WEBLOG

Wermuth's
Investment Outlook

March 2011

ZEIT online • HERDENTRIEB

blog.zeit.de/herdentrieb/

Wermuth's Investment Outlook

by Dieter Wermuth*

March 17, 2010

1. Most global stock markets have passed their tipping points in the past few days. The correction is more than just profit taking after a long rally which had led to fairly rich valuations. It is probably the **beginning of a bear market** that will last several months.

2. Risk aversion is clearly on the rise. While bad for equities and corporate credits, the flight to safety is good news for bonds issued by developed market sovereigns and should further strengthen currencies such as the Swiss franc, the Swedish krona and the euro. The yen will also appreciate further as foreign assets are partly repatriated to rebuild Japan's infrastructure and housing stock; the rouble is a beneficiary of high oil prices and a pick-up in demand for gas as an alternative to nuclear power.

3. **Risk number one is interest rates**: with the exception of the US and Japan, policy rates have begun to creep up or, as in the case of the euro area or the UK, are expected to be raised some time soon. Deflation and double-dip recessions are not seen as serious risks any longer – headline inflation is on the rise everywhere and is forcing policy makers to tighten the reins. This is especially true for those fast growing emerging economies where spare capacities are small by now.

4. By themselves, higher interest rates must not be negative for stocks. They reflect the robust expansion of the world economy: in annualized terms and at actual exchange rates, real GDP is presently increasing at a rate of about 3½%. In purchasing power terms - which give a larger weight to fast-growing emerging markets - global GDP is advancing by no less than 4½%. After almost two years of economic recovery from the deep recession, central banks have begun to argue that monetary policy support can gradually be withdrawn.

5. **In general, interest rates are still far below their "equilibrium" levels**, defined, for instance, as the rate of growth of nominal GDP. As the recovery proceeds they will have to rise significantly and for a rather long time. This is a scary prospect for equity investors. At this point in time, though, monetary policies are without exception still very stimulative, i.e. growth-supportive. Moreover, the new political uncertainties will make central banks hesitant to proceed too aggressively. Even the tough-talking ECB may have second thoughts and postpone the rate hike scheduled for April 7. Higher interest rates will probably be phased in very gradually which in turn limits their negative impact on stock markets.

* Dieter Wermuth works as a consultant for Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

Important disclosures appear at the end of this document.

6. **Risk number two has been the explosion of oil, metal and food prices.** This is more serious. Industrial commodity prices have been driven by global manufacturing which is presently expanding at a year-on-year rate of growth of about 8% while the 48% y/y increase in (dollar) food prices is due to temporary supply bottlenecks, rising global household incomes and the increasing share of crops used for the production of fuel. At the early stage of an economic recovery, stock prices and commodity prices tend to move in synch, but they part company once the transfer of purchasing power from the users to the producers of raw materials becomes excessive. This is the case now. Most OECD countries and large emerging economies such as China and India are suffering from the present commodity boom.

7. Just one example: crude oil (Brent) had cost $35.5 at the end of 2008; by early March this year, its price had reached $116.0. During that 26-month period, daily oil output rose from 84.9m barrels a day to 89.3m. On an annualized basis, the oil bill had thus gone from 84.9m x $35.5 x 365 days = $1.10tr to 89.3m x $116 x 365 days = $3.78tr. **The difference of $2.68tr is about 4½% of global GDP which is an indicator of how much the global income distribution has moved in favor of oil producers.**

8. This so-called terms-of-trade effect is exacerbated by the very high prices of other commodities. At some point, these will all surely crash, as they always do, but in the meantime, they push up headline inflation and interest rates and thus tend to slow down income and profit growth in the commodity importing part of the world. **Disposable incomes there are increasing significantly less than production (GDP) which is negative for household demand and asset prices, including equities.**

9. Uprisings in Arabian countries may mostly be suppressed in the near-term by the ruling monarchs and dictators, but they show that political stability can not be taken for granted any longer. The numbers of underemployed but relatively well-educated youths keep rising, and modern media make people increasingly aware of the poor deals they get from their governments. Unrest will probably be a permanent feature of oil-producing Muslim countries. This suggests that **oil prices will remain high even if global growth cools down**.

10. The **destruction of nuclear reactors in Japan** and the panicky decision by the German government to idle half of the country's nuclear capacity, followed by a reassessment of nuclear power policies in other countries, is good news for oil producers but obviously bad news for oil consumers. The gas and coal demand for power generation will rise as well for some time. Since power generation will produce more dirt from here on, the price of (European) CO2 emission permits will stay high after its recent quantum jump.

11. The momentum of global GDP growth has been little affected by the commodity boom so far, mostly because economic policies are so expansionary. But it is only a matter of time before the commodity boom will take its toll. Equity markets are already anticipating this.

