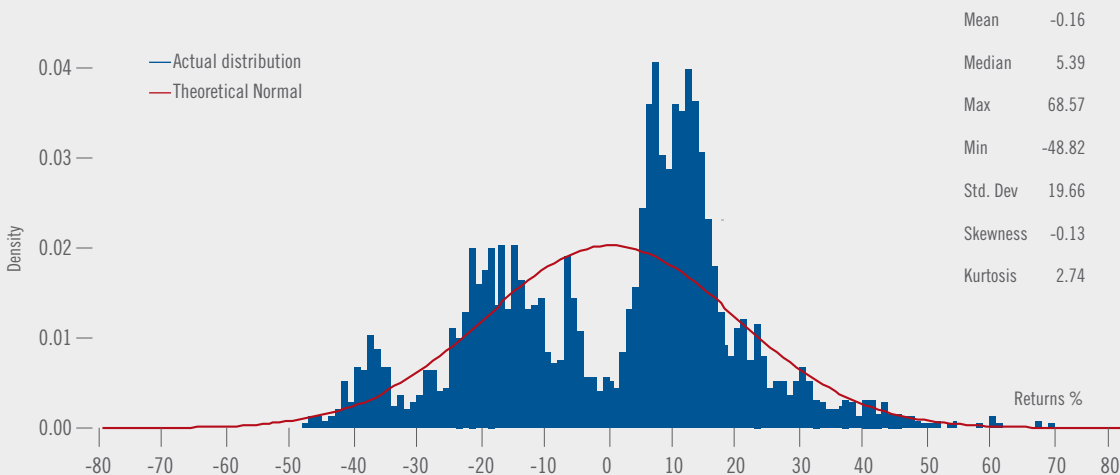
*Q: How do you see the next decade in global financial markets?*

Globalisation has created a tension between winners and losers. When the winners are succeeding, there is fast growth; when the losers drag the global economy down, we have low growth or recession. It is worth remembering that in the last ten years we have had six years of the highest growth rate in human history, especially between 2003 and 2008. When 2.5 billion people emerge from the deep ditch they dug for themselves 300 years ago, this has to be a positive process and there are ample opportunities. But this is a Ricardian process where there are winners and losers: the winners are the ones located in the intersection of the Ricardian exchange where they enjoy the benefits of cheap labour, cheap capital, cheap commodities, technology and organisation. The losers are not confined to the developed world, but certainly include labour facing wage competition and long-term savers facing depressed interest rates and elevated liabilities in the developed world. This tension is creating an intensely binary outcome world with bimodal returns across risk assets. However, by the end of the decade, we will be likely to be living in a very different world — one where engineering growth through low exchange rates and low interest rates in countries like

**In the past, this would not have been the end of the world, but globalisation turns the crack in the wall into an earthquake. Over the course of the last decade, the US' enormous trade deficits have caused the dollar to plummet against the euro. The single currency went from parity to as high as 1.60 at one point.**

### LIVING IN A NON-GAUSSIAN WORLD: EXAMPLE OF A BIMODAL DISTRIBUTION

S&P 500 price index rolling 1-yr returns for the period Jan '00 –Dec '10



Sources: Bloomberg Finance LP, Standard & Poor's, Deutsche Bank GMR



China is no longer possible because they run into severe raw-material shortages; elementary things like water, food, energy. This would be a situation analogous to the one in the late 1960s when Europe and Japan ran out of surplus labour. We will then be heading into an era of lower real growth globally, in which emerging-market exchange rates are rapidly appreciating. And although my primary fear today is of the risk of deflation or at least disinflation, I fear that by 2020 the risk will be one of inflation in the developed markets as the appreciation of emerging-market currencies exports inflation to the West.

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**Q:** *How do you hedge your portfolios?*

The world has become very unstable in GDP terms and much more unstable in earnings terms. Where there's a good outcome, profits are extraordinary and so, therefore, are returns on equities and high yield debt. When the economy sinks, profits collapse, equities collapse, high-yield collapses — risk assets collapse. This produces bimodal distributions of return outcomes. The most powerful defence against

disaster in a portfolio is to invest in assets that because of the environment or a valuation that is depressed or elevated present asymmetric pay-offs. Interesting long positions lie in assets where if bad things happen, their valuation goes down only so much, but if good things happen, it goes up a lot. An asset that goes up very little if good things happen but collapses if bad things happen is an interesting short. I combine these to produce an efficient asymmetric-type portfolio with a smile. I layer onto this option strategies, often short-dated, that take advantage of opportunities where this asymmetry, or bimodality, is inappropriately priced in volatility markets. ●

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