

It's all in that rally to be invested.
But to over-act upon will be very heaven.

The markets are going up. But they're vulnerable. A derivative has lots to recommend it.

Activity is not quickening,
but slowing

Last week's economics numbers were anaemic. In the old industrial world, sales and production indices disappointed, leading indicators drifted and housing activity weakened. The recovery, such as it was, seemed to have stalled. It had been driven in 2009, not by a revival in final demand, but by a correction in inventories. The latter now completed, there was an implication that growth in the second half of 2010 would be moderate.

There's no justification for
tighter credit

Central Banks acknowledged the prospective deceleration. The Fed and BOJ no longer talked of exit strategies. Mindful of the possibility of double-dip, they were careful to stress their long term commitment to monetary accommodation.

Jean-Claude is in a hole—
and still digging

The ECB, of course, had no time to fret about economic trends. It was as much as it could do to stop the euro falling apart. The yield spread between German and Greek Government bonds had risen above three hundred basis points again. Investors, in other words, saw the risk of Hellenic default as being uncomfortably high: a 10% probability of a 30% repudiation in the next twelve months; a 50% probability of a 51% repudiation in the next ten years!

Politicians likewise

It wasn't just Central Bankers who were feeling the heat. Government Ministers too were under fire. In Japan and the States, support for incumbents had been falling for some time. In Europe, likewise. Chancellor Merkel's poll ratings were not good; President Sarkozy had been slaughtered in recent municipal elections.

Why is Brown less un-
popular than he used to
be? Cameron!

Only in the UK was Prime Minister Brown holding his psephological own. And why was that? Because the British economy was shining again? Certainly not. Probably because the alternate, Candidate Cameron, was deemed equally unattractive: no more competent and no less dishonourable.

Markets are rising, though
comparison.

For the moment, though, the securities markets were quite happy. Investors liked the idea of easy credit and they didn't mind the anaemic real growth that accompanied it. The combination kept pay settlements moderate and profit margins satisfactory; concurrently, it kept demand for financial assets high. Bliss!

Will it last?

The anxiety was that the authorities mightn't be able to preserve the favourable circumstances. If activity were either to quicken or slow, there'd be risks. In the one event, inflation would rise; in the one other, it would be bankruptcies that did so.

Probably not

For London, there was another worry. It was that the European Commission, attempting to divert blame for the financial crisis from itself, would implement regulations aimed at making life for Hedge Funds intolerable. Significantly, Merkel and Sarkozy were supposed to have agreed some proposals along these lines, and had only to convince Brown to go along with their ideas!

The loonies in the EZ are one threat

What was to be made, though, of Wolfgang Schaeuble's suggestion that the German Secret Service be used to spy on and identify those investors who'd undermined the euro? What a splendid idea! It was a story line that might have been dreamt up by the authors of "Allo, Allo!" Would today's equivalent of Major-General von Klinkerhoffen instruct today's equivalent of Herr Otto Flick? And would the results be as hilarious? Probably.

An economics aftershock, another

The reality, less so. There's a fairly high probability that the world economy will suffer another severe downturn in the not very distant future. The danger is not that it occur in the second half of 2010, but in 2012—when activity is due to be cyclically low. There is a fairly high probability also that the euro (and possible the whole EU) will disintegrate. In such circumstances, politicians can't be relied on to behave rationally (*vide* Schaeuble now). The risk is they'll do something daft (protectionism, for instance) and make matter worse

If in doubt, ask the people

We don't know what will occur to them, and we can't therefore protect ourselves from it. All we can say is that democracy tends to help: the judgment of the amateur typically being better than that of the professional. Predictably, therefore, anglo-saxons have a better track record than others.

And reduce risk in the portfolio

Near term, the chances are that equities will rise, but next year the going may be tougher. It'd be sensible for most funds to stay fairly flexible in the second half of 2011.

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