



# **Wermuth's Investment Outlook**

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# Wermuth's Investment Outlook

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1. **Near term, global growth continues to strengthen while inflation rates are rising** – deflation is not an issue at this point. Equities are thus well supported, as are commodities, but after their strong rebound in 2009 they are no longer cheap.
2. **Bond markets** might suffer from higher inflation rates, record government deficits and debt as well as from the coming end of monetary easing – as it is, they are doing just fine. Corporate bond markets in particular are booming. With banks sidelined by their balance sheet problems, borrowers have actually stepped up the issuance of corporate bonds (by about 50% between 2008 and 2009, to almost \$3tr). Since there is no lack of demand for such securities, nor of liquidity, spreads over government bond yields have shrunk considerably. Even the junk bond market is back in fashion. There is no lack of capital looking for a decent return.
3. Moreover, investors **are not yet convinced that central banks are indeed serious about reversing course** and launching exit strategies, at least for the time being: labor markets are too distressed, and core inflation is still falling. They may be more discriminating than in the past with regard to sovereign borrowers such as Greece, Ireland, Argentina, or Italy and the UK, but in general they do not seem to worry about government bonds. This includes sovereign issuers from emerging economies, many of which benefit from solid public finances.
4. **In its new Financial Stability review the ECB paints a fairly bright picture.** It argues that the resilience of financial systems around the world has been greatly improved by the determined provision of funding support to key financial institutions and the bolstering of their equity base, combined with an unprecedented macroeconomic policy stimulus. These actions have made business more confident and caused systemic risks to fade. Risk premia such as the difference between the earnings yield of stocks and the real yield of riskless bonds, as well as prices of equity put options, have declined significantly since last spring. Investors are presently not afraid of another stock market crash.

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5. **Medium term, things look different. For me, the overwhelming evidence continues to suggest that equities are only in a bear market rally, if a very strong one, and that inflation is not a serious risk given rising unemployment and huge output gaps in advanced economies and some emerging countries. The deleveraging process, ie debt reduction, is still going on.**
6. **Especially banks in OECD countries must further strengthen their capital base.** Since their price-to-book ratios are mostly less than 1 rather than the more normal multiple of 2, raising fresh capital is not only difficult but also expensive. They must therefore improve their return on assets. It helps that the very generous provision of central bank money has boosted asset prices, and that yield curves are unusually steep. But non-performing loans are still increasing, for instance in commercial property. One strategy is to shrink balance sheets by getting rid of the least-promising assets. **They are thus not keen on expanding their loan portfolios - which in turn tends to prevent the transition to a self-sustaining, long-lasting economic recovery.**
7. At the same time, **households which have seen the value of their homes collapse are forced to cut back on spending in order to regain financial health as debt levels often exceed the reduced market value of their properties.** The countries most affected are the US, Britain, Spain, France, Denmark, Ireland and the Emirates which together account for 41 per cent of global GDP at current exchange rates. It is not easy to imagine that the world economy can actually take off for good with consumers in these countries staying on the sidelines. There are also some other countries, such as Hong Kong, Australia, South Africa, Italy, Sweden and Canada which I regard as accidents to happen. Previous property booms there have not yet been followed by noticeable price adjustments – these countries account for another 9.9 per cent of the world's GDP.
8. Apart from stimulus measures of OECD governments and central banks, **the main drivers of global demand and thus of stock and commodity prices have been a few Asian countries.** China, India and Vietnam (10.5% of world GDP at market exchange rates, 16.5 % in purchasing power terms) kept growing briskly during the global recession that ended last summer, and seem to accelerate now. China's industrial production has been up 19.2% y/y recently, India's 11.7%. South Korea and Taiwan are catching up quickly as well, with growth rates of industrial production of no less than 17.8% and 31.5% y/y. Output gaps in these countries are about to disappear. Japan's and Germany's export orders and actual exports already reflect the vigorous pick-up of demand in this part of the world.
9. Market participants are currently betting that Asia's expansion, in particular China's, rests on solid fundamentals and can therefore continue for the foreseeable future. Since **Asia is increasingly less dependent on exports to the rich world, ie the United States**, it does not matter so much any more that America's consumers are no longer the big spenders they used to be: for ten months straight, outstanding credit to US households has declined by now.
10. Unnoticed by many analysts and commentators, **China's strong growth is now fuelled by domestic demand. Imports are therefore taking off, in spite of the supposedly undervalued exchange rate.** Technically speaking: the income effect (of the economic boom) exceeds the price effect (of the artificially weak exchange rate). In 2009, the US has probably imported a total of \$1,865bn of goods and services, or 26% less than in 2008,

while I estimate that China has imported \$1,155bn (-14% y/y). More recently, the discrepancy between the two economies has widened. In the fourth quarter China imported 22.3% more than one year ago, America imported 19.5% less in October and November (no December data available yet).