12. **The third risk is a chain reaction of sovereign defaults of peripheral euro area countries.** It would dwarf the Lehman collapse of September 2008 and wipe out more banks, insurers and various other leveraged asset holders. Greek, Irish and Portuguese 10-year bond yields of 12.1%, 9.2% and 7.3% are a sign that investors are doubtful about the solvability of these borrowers. German Bunds yield just 3.1%. The heavy debt service,

combined with extremely restrictive fiscal policies such as tax hikes and cuts in social benefits and government wages is probably unbearable. To achieve primary budget surpluses in a recessionary environment, at a time when government debt has been exploding, is de facto suicidal. Non-Europeans are mostly convinced that defaults are therefore inevitable.

13. So the search is on to find a solution**: the euro will not be allowed to fail, and another financial melt-down must be avoided at all cost.** In the typical muddling-through fashion of European politicians, the compromise among euro area heads of state and governments consists of a large increase of the rescue facility for countries that need to be bailed out, probably combined with an extension of the life of future bond issues, subsidized interest rates, a participation of the European financial stability facility EFSF' successor in future government bond auctions of weak borrowers (from the summer of 2013), and some sort of conditionality concerning the reduction of debt, but not of the really tough kind.

14. Details of **the "Pact for the Euro"** will be hammered out and finalized at the EU-17 summit on March 24/25. But we know the bottom line already: there won't be any defaults, just subsidized borrowing terms for the periphery. Strict conditionality and a new "effort for stronger economic policy coordination for competitiveness and convergence" mean that the euro area is taking a large step in the direction of a fiscal (and thus political) union. As usual, a crisis was needed as catalyst in this long-running process. I wonder how long the UK can remain on the sidelines; at some point it will leave the EU.

15. **Against its will, the ECB is not be let off the hook and may be asked to provide further support in the form of buying (and holding to maturity) euro area bonds**, a substitution for lending shorter-term funds to banks. The quality of its balance sheet may thus deteriorate further and require new capital injections. It has become the fiscal agent of the governments of the euro group of 17. In this regard, it is in a similar position as the Fed, the Bank of Japan or the Bank of England, which are also fiscal agents - it is certainly not a clone of the Bundesbank any longer. It also means that the ECB will probably pursue a more expansionary policy than it likes which limits any future appreciation of the euro. Given the huge output gap this is really good news.

16. Especially for German tax payers, the amount of money that is at stake is breathtaking – almost 10% of GDP. The Merkel government is treading a fine line between the demand of the constitutional court that there may be no bail-out of euro area countries without a change in the Basic Law, hostile tabloids and the desire to save the euro and indeed the European post-war project. There is a long tradition that muddling-through does actually yield results, usually against all odds – it will happen again this time. The risk of sovereign European defaults will thus not materialize and secondary market yields of bonds of supposedly weak borrowers look attractive. **Going forward, the effects of the euro crisis on global equities are close to negligible.**

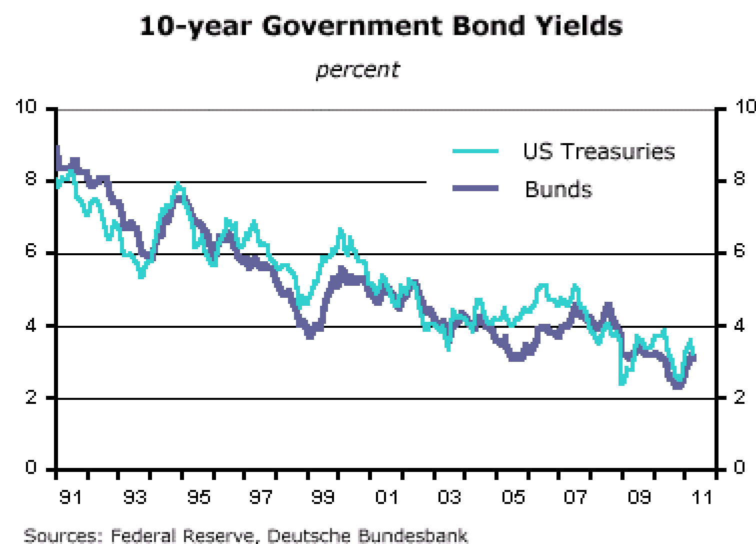
17. **A fourth risk for stock markets is valuations.** As Yale's Robert Shiller, the author of "Irrational Exuberance", keeps emphasizing, they should be based on cyclically adjusted rather than 1-year-ahead earnings per share. If this is done, for instance by using 10-year averages, price to earnings ratios would be quite a bit higher than the numbers reported on our Bloomberg screens – and well above historical highs. In other words, stocks are not cheap and thus prone for a correction. This is particularly true for US, Japanese and Chinese markets.

18. **The major exception is the Russian stock market** which trades at a 2011 p/e ratio of just 6.3; even after a cyclical adjustment, the ratio would be less than 10. Investors overemphasize the negative investment climate and underemphasize the fact that Russia benefits more than any other large country from the commodity boom, the coming phasing out of nuclear power and the rise of emerging economies.

19. **As to the bond markets, the main driver is inflation expectations**, apart from changes in credit quality. The increase in headline inflation in the wake of steeply rising oil, food and metal prices has been fairly modest so far. In advanced economies, consumer prices have moved from a low of 0.1% y/y in 2009 to about 2% y/y in the first quarter of 2011, and from 5.2% y/y to about 6% y/y in emerging and developing countries. The fact that inflation has accelerated somewhat faster in the rich part of the world is mildly surprising: output gaps are still quite large, and unemployment remains high. Core inflation, an (often unreliable) indicator of future headline inflation, is still much lower than at comparable points in time during previous recoveries: US 1.1% y/y, euro area 1.0% y/y, Japan 0.6% y/y. No reason to worry there.

20. Consumer inflation expectations can most easily be derived from **inflation-linked government bonds** (via WBI and WB on Bloomberg). They have gone up somewhat but are still in the green range. For the next ten years, investors expect US and French inflation to average 2.4%, Germany's 2.1% and – surprise – Italy's 1.9%. There are no signs of a new inflation mentality. Wage inflation, in particular, is well-contained. This is mostly due to the ever more intensive international division of labor which is gradually bringing about a world labor market for certain skills. This structural factor will continue to weaken the negotiating power of workers in the rich countries and keep wage inflation and overall inflation in check.

21. A US Treasury yield of 3.25% for the 10-year maturity may look low compared to an expected inflation rate of 2.4%, and Germany's Bund yield of 3.15% looks barely more attractive in real terms. **Both bond markets are regarded as liquid safe havens** in a rather uncertain global environment. The prospects for equities are not so good, as I have shown above, and investors are not deterred by the prospect that central banks will sooner or later have to give up their ultra-loose policies and start raising rates. It will strengthen their anti-inflation credentials and simply lead to flatter yield curves.



22. Moreover, the Fed keeps telling the markets that the **Funds rate will remain close to zero for an extended period of time,** while the ECB may have second thoughts about tightening too rapidly, given the precarious situation of some sovereign borrowers as well as that of the euro area's financial sector. Another factor should also not be neglected: the euro exchange rate could appreciate too much if rates go up fast.

23. **American and German bond yields are low, but not outrageously so – they have been about 100 basis points lower than today not so long ago.** And they are still quite high compared to Japanese and Swiss yields, if only in nominal terms.

24. **The Chinese 10-year swap rate of just 4.19% can also be taken as a sign that markets do not expect that country's inflation to get out of hand**: since headline consumer price inflation, at 4.9% y/y, is actually exceeding the swap rate one can conclude that medium term inflation is seen to fall below 4% again. For a fast-growing emerging economy such as China, an inflation rate of 5% can be considered to be optimal. It should certainly not have caused the minor market panic of recent weeks.

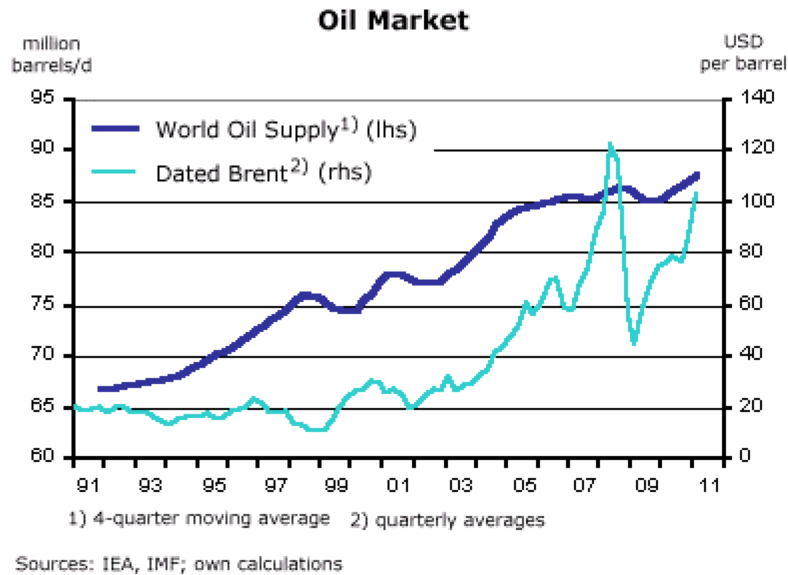
25. Why? Because the 9% trend growth rate of real GDP and annual employment gains in the order of 1% or even 2% suggest that productivity in those parts of the Chinese economy which are exposed to international competition is rising at rates of well above 10%. Even if wages there are up 10% annually, unit labor costs would not increase, and international price competitiveness would not suffer. But one predictable effect is that wages in the "non-tradables" part of the economy, where productivity gains are typically smaller, would also tend to rise by about 10%, the result of a normal labor market arbitrage process. This would push up costs and inflation in that sector to well above zero. This is the so-called **Balassa-Samuelson effect.** In other words, poor economies that are in a catching-up mode can be expected to have significantly higher inflation than capital-rich advanced economies. China's inflation rate of 4.9% is thus no reason to adopt significantly tighter monetary policies. I know that this is a minority view but judging by their actual decisions Chinese policy makers seem to follow the same reasoning.

26. With regard to **yield spreads inside the euro area**, I have already argued that there will be no formal defaults. Weak borrowers will get the necessary help at conditions that won't cripple their economies. Down-gradings by the rating agencies (which want to regain some of the reputation lost in the sub-prime crisis by being tough on euro area peripherals) will probably continue, but blow-outs should mainly be seen as buying opportunities.

27. **How about the oil price?** The demise of nuclear power is not only pushing it up in the near-term, it is also raising the floor below which it will not fall any more. There is another structural factor that suggests that oil will never again be cheap: the rapid increase of living standards in emerging markets. I have recently visited all four BRIC countries which together have a population of 3 billion. One of the most lasting impressions has been traffic jams wherever I was. Motorbikes, three-wheelers, small SUVs and limousines have apparently become affordable for almost everyone, or will soon be. The average age of the vehicles seemed to be much lower than here in Western Europe (except, strangely, for trucks).

28. The conclusion must be that **the demand for gasoline in that part of the world is rising in lockstep with car registrations** – where the growth rate is well above 30% a year. The coming slow-down of global GDP growth that is a result of high commodity prices will not

be enough to bring down oil to less than 70 or 80 dollars a barrel again, not to speak of the 20$ level that prevailed in the 15 years to 2001. I have changed my mind in this respect. I had underestimated the momentum of the growth process in emerging markets, and overestimated the effects of energy-savings policies in Western Europe.



29. It also seems to me **that the demand for anything related to infrastructure, capital spending and manufacturing in general will remain strong and support the prices of things like steel, cement, copper, nickel, aluminum and other metals, plus all sorts of power inputs.** Some correction after the recent run-up is still likely, though. I think that food prices will come down almost as steeply as they have gone up – in general, productivity growth in agriculture is more rapid than population growth, and the share of food in consumer baskets will invariably fall as incomes rise. Gold is also overpriced: actual risks are smaller than the promoters of the metal want us to believe.

30. **As to exchange rates, the near-term driver will not be interest rates** – because they will not move much – but safe haven considerations. Countries with solid external finances, combined perhaps with the ability to tighten monetary policies, will be the preferred choices. **Switzerland, Norway and Sweden come to mind first.** They all have balance on current account surpluses in the order of 6½% to 13% of GDP. The Swiss franc appreciates and appreciates, and yet unemployment remains in the order of 3½%. There is a lot the rest of the world can learn from that country. Sweden is similar. **The euro's fundamentals are less sound** but they are much better than those of the US or the UK – I therefore expect some further appreciation against these two currencies.

31. **The yen will also strengthen further, just as after the Kobe earthquake that led to a large-scale repatriation of foreign assets and claims against foreign insurance companies.** To reach, in real terms, the exaggerated level of April 1995, the dollar would have to fall to somewhere near 60 yen, compared to 78.8 yen today. It is also a foregone conclusion that the renminbi will continue to appreciate, if only in a restrained fashion. Some other Asian currencies such as the Taiwan dollar, the Thai baht or the Singapore dollar have a larger upside potential than the renminbi.

32. **A currency that has seen a renaissance is the rouble**. Russia's current account surplus will reach 5% of GDP this year. Since inflation is now close to 10% the central bank does not mind if the external value of the currency goes up. The dollar is presently at RUB 28.64, after 31.50 at the end of November. My broadly optimistic view on commodities means that there will be strong demand for the currency of the world's main producer and exporter.

Disclaimer: We cannot give any guarantee that the information and data in this "Investment Outlook" is correct, and we cannot accept any liability whatsoever in respect of any errors or omissions. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or investments.

Disclaimer: Alle Inhalte aus diesem "Investment Outlook" dienen nur zur unverbindlichen Information und stellen keine Anlageberatung oder Aufforderung zum Kauf oder Verkauf von Wertpapieren oder anderen Finanzmarktinstrumenten dar. Für die inhaltliche Richtigkeit der Informationen können wir keinerlei Gewähr übernehmen.