►On Target

Martin Spring's private newsletter on global strategy

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It Should Be a Good Year for Investors

It is important to have a game plan that shapes our investment tactics – to move forward beyond the short-term volatility of the markets, reduce the risk of emotion-driven wrong decisions, and make it easier to ignore the turbulence.

The festive season offers an opportunity to do some serious thinking as well as relax. Liz and I had a wonderful vacation at the best resort hotel in Cambodia, La Résidence d'Angkor, where we were delighted and proud to find that the general manager is a fellow South African, Karin van Zyl. I had the time to consume some excellent brain food, such as John Mauldin's book *Endgame*.

Looking forward, here's how I see the major factors that are likely to influence values this year in the principal asset classes:

Equities

America's stock market was the strongest of the major bourses last year and is likely to remain resilient despite the well-known negatives.

The crisis in real estate will worsen. The proportion of home owners with mortgage loans who are trapped in negative equity (they owe more than the value of their properties), already about 25 per cent, will creep up, as will defaults and foreclosures. It's easy to foresee further declines in average home values of ten, 15 per cent before the market bottoms out.

Another round of the banking crisis threatens. Encouraged by their huge success in getting the politicians to guarantee them against default and provide virtually unlimited, almost-free loans, the bankers went on another speculative spree. But that has been coming to an end, and the bills are being presented – for gambling on Greek bonds, etc.

Occupy Wall Street and the Tea Party, whose anti-banker views have strong public support, make it much harder for the politicians to come to the aid of the financial classes -- and other vested interests such as organized labour -- with public money.

In an election year, policy compromises beyond very short-term fixes will be near-impossible. No serving or would-be congressman or senator will want to support measures such as raising taxes or cutting welfare benefits that will cost many more votes than can be gained through their showing responsibility about tackling the fundamental, long-term problem of ballooning public debt.

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Against those negatives is a formidable array of positives for Wall Street:

► Earnings are growing and likely to continue doing so, driven by the formidable resources of corporate America – excellent big-company managements, global brands, and a culture that promotes inventiveness and business risk-taking.

► The financial climate is hugely favourable for those multinationals. They have strong balance sheets, access to as much really-cheap capital as they want, and get half their profits outside the low-growth domestic market.

► The climate for containing… squeezing… labour costs is also very favourable. It remains relatively easy to resource growth in labour-friendly, modern plants elsewhere. At home, there is an abundance of job-seekers that keep a lid on pressures to raise pay rates. It's become relatively cheap to hire new labour – in manufacturing companies are now paying $12 to $19 an hour versus $21 to $32 for established employees.

► In an election year, and with the banker class who control the Federal Reserve wedded to the idea of "printing" unlimited money, there is no risk of any rise in official interest rates.

► For the same reason, there is no risk of any big bust. The banks and mega-companies who control the political system know they are "too big to fail."

► The weight of nervous money keeps income yields of securities without default risk such as Treasuries so low that dividend yields of many large, low-risk companies offer an attractive alternative for income-seekers.

The outlook for most other stock markets is also favourable.

In **Europe** shares have already fallen sharply in anticipation of a very difficult earnings environment, rising corporate default risks and corporate refinancing stresses.

The Eurozone crisis is a serial that will deliver further unpleasant episodes as the year progresses… without reaching the required final conclusion -- removal of the huge and still-growing burden of government debt that is the base cause of all the problems.

That will be a troubling environment for corporate managements.

The regional economy – which, taken as a whole, is larger than that of the US – is sliding into recession. Germany, its growth machine, faces austerity-squeezed sluggishness in domestic demand within Europe and more difficult export markets outside it. Germany's strengths are in the very sectors, such as capital goods and automotives, that are hit hardest by global economic slowdown.

Europe's ongoing banking crisis will starve businesses of credit, especially those in the job-creating small and medium enterprise sectors.

The corporate sector will continue to be burdened by negative fundamentals such as high taxes and social insurance levies on employers, over-regulation (it takes an average of 258 days to get permits in Italy to open a new warehouse), rigid labour laws that make it difficult and extremely expensive to retrench staff, and cultures hostile to entrepreneurs and strong economic growth.

Nevertheless, Europe has some fine, internationally-competitive companies such as Novo Nordisk and Fresenius Medical in healthcare that should benefit from weakness in the euro.

I suspect that the worst is over for European equities and we should see rebound or greater strength in the better prospects.