11. **Within two years, China will be the world's second largest importer**, behind the euro area and ahead of the US, if present trends can be extrapolated. It is already the world's growth locomotive. Incidentally, this is also reflected in China's rapidly shrinking trade surplus.
12. **So far, China's economic model is delivering good results** (not for the environment, though). One argument for allowing the yuan to appreciate is that this would put more purchasing power into consumers' pockets. Both American and European politicians and academics such as Paul Krugman argue (self-servingly) that this is the way forward. As a matter of fact, China's real private consumption is already rising faster than real GDP, a trend that will continue in 2010. And real GDP will grow by 10% or more this year! No other large country comes even near such a rapid improvement of general welfare.
13. **The national savings rate is gradually declining but is still at an unheard-of 55% of GDP** (IMF World Economic Outlook, Oct. 2009, p. 62). In view of this number it is not a problem to accommodate fiscal stimulus programs of 10 to 20% of GDP annually – which China is doing -, and to simultaneously run a current account surplus, ie export capital in the order of 6% of GDP (net). At the same time, the physical capital stock grows in leaps and bounds which boosts productivity and incomes, helps avoid bottlenecks on the output side and keeps inflation down.
14. Is this too good to be true? **Is China overheating?** The main risks are that (1) all this capital spending will lead to overinvestment, followed by falling returns on capital, and that (2) the strong monetary expansion, mainly caused by interventions in FX markets, creates new asset price bubbles. Both trends actually reinforce each other. In December, Chinese M2 has been about 30% higher than one year ago while corporate borrowers are charged only 5.3% to 6% for maturities between one and five years. Given that real GDP grows by 10% or more, and that consumer price inflation is 0.6% y/y, an appropriate interest rate should be well in excess of 10%! In short, money is cheap and plentiful, and the government provides, presumably for fear of social unrest, a sort of People's Bank put, comparable to the infamous Greenspan put, a guaranteed bail-out and invitation for borrowers and speculators.
15. For now, the risks appear limited: investors are not yet euphoric and valuations are fairly reasonable. Price-to-earnings ratios on the basis of earnings forecasts for 2010 are 19 for Shanghai A-shares, 26 for Shenzhen A-shares and 12.5 for Hong Kong's H-shares while mainland house price indicators have been up a fairly modest 8% last year, after 5.3% in 2008. There is no buying frenzy yet. **Some elements of genuine bubbles are thus still missing which suggests that the upside potential of asset prices is not yet exhausted. This is good news for the rest of the world. The global bear market rally in stocks and commodities must not end in the near future. But risks of an eventual crash and global collateral damage are clearly rising.**

16. **Support for equities and commodities is also provided by the simple fact that – at market exchange rates rather than purchasing power parities - the world economy is growing at annualized rates of 3% to 3¾% this year, not significantly slower than before the crisis:** inventories are being re-stocked, government spending plans and widespread tax cuts are catching on, as are exports to Asia and commodity producing countries.
17. At the same time, though, the **global output gap** that resulted from the slow-down of growth and the recession of 2008/09 is not shrinking if growth continues at those rates. Under the assumption that trend growth has been 3.75% per annum, as in the four years before, the gap between actual and potential output is about 8.6%, a post-war record, I think. Even if the growth rate of potential GDP has slowed to less than 3.75% – because the decline of the auto industry, of financial services and construction is permanent and will not be compensated by faster growth in other sectors – the gap remains huge. To it and thus cut average costs, firms will go to some length in their pricing policies. Price wars in manufacturing, in construction but also in services have only just begun.
18. **From this perspective alone, the inflation outlook could hardly be better. Add that unemployment is high, if not rising,** being a late-cycle indicator. Wage inflation is therefore likely to be very subdued. **In the US**, the unemployment rate is 10% and total employment has fallen 6% from the cyclical high two years ago – to accommodate the steady increase of the labor force, the number of jobs should actually rise by about 1.1% annually. In the three months to December, total employment has still been declining at an annualized rate of 2.8% seasonally adjusted (household data). No relief in sight there.
19. In terms of the unemployment rate, the **euro area** is just as bad off as the US (10%) but employment has “only” fallen by about 3% from the cyclical peak in Q2 of 2008. In **Japan**, 5.2% of the labor force is out of a job, up from 3.7% at the last low in early 2008; employment has declined by 2.8% over the past two years.
20. In light of such numbers, **wages have held up surprisingly well.** America’s hourly earnings are still +2.2% y/y while Europe’s most recent indicator of negotiated wages has been +2.3% y/y. In both economies, wage trends are firmly pointing south. Japan is still in deep deflation territory: an indicator called “average monthly cash earnings” has averaged minus 3.1% y/y over the twelve months to November (consumer prices were probably minus 2.0% y/y in December). So it is more or less consensus that there is no wage inflation to speak of in the main OECD economies and that unit labor costs, ie wages adjusted for productivity gains, will be falling. **No wage inflation, no underlying inflation.**
21. **Headline inflation has been picking up quite a bit, though, mostly because commodity prices have risen so much over the past year.** The rebound of the world economy has mostly been driven by energy and raw material-intensive industrial production. The oil price has moved from a low of \$34 a barrel in December 2008 to \$79 now, with corresponding increases of gasoline, heating oil, diesel and kerosene prices for the end-consumer. The total impact of this price increase has been a loss of purchasing power for consumers in the order of \$1.4tr annually, or about 2% of global GDP. So there has been a rather negative effect on household incomes, reflected in a quickened pace of inflation.

