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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. **Two years into the recovery from a deep recession, the world economy is in good shape: growth is robust, inflation moderate.** Timely large-scale expansionary policies and the animal spirits of households and entrepreneurs have done the trick. **At the same time, the global economy is also rather fragile.** The list of major risks and unresolved problems remains long and scary: a new commodity boom, revolutions in Arab countries, the euro crisis, America's debt problem, overvalued assets on many bank balance sheets, the flood of international liquidity, manipulated exchange rates, deleveraging processes in countries where asset price bubbles have popped. It is difficult to forecast where all this will lead to.

2. The main question from an asset allocation point of view, apart from the question whether the system as a whole is at risk, is whether the commodity boom, caused by robust growth and lots of liquidity, is the harbinger of a **new era of global inflation or of exactly the opposite, slower growth and subdued inflation, if not deflation.** Is the recent decline of commodity prices just normal volatility around a rising trend or the beginning of a major decline? Other questions that need to be answered concern the stability of the euro area, the outlook for the main exchange rates, and equity valuations.

3. **I argue (1) that inflation fears are mostly unwarranted, (2) that commodity prices have peaked, (3) that the governments of the euro area, the ECB and the IMF will be able to handle the solvability problems of the (small) peripheral countries, that (4) a further dollar depreciation is the most obvious way to reduce global imbalances and that (5) high risk premia make most equities attractive assets at this point.**

the case for lower inflation rates

4. To start with the inflation/deflation issue: **the high cost of energy, food and other raw materials reduces the purchasing power of households in commodity-importing countries and thus leaves less money for other products and services.** Since this group of countries dominates the world economy in terms of GDP, the net effect on global demand is negative and inflation will eventually fall. Global activity indicators which had surged until last February have slowed sharply since, mostly, it seems, in response to firms' higher input costs and a new reluctance of consumers to spend.

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5. Virtually all central banks – except for the Fed, the Bank of Japan and the Bank of England which remain on hold - are **tightening their policies** because headline inflation rates have been pushed above target by commodity and energy prices. Higher interest rates **will have only a minor near-term effect on the rate of inflation.** Inflation will fall, but not yet because of this. On balance, monetary policies **will remain expansionary for some time to come.** Interest rates are in general still very low compared to their "equilibrium interest rates" such as the trend growth rate of nominal GDP.

large excess capacities hold inflation down

6. **The outlook for inflation is crucially determined by the extent of spare capacity, including unemployment**. In aggregate, the global output gap is still large and the inflation outlook therefore positive.

7. World real GDP is presently expanding at an annualized rate of 3% on the basis of actual exchange rates and at a rate of 4% on the basis of purchasing power parities (PPP) which give a larger weight to fast growing emerging economies. This is somewhat less than in the pre-crisis years to 2007 which means that the setback of the years 2008 and 2009 has not yet been made good. The world's aggregated output gap is still quite large. **So why have commodity prices and, in their wake, headline consumer prices accelerated so much?**

8. The simple answer is: because emerging economies are expanding so fast. At this juncture, their growth rates are about three times higher than those of developed markets (6% versus 2%). Countries in catching-up mode are always growing more rapidly than rich countries, due to high investment ratios and large gains in productivity, but rarely by such a margin.

9. In other words, **that part of the world economy grows particularly fast whose production and demand is commodity and energy intensive.** And their impact on the world economy is increasing dramatically: sometime next year, emerging and developing countries will account for more than half of global GDP (at PPP). They have been the main drivers behind the commodity boom. It is also fairly clear that their output gaps must be quite small by now. Between 2003 and 2010, their real GDP increased at an average annual rate of 6.7%. The only outlier was in 2009, when GDP expanded by "just" 2.7% (IMF, World Economic Outlook, April 2011, p.181). For the years 2011 through 2016, the IMF predicts growth to average a little more than 6.5%.

10. The calculations of output gaps are notoriously imprecise, but I would guess that the **difference between actual and potential GDP in emerging economies – the output gap – is not more than 4%, and gradually shrinking.** Strong growth has thus been accompanied by upward pressure on the prices of raw materials, at least as far as this group of countries is concerned, and also on global inflation rates in general. We should not extrapolate these time series. I argue below that commodity indices are in for a correction because a new wave of exuberance has carried them far above trend.