Britain, squeezed by public-sector austerity and imported inflation, paying the price for decades of reshaping the economy away from manufacturing into money-shuffling and property speculation, and burdened by bureaucratic overload and poor political governance, is certain to face a more difficult year.

But at least it doesn't have an immediate sovereign debt problem. It only needs to refinance its government debt over 13 years, compared to five to seven years for most major nations. And it controls its own currency. Unlike Italy (or indeed Germany) it can "print" money to refinance, should it need to.

There is always an exchange-rate risk when investing in British securities as sterling could fall significantly in dollar/euro terms, as it did in 2008. When that happens foreign investors experience a fall in capital value; domestic investors miss out on the capital gains they could have had outside the UK. I do not see that as an immediate risk.

Britain has many fine companies in which you can invest, and they offer some protection against currency risk, as they get more than half their earnings overseas.

The strongest major currency

Japan, another nation with some fine companies, continues to struggle with the aftermath of its own financial bust, which predated the American one by almost two decades. Many years of fiscal spending, much of it wasteful, has insulated its economy against collapse, but has left it with a huge burden of public debt – about 200 per cent of GDP in gross terms, and about 120 per cent in adjusted terms after stripping out inter-government liabilities.

Its domestic market remains bogged down by sluggish consumer and corporate demand.

Consumers see little growth in their incomes and have to husband their resources to provide for retirement – Japan has the world's worst ageing-population problem.

Corporations have little debt and big savings, as they can't see enough opportunities in which to invest at home. Export markets are unusually difficult because the yen is so strong, driven by repatriation of Japanese investment capital from overseas.

Those of us who respect Japan's formidable technical and managerial resources periodically look for some development that will trigger a new round of growth in sales and profits, such as a significant weakening in the exchange rate. But it never comes.

It is very difficult to find attractive opportunities in Japanese shares.

Resource markets such as Australia, South Africa and the oil producers have suffered from declining commodity prices and investors' anticipation that the

slowdown in the world economy will reduce demand and keep those prices under pressure.

Energy supplies in the biggest single market, the US, are growing more strongly than demand, largely because of the "game-changing" explosion in shale gas and oil production.

Prices of industrial minerals are mainly driven by demand from China and other developing economies, but for the moment continued growth there has been offset by sluggish demand from the still-more-important mature economies.

The longer-term outlook for commodities is encouraging because many factors constrain, or are likely to constrain, increases in supplies. Additional production has to come largely from expensive sources such as shale, deep-water and remote locations requiring costly infrastructure. There are major shortages of skilled technical staff. Political risks and the cost of risk capital impose their own limits on exploration and development.

The immediate outlook for prices of commodities – except for gold, the currency-substitute – remains negative. But we could see prices stabilize later this year if markets start to anticipate more aggressive policy-easing in the emerging markets and some increase in their demand.

Commodities could provide some of the more interesting share opportunities in 2012.

The Growth Economies

These have been hammered by the classical enemies of equities – inflation and policy-driven measures to combat it.

We are probably close to ending that period of regression, so these are also markets that more adventurous investors will shift into, or increase their exposure to, during the coming months.

China will be the key. Its direction will be determined by policy changes in Beijing.

Their priorities have been reducing inflation, which is a politically-sensitive issue, curbing speculation in real estate, and the exposure of banks to bad-loan risks following the splurge of spending in 2009.

Progress is being made on all those fronts. Inflation is falling. The property bubble is deflating. Banks are being forced to strengthen their balance sheets.

Because of its fundamental strengths – the power of its manufacturing sector, high personal savings, sound government finances, enormous foreign reserves, progress with stimulating personal consumption and providing social housing, the close government/business partnership, and control over exchange rates – China is well-positioned to ease policy constraints, and has already made a cautious start doing so.

Such easing will certainly happen more rapidly and aggressively if financial or other crises threaten to plunge the world economy back into recession and endanger the forward momentum of the Chinese economy.

We aren't there yet. When it happens, the first signal will be a rebound in Chinese domestic stock markets. It's likely to happen soon. China will probably deliver the

world's strongest major share markets this year, after being among the worst performers in 2011. Bourses of other Asian economies, especially those closely linked to China, will be quick to follow the lead from Shanghai.

Other assets

Bonds. These markets are driven by several major influences that sometimes neutralize one another – inflation, interest rates, policy changes, currency risk, default risk, economic growth.