22. **Other commodities and basic materials have also become rather expensive compared to the lows reached in the fourth quarter of 2008.** Just two examples: copper is up 160% and is now just 15% below its all-time high, steel (Far East) has gained 73% but remains 64% below its peak. Grains have also become very expensive. Commodity markets are thus heavily betting on a sustainable global recovery. This is confirmed by the international transportation cost “Baltic Dry” index which has increased 376% from the bottom in December 2008.
23. **Overall, the effects of this commodity boom are negative, in the sense that it will slow the growth of global demand and real GDP** – the importers of commodities have a much lower savings ratio (higher absorption ratio) than the producers (OPEC, Canada, Australia, Russia). Since this new trend raises headline inflation rates, the probability of an early exit from expansionary monetary policies is increasing, ceteris paribus, which is also negative. The bottom line is that core inflation will fall further, though.
24. **Bond investors are not visibly impressed by the pick-up of headline inflation – they correctly anticipate that it is only a transitory phenomenon.** Recall that the commodity price boom that lasted until the summer of 2008 has been a major reason for the steep decline of real GDP in the OECD area during the following year. Something similar, if on a smaller scale, is happening again. For bond investors, the prospect of bursting bubbles, followed by disinflation or deflation, is actually a rather pleasant one.
25. As an aside, the policies which had created the earlier booms and bubbles are at work again: easy money, implicit promises to underwrite the gambling losses of financial institutions if they are only big enough, light-touch regulation and expansionary fiscal policies. Hire the devil to drive out Lucifer.
26. **For commodity producing countries, be they Russia, Canada, Norway, Australia or OPEC, the economic outlook has considerably brightened. The price rally will probably not last much longer, but for the moment these economies are reaping large windfall gains.** They gain what the others have to give up in terms of purchasing power (to be sure, from a global perspective it is still not a zero-sum game but rather a negative-sum game, mostly because the number of winners is much smaller than the number of losers).
27. **Russia is now recovering from a very deep recession: on average, its real GDP had declined by 8.5% year-on-year in 2009.** The preceding boom of raw materials had the unpleasant side effect that the production of goods and services not related to commodities had become very unattractive, leading to de-industrialization and imports of goods which used to be produced domestically.
28. The mechanism at work is called the **Dutch disease**. It unfolded like this: in the first round, the explosion of export prices led to a large trade surplus (up to 10% of GDP), accompanied by a surplus demand for roubles, an appreciation of the exchange rate, steeply rising output, productivity, profits and wages in the commodity producing sector, followed, via an arbitrage process, by wage inflation in the rest of the economy (of about 25%, several years in a row), a steep increase of general inflation (up to 15%), a serious loss of international competitiveness of the non-commodity manufacturing sector, an import boom on the back of the strong currency and briskly rising household incomes, and the shut-down of many if not most firms that were exposed to global trade.