11. **In advanced economies** – which account for 52.3% of global GDP -, the recession was much deeper. Real GDP expanded by just 0.2% y/y in 2008, and contracted by 3.4% in 2009. Since trend growth had been in the order of 2.7% per year (fairly steady since 1993, see IMF, ibid, p. 181), the recession has created an **output gap of almost 9% which was not nearly closed by last year's growth rate of 3%; unemployment reached, and still is, in the order of 10%,** a record high. The recession had almost turned into a depression had it not

been for the extremely aggressive monetary and fiscal policies in virtually all OECD countries.

12. The combination of a significant loss of purchasing power in the form of a "commodity tax" collected by the producers of raw materials, and of large output gaps and very high unemployment makes it virtually certain that **inflation will not be a serious issue in most rich countries.** No new inflation spirals, no new inflation mentality without an acceleration of wage inflation! In the US, hourly wages were +2.1% y/y in April while consumer prices were up 3.2% from one year ago. In Japan, over the past six months the average real income of workers' households was -0.1% y/y. Even in Germany where real GDP had been up by no less than 6.1% annualized and 4.8% y/y in Q1, and where total employment exceeds its pre-crisis high (of Oct '08) by at least 1.2% already, workers don't seem to have any bargaining power either: hourly unionized wages averaged 1.8% y/y in January and February while consumer price inflation was 2.1% y/y. And so on in other countries as well.

commodity prices on a rising trend, but presently in for a correction

13. As we have seen in the spring of 2008**, a commodity boom becomes self-defeating at some point.** In the beginning, it reflects strong global economic growth, but then markets invariably become euphoric and prices rise by more than is justified by fundamentals. This has been happening again since early 2009. For the first time in many decades food prices have joined the party. Bubbles are in general not as big as three years ago (gold, silver and copper are the main exceptions), but prices still exceed their long-term trend lines by more than one standard deviation.

14. **In short, while commodity price trends are well supported fundamentally by the changing structure and the strength of global demand, they are now causing reactions on both the demand and supply side that will bring them down to more reasonable levels. I guess that global headline inflation has therefore peaked, or will soon peak – which will boost GDP growth but will also reduce the pressure on central banks to tighten policies.**

deleveraging and tighter fiscal policies hold down inflation as well

15. **There are at least two other factors at work which suggest that inflation is not a serious issue:**

16. **One is the deleveraging of private household balance sheets**, ie the attempt of home owners to reduce their debt-to-income ratios and become creditworthy again. The process is not yet completed in Japan even though it has been going on for more than 15 years, and it is in full swing in the US where home prices continue to decline. Falling prices have put more than a quarter of all American home owners financially under water, forcing them to cut back on consumption which in turn makes it difficult for firms to pass on their rising commodity and energy related input costs. Similar processes are under way in Spain, in Ireland, probably in the UK, Australia, Canada and several emerging countries. In total, close to one half of the world economy is affected by property bubble hangovers. If the top priority is to reduce debt levels, people will not easily be persuaded to borrow and spend even if rates are low and credit conditions generous. Monetary policy is a toothless tiger in such a situation. The bursting of big asset price bubbles has deflationary effects.

17. Second, it is also pretty clear that **in many countries fiscal policies are no longer effective today, including heavyweights such as the US, Japan, the UK, France and Italy.** As the examples of Greece, Ireland and Portugal show, there is a natural limit to government debt. Foreign lenders in particular are unwilling to provide funds at “normal” conditions when these limits have been reached. Rating agencies will downgrade their debt. Countries are then de facto excluded from international capital markets and forced to tighten fiscal policies – which is deflationary. From a global perspective, monetary policies are still rather expansionary, as I said, but **fiscal policies are increasingly restrictive, or will be, and not only in the US.**

18. Moreover, there is **David Ricardo’s equivalence principle** that states that from a certain point onwards any additional government spending will be compensated by an equally large cut in private sector spending and is thus ineffective. The new debt will be tomorrow’s taxes. Households cannot be fooled into believing that the government is able to hand out free lunches no matter how much it has borrowed already – and therefore they start saving more to prepare for rising taxes down the road.

19. **I do not know how relevant this principle is** in the present environment of significant global output gaps, but the basic idea has some merit. In **Japan**, the jump in the government deficit-to-GDP ratio from 3½% in 2005-2007 to about 10% in the following three years has not been noticeably expansionary or inflationary; the main effect was to drive gross general government debt from 195% of nominal GDP to 230% this year. Incidentally, this has not at all been negative for the creditworthiness of the country which is either the world’s largest or second largest holder of net