Inflation is poison for the value of traditional fixed-interest securities whose values are not protected against rising prices. Although investors are understandably pessimistic that large-scale money printing lays the foundation for a future explosion in inflation, that risk is still a long way off – except for countries such as the UK, which are very exposed to imported inflation brought about by devaluation of their currencies.

Higher interest rates not only signal that central banks are moving to anticipate inflation – they also have an immediate negative impact on bond values. However, they may also come about because the owners of capital demand higher returns to offset risks such as inflation, default or currency devaluation.

In the mature economies, higher policy rates are not an immediate threat. Central banks are committed to ultra-low interest rates and money printing to combat recession, especially given political obstacles to providing fiscal stimulus.

In the emerging economies, policy rates have been rising for some time. But they are unlikely to increase much, if at all, as inflation in those economies is being brought under control. Also their fundamentals are much sounder because of low levels of debt and high savings ratios.

Economic growth is important because without it lower rates make it harder to reduce debt. Strong, sustained growth enables countries to eradicate much of their public debt, as has happened in the recoveries following major wars.

Currencies, defaults and politics

That leaves several dangers for bond markets.

One is the risk in securities denominated in currencies other than the one you use to measure your own portfolio. This is significant for those of countries that have a track record of using devaluation to protect their economies. But there is also the risk of lost opportunity for capital gains in the currencies of nations whose exchange rates are likely to strengthen – China, for example.

Default risk is always in the minds of bond investors, which is why they have been fleeing the securities of Eurozone governments, just as they have always fled from those of high-yield corporate borrowers. However, remember there is no default risk in the bonds of nations that can "print" money to repay their maturing bonds (just potential currency risk).

Finally, there is the less obvious danger of political risk. Governments sometimes default on their foreign-currency liabilities. Governments also sometimes change the rules, so penalizing bondholders. We've just seen that happen in the Eurozone for private-sector owners of Greek state bonds.

The outlook for 2012 is that bonds considered to be the safest – whether those of sovereign issuers such as Germany, or the best large companies – are likely to continue rising in value because the owners of capital, especially pension and long-term institutional funds, have to invest somewhere. Higher-risk bonds should remain under pressure.

Gold. This is a commodity that doesn't behave like the others because it is a money-alternative that can't be printed, and whose value is difficult for governments to manipulate. It has been called "the anti-dollar" – although it's just as much an alternative to the euro, the pound, the yen or the yuan.

For some years now the value of the yellow metal has been driven up by strengthening investor demand and, more recently, the decisions of central banks to abandon their foolish policy of selling off their reserves and, in many cases, to buy gold.

Those positive factors will remain in place this year, boosting the price to new records.

Investment Traps for Expats to Avoid

Those working/living abroad are a promising target for promoters of packaged investments. They usually have large savings to invest, lack the expertise and information flow to invest wisely, and need good advice on tax planning for their home countries… yet they're far from their usual sources of personal advice.

Unfortunately they easily become victims of financial advisers who, while promoting products that are usually perfectly legal, channel them into investments that deliver poor returns, lock up their capital for years, and are burdened with high expenses… while generating good commissions for the advisers.

In Thailand, where I live, I was recently given two examples of expats being lured into such poor investments.

In one case the investor has discovered, too late, that his money is locked in for seven years, with huge penalties if he tries to withdraw his money to avoid high ongoing fees. In another case an American was talked into placing a million dollars with a high-profile British insurance company before discovering that fees totalling 4 or 5 per cent a year are being levied – he is also effectively locked in for years to come.

Don Freeman, one of the handful of US-registered investment advisers living in Thailand, argues that the problem is that most of his competitors earn their living from commissions paid by insurance companies and other financial firms for promoting their products or services.

Typically the investor finds himself locked in for years to pay for the adviser's sales commission, and facing large redemption fees – typically 5 to 9 per cent – if he wants to move the money elsewhere before the contract completes its term.

Freeman doesn't say so as bluntly as I can -- but such advisers have an obvious incentive to channel clients' money into investments that are more remunerative for them, even if they know they are a poor choice in terms of probable investment return, safety and flexibility.

In my experience, not all such commission-earning advisers allow such bias to influence their advice. But most of them do.

In the US and the UK the commission-based model is being banned or at least heavily penalized. In many countries where expats live, however, such advisers continue to operate, free of such home-base regulation.