29. **When the commodity bubbles finally burst**, Russia suffered from lower export prices and smaller export volumes. The trade surplus melted like snow in the sun – and the rouble crashed, despite large-scale interventions. While this was good for competitiveness, the problem was that not many firms had been left to benefit from it. Unemployment shot up, real wages and real disposable incomes dropped steeply. So did household consumption. Capital flows into the private sector stopped and then reversed; spending on capital goods fell, including construction. The government budget went from surplus to large deficit (8% of GDP). The stock market dropped 80% between May 2008 and January 2009.
30. In the meantime, **the one year long recovery of commodity prices has lifted Russians' spirits again**. Because the blows to the economy had been so severe, there are **no signs of the old exuberance, though**. Banks are still struggling to get rid of mountains of foreign debt and non-performing loans, the construction sector is forced to deleverage as real estate prices have plummeted and show no signs of rising, and the labor market is still depressed.
31. On the other hand, the rouble has appreciated again, currency reserves are up, the trade surplus is getting larger, the government has more money to spend, foreign private capital is rediscovering Russia, and the stock market has rebounded by 213%. **Real GDP will rise by about 5% y/y in 2010, but inflation will nevertheless fall to an average rate of 6 or 7%. In such an environment the central bank can afford to keep lowering interest rates** – which it actually must because banks badly need a shot in the arm, just as the majority of their borrowers who are still paying interest rates in the upper tens.
32. **Rouble bonds** of sovereign issuers and state or quasi-state corporates are thus good bets at this point. **Russian equities** will also do well as long as the world economy supports commodity prices – the average 2010 p/e ratio of the 50 stocks in the main index is only 9.25 (note that stock markets dominated by commodity names must have low valuations!).
33. **So, here is the key question, not only for investors in Russian equities: will the world economy maintain its momentum? According to the consensus, it will. I think, however, that this is by no means a foregone conclusion**. I find myself in the company of most fixed income investors and the ECB, among others, in suspecting that the **chances of a double-dip global recession are not negligible**.
34. **America's real GDP has probably expanded at an impressive annualized rate of about 5% in Q4, after 2.2% in Q3**. The re-stocking of inventories and the massive fiscal and monetary stimulus argue for a continuation of brisk growth in the first half of this year. After that, some negatives kick in: the weakness of household consumption (because of ongoing deleveraging and the commodity-related deterioration of the terms-of-trade), of capital spending (low rate of capacity utilization) and, presumably, exports (because the dollar has not depreciated enough), plus the end of quantitative easing. Neither the Fed nor the government can step up their expansionary policies much more. I would therefore guess that GDP growth will fall back to less than 2% annualized in the second half.
35. **In the euro area, fourth quarter growth is now generally expected to be only 0.3% or 0.4% q/q in Q4**, more or less the same as in Q3. Peripheral countries such as Spain, Greece, Portugal and Ireland are in deep trouble after their property busts; on the other hand, Germany will get a contribution of net exports to Q4 quarter-over-quarter growth of perhaps no less than 2.6 percentage points – which makes the Federal Statistics Bureau's

estimate that growth between Q3 and Q4 has been more or less flat hard to believe. In any case, the ECB expects an average real GDP growth rate for the currency union as a whole of just 0.8% y/y, and 1.2% in 2011. Output gaps will widen further if this is the case, unemployment will be heading toward 11%, inflation will be far below 2%. In April, the ECB will also start its juggling act of withdrawing liquidity – how can this be done without pushing up money market rates? The euro area also suffers from a negative terms-of-trade effect (though much smaller than America's, because of the exchange rate), and a loss of competitiveness caused by the euro appreciation. The euro area will certainly not be the world's growth engine.

36. The same is true of **Japan. The country is still in the grip of deflation.** Both wages and employment are declining, so consumer demand has no strength whatsoever. Monetary and fiscal policy makers have about emptied their tool kits – the only instrument left is the exchange rate. The new government seems determined to prevent a new round of yen appreciations since foreign demand is the only source of strength left. Exports are rebounding strongly from their lows of Q1 last year (but were still down 17% y/y in Oct/Nov) while imports are also recovering, but at a slower pace - they are 29% lower than one year ago (also Oct/Nov). China has become the largest trading partner: the sun may rise in the east, but for Japan it is more important to know what happens in the west - where it sets.
37. **How about China then? As I have shown above, the environment there is mildly bubbly – but getting more so.** Listening to a Chinese analyst earlier this week reminded me of Japanese brokers in the eighties: strong growth as far as the eye could see, this is the Chinese century, everything is how it should be, don't be timid, we tell you when it is time to get off. The following risks must certainly be monitored, though: a trade war with the OECD, especially the US, negative terms-of-trade from rising commodity prices, ie a loss of purchasing power, an acceleration of inflation and a tightening of the monetary reins (because inflation is politically dangerous), and overinvestment 19<sup>th</sup> century style. What it will be in the end can not really be predicted with confidence – for now it is smooth sailing, as it always is before a bubble bursts.
38. **For investors who share this view of the world economy, the best strategy is to diversify risk across asset classes, markets and currencies. Bonds of highly rated governments and corporates should be a significant part of any portfolio. High-dividend conservative stocks should be preferred over cyclicals which have had a good run already. It is tempting to increase leverage but only for those with a very disciplined risk management. Be prepared to increase the relative size of cash (short-term interest rates may go up after all, not least because they cannot go much lower). I always counsel against holding gold, and I do it again, even though this has been rather embarrassing in the past.**

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