Freeman argues that the structure of compensation that advisers receive for their investment counsel can be "a good gauge" of their soundness. "A fee-only compensation model guarantees the highest degree of impartiality regarding the enforcement of the adviser's fiduciary duty."

Compensation derived from fees paid by the client "provides an obvious built-in incentive for advisers to act in the investor's best interest":

► If they fail to do so, "they will lose you as a customer" and lose income derived from you;

► "When fees are assessed as a percentage of assets under management, managers have an incentive to grow your assets."

However, as some advisers who "tout themselves as 'fee-based'… also accept other payments that could influence their recommendations," before anyone makes an investment, he/she should first insist on full disclosure by the adviser of how he/she is compensated.

Doubtful tax benefits, high costs and penalties

Peggy and Chad Creveling, who are also US-registered personal investment advisers based in Thailand, offer this detailed analysis of the traps awaiting the unwary in investment plans widely promoted to expats…

The promotional literature for these plans can be pretty compelling. The sales pitch might go something like this:

"You have the opportunity to invest in an offshore savings scheme offered by a leading provider of sophisticated financial products in a low-tax offshore jurisdiction with world-class standards of regulation and transparency. Premium multi-currency savings plans are available, with built-in flexibility, easy access, and a wide-range of investment funds. Depending on how much you choose to invest, allocation rates of 110% and higher are possible. Unlimited switching between funds is allowed with no charge, and there's no bid-offer spread."

The above offer may also be accompanied by a hypothetical graph showing how much your plan could be worth over time. But what's not disclosed is that the calculation is based on an unrealistically high rate of return given the significant fees involved in the scheme.

Based on this type of marketing, it's understandable that many expatriates are tempted to purchase such a plan. Even Americans married to foreigners who wouldn't personally benefit from an offshore tax structure may wonder if they should purchase a scheme for their non-US spouse.

But before taking action, it really pays to do your homework. To help you evaluate whether these schemes make sense for you, we've put together the following list of things you should know:

1. You’re not just buying an offshore investment; you’re buying investments inside an offshore insurance wrapper.

Although this point ..may be glossed over in the marketing, you should understand that you’re actually investing inside an insurance structure as defined under the laws of an offshore jurisdiction, and you should also understand why this may not be a good deal.

The assumed attractiveness of investing inside an insurance wrapper is the tax-deferral benefits that might accrue to the buyer. But depending on your situation, these benefits may not be of much use to you. Unfortunately, there are several drawbacks to using an insurance wrapper to house investments:

► The buyer must enter into a “long-term obligation” (usually between five and 25 years) that can only be undone at great expense.

► The insurance policy structure makes it easier to hide fees. Significant costs can be buried in the policy’s layers, making it difficult to work out how much is regularly being deducted from your savings.

► Depending on your situation, you may find that you already can invest at a low tax rate using an offshore brokerage account, without the insurance wrapper.

► When you return home, you may find that your home country does not recognize the offshore structure as being insurance, so the tax-deferral may be lost.

► For US citizens: Generally, most offshore schemes don’t meet the IRS definition of an insurance policy, and so US citizens, who are taxed on global income, may not get any tax-deferral benefit from the insurance policy structure even while they’re living overseas.

2. The scheme’s fees really add up. The specifics can vary between insurance firms and plans. However, one thing they all have in common is that the fees involved are significant and not all are transparent.

For example, if you total up all the fees that are deducted over the life of your plan, you may find that your end investment is worth 30-40 per cent less than if your investments had not been held inside an insurance wrapper.

Here are some of the fees that can be involved:

► Charges on initial units: Also called expense recoupment, this fee can range between 1 to 1.5 per cent per quarter, or 4 to 6 per cent per year. It’s applied during the length of the plan against the initial units purchased in the first 12 to 18 months.

► Scheme fund administration or mirror fund charges: Ranging from 0.7 to 1.2 per cent per year, this fee is deducted in monthly increments from fund NAVs (net asset values) and is not expressly spelled out in your statement.

► Scheme ongoing management fee: Some insurance companies charge an additional fee of up to 0.75 per cent per year for management.

► Broker’s fees: Some IFA (independent financial adviser) salesmen receive an additional 1 per cent of the plan value per year for selecting funds on your behalf.

► Initial commission: Depending on the plan and the amount you're investing, you may also be charged an upfront 5 to 7 per cent every time you pay a premium into the plan.

► External Fund Charges: Charged by the investment fund and not shown on your statement, these include management fees and administration charges. These fees are deducted from the fund's NAV and can range up to 3.5 per cent per year, easily averaging 2 per cent across all funds in a typical scheme.

3. You'll pay most of the surrender charge, even if you don't surrender the plan. The cost of surrendering a plan is based on a percentage of the initial units purchased, with the percentage declining over time.

The high apparent cost of surrendering a scheme can act as a psychological barrier to prevent expatriates from quitting their schemes early. Yet in reality, the high ongoing fees applied to the initial units (layers of fees that can total more than 8 per cent per year) means the the net present value of what's left at the end of the plan is not worth much today.

In both situations, a significant amount will be deducted, either in an up-front surrender charge if you quit the plan early, or in ongoing fees over time if you keep it until the term end.

Cost-effective ways for expats to invest

4. There are better options. The marketing literature may suggest that offshore investment schemes using insurance wrappers are the most cost-effective way to structure an offshore investment portfolio.

That may have been the case many years ago. Today, however, there are much more cost-effective ways for expatriates to invest offshore.

For example, if you expect that overall global markets can return 9 per cent per year on average over the 25 years you plan to invest, consider the following two choices:

► Offshore scheme inside insurance wrapper with $1,000 monthly contributions for 25 years. No up-front commissions or explicit fees for advice, 1.2 per cent per year in imbedded mirror fund charges, 1.5 per cent quarterly initial unit charges, and 2 per cent per year average external fund charges.

Total contributions: $300,000. End-of-plan value: $596,158. Internal rate of return: 5.29 per cent.

► Offshore investment portfolio held in a brokerage account with $1,000 monthly contribution for 25 years. Total portfolio costs averaging 0.56 per cent per year including custodial fees, brokerage trade commissions, and fund total expenses.

Total contributions: $300,000. End-of-plan value: $978,146. Internal rate of return: 8.74 per cent.

Based on the above numbers, you end up with far more in your pocket after 25 years if you choose the offshore investment portfolio without the insurance wrapper.

5. For Americans: Punitive PFIC rules may apply to offshore investments. Not only are offshore insurance wrappers unlikely to qualify for US tax-deferral benefits from the IRS, worse, the investments they house may be considered Passive Foreign Investment Companies (PFICs).

Unlike US-incorporated mutual funds, where capital gains are deferred until realized, and which are subject to preferential long-term capital gains rates, PFICs are subject to a particularly punitive taxation regime. Annualized tax rates on PFICs can add up to 50per cent or more.

Luckily, there are much better ways for Americans to invest globally. For more details on PFICs, see *The IRS Never Sleeps: Taxes Americans Need to Know About Before Investing Offshore* at <http://crevelingandcreveling.com/blog/34-the-irs-never-sleeps-taxes-americans-need-to-know-about-before-investing-offshore.html>.

In summary, before you buy an offshore investment scheme, it's important to carefully read all the terms and conditions of the plan.

Consider whether you receive any tax benefit from using an offshore insurance structure versus simply investing in an offshore brokerage account.

Build a spreadsheet to model the plan over time, and include all fees, hidden or otherwise. What the sales literature does not expressly tell you may become clear once you agree to purchase the scheme, your investment is subject to a layered fee structure that can lower your investment earnings significantly, perhaps by 30 to 40 per cent per year, and thereby dramatically lower the value of your overall investment over time.

Your money will no longer be your own; your investments are locked inside the insurance wrapper for up to 25 years, and the policy can only be surrendered at great expense.

It really pays to do the analysis first. You may find that you can end up with far more over time, if you choose carefully.

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Hunting for Prospects in High Growth

There are many difficulties about investing in emerging economies.

Several of the most important, such as China and India, are effectively closed to direct investment by foreign individuals – although some of their biggest companies can be accessed indirectly through depositary receipt certificates listed in major centres such as New York, London or Frankfurt.

Accounting standards outside a handful of jurisdictions such as Singapore and Hong Kong are inferior. There is less protection for investors (although cynics, seeing the MF Global scandal, will ask how much safer it is elsewhere).

Conventional advice is that the low-risk way to buy into the emerging economies is to invest, not into their listed companies, but into multinationals that have major stakes in those countries' markets, so can be expected to participate in their future high growth.

Unfortunately not many firms get a high proportion of their sales from such markets – enough to make a significant impact on their earnings growth.

Fullermoney newsletter recently listed 110 companies that got at least 20 per cent of their revenue in the last quarter from Asia-Pacific and/or Latin America (APLA). But only 39 gained 40 or more per cent from those regions, and I struggled to identify those that look attractive investments.

Most of those focused on the growth economies are infotech companies with highly volatile earnings over the past five years, suggesting they will be hit hard by the slowdown in the world economy – although some have encouraging charts:

Qualcom, whose technology is widely used in wireless voice and data communications, has a last-quarter APLA ratio of 75 per cent. It has had average annual earnings-per-share growth of 13 per cent over the past five years and currently trades on an earnings ratio of about 20x.

Jabil Circuit, which provides tech management services, has an APLA ratio of 70 per cent, with a volatile earnings growth record. Its PE ratio is currently around 11x.

Sandisk Corp., the data storage developer, enjoys an APLA ratio of 67 per cent, with an annual earnings growth figure of 22 per cent and a current PE of around 10x.

Outside the infotech sector, several companies stand out for their combination of sustained earnings growth over the past five years and encouraging charts:

Yum! Brands, the fast-food chain, boasts an APLA ratio of 49 per cent, with annual profit increases that have been averaging 13 per cent. It currently trades on an earnings ratio of about 23x.

Colgate-Palmolive, the consumer staples and household products giant, enjoys an APLA exposure of 48 per cent. Its earnings growth has been averaging 12 per cent a year, its current ratio is around 19x.

British American Tobacco, long-time champion of the "sin stocks," earns 45 per cent of its income in the APLA regions. It has also been growing its profits at a 12 per cent annual rate and has a current PE ratio of about 19x.

Apart from this, all the above companies are American. The only European firms listed as having APLA exposures greater than 40 per cent are the German infotech developer **Aixtron**, Belgium's **Anheuser-Busch** (brewing) and **Bekaert** (industrial materials), Spain's **Telefonica** (with its big telecoms exposure in Latin America), the Anglo-Dutch consumer products giant **Unilever**, the French geophysical services provider **Veritas**, the Swedish capital goods supplier **Alfa Laval**, and Switzerland's **Holcim** (building materials).

Smearing the Good Guys

For years apologists for poorly-performing economies have argued that the outperformers such as China and Germany are just as much to blame for the

fundamental imbalance in world trade because they depress their consumer demand and so save too much.

That's equating the thrifty with the profligate, which is outrageous. If the over-spenders curbed their excesses, that would slash demand for the exports of the trade-surplus countries and bring the system back into balance.

One important reason why the Germans, for example, are unable to stimulate their domestic demand is that its consumers, who already enjoy high living standards, are unwilling to indulge in the spending sprees fuelled by personal debt that have distorted and disfigured the US and UK economies.

The latest example of seeking to blame those who stick with the virtues of thrifty behaviour is the accusation that the Germans are responsible for the imbalances within the Eurozone, where the Club Med countries have been able to develop big foreign trade deficits without suffering any run on their currency that would force them to act to curb the deficits.

GaveKal, the respected economics and investment consultancy, demolishes this argument, giving the facts in the case of Italy, the biggest of the problem children.

When Italy changed to the euro as its currency in 1999, it had an annual foreign trade surplus of €25 billion. It now has a deficit of €35 billion – an adverse swing of €60 billion. But trade with Germany accounted for only €13 billion, or 22 per cent of that swing.

The bulk of the deterioration in Italy's external trade balance came from oil (€60 billion a year) and trade with China (€20 billion).

GaveKal says: "Excluding China and oil, Italy today runs a comfortable trade surplus that is almost twice as high as it was in 1999 in nominal terms, and that has remained roughly stable as percentage of GDP (3 to 4 per cent)." So Germany's "advantage" from being able to trade more easily within the Eurozone had little to do with it.

And by the way...

Despite all the fuss over its high public debt-to-GDP ratio of about 120 per cent, Italy has many fundamental strengths that are largely ignored.

For example, Italians are richer than Germans... or Americans. Their private wealth of €9 trillion is an average of more than €350,000 per household, or enough to cover the public debt four times.

Among the advanced nations, it is at the top of the IMF's debt sustainability ratings (the US has one of the lowest), and runs a primary budget surplus (revenue meets expenditure, apart from interest on the debt). The average maturity of its government debt is seven years – higher than the US's five years.

The Club Med President Shows His Colours

Despite the stern, father-like posturing of the new Italian president of the European Central Bank, Mario Draghi, it's clear that he is going to be much more amenable to pressure from governments of the 17 Eurozone member-nations to implement loose-money policies than his predecessor.

One of his first actions has been to offer unlimited three-year loans to European banks, with no specific limits on what they do with the money. This gives them huge capacity to borrow from the ECB at 1 per cent and use the money to buy government bonds now yielding 6 per cent or more.

At a single stroke, Draghi has collapsed the dangerous stresses that were building up in the European financial system because of lenders' reluctance to provide short-term credits to banks.

What is not admitted, however, is that the new easy-money policy is clearly a manoeuvre to circumvent the ban in the ECB's constitution on lending money to Eurozone governments, who were facing a huge problem over the next three months refinancing their maturing bonds – some $600 billion worth.

Seeing the opportunity to do this, as well as shield themselves against the risks of panicky flights by their depositors, the banks have rushed to take advantage of the ECB's new facility, immediately signing up for the equivalent of $645 billion worth of the loans.

GavKal says banks "will now be able to theoretically acquire unlimited government bonds portfolios without exposing themselves to rollover or maturity risks…

"This Ponzi scheme could potentially result in an even bigger money-printing operation than anything the US, British and Swiss central banks have done on their own accounts."

Tailpieces

Rip-offs: One interesting proof of how executives of many banks have lost focus on their primary responsibility (giving efficient and honest service to their customers), concentrating instead on speculative trading and other high-risk pursuits, is the fine of nearly £30 million imposed in the UK on HSBC, the international mega-bank, for grossly irresponsible marketing of its investment products.

Between 2005 and 2010 a subsidiary sold £285 million worth of investments to elderly and disabled customers. Investigators discovered that 87 per cent of the sales were unsuitable, as the average age of the customers was 83 – most would not live long enough to benefit, as the investments required the buyer to take a five-year view.

Credit default swops: Are these another sub-prime financial time-bomb?

The safety of these – contracts for insuring against default on sovereign bonds and similar securities – depends on the safety of the counter-parties selling then. Often they are European banks. Which explains the extraordinary efforts by European governments to avoid declaration of an official default on Greek debt.

There is no transparency about CDSs, as these derivatives are not listed on public exchanges. So there is no certainty about the scale of the potential problem, although it is clearly huge.

The seeming failure of CDSs to protect holders of Greek debt from the "voluntary" haircut – agreed cut in the capital amount of bonds repayable at maturity date –

has encouraged banks, especially those outside Europe that cannot count on compensation from Eurozone governments, to flee Eurozone sovereign debt.

Germany: Not as strong as you might think. It has a fiscal deficit still above 4 per cent of GDP and a debt-to-GDP ratio close to 80 per cent, with its economy certain to be hit by renewed global slowdown as it's heavily dependent on exports of capital goods and automotive products.

Nevertheless, it's important to keep a sense of perspective. Investor demand is still so strong that yields on its government bonds are still very low, and in some cases even negative on shortdated debt – investors are prepared to pay to lend money to Germany.

Safe jobs: Amazingly, not a single public servant in Britain's ministry of defence has faced compulsory redundancy, at a time when thousands of soldiers, sailors and airmen are being forced out.

The reason, apparently, is that the previous government, whose party power base is closely linked to labour unions, signed up to an agreement that everything possible has to be done to avoid compulsory retrenchment of public servants – civilians, that is, not ones who do the fighting to defend the nation. The current government has done nothing to scrap the agreement.

Mega-bucks: There's never been a better time to be a capitalist in America, argues Orrin Sharp-Pierson of BNP Paribas. Profit margins before interest and tax for both listed and unlisted companies are at their highest since the 1960s. Thanks to falling tax rates and rock-bottom interest rates, after-tax margins are at their highest apart from a brief period in 1949.

Stuck in the wrong places: About half of all institutional private-equity investors have a stake effectively locked into a "zombie fund" where unsuccessful managers with no hope of getting a bonus are holding on to the investments as long as possible to live off the management fee," typically 1½ to 2 per cent a year, instead of releasing capital to the investors, the *FT* reports.

Stock-market forecast: The next significant move in equity markets is likely to be on the upside, argues well-known analyst David Fuller, taking into account "monetary policy (mostly accommodative), valuations (reasonable and often quite attractive) and sentiment (still quite pessimistic)" – a contrary indicator.

Wise words: *A government which robs Peter to pay Paul can always depend on the support of Paul.* George Bernard Shaw.

Martin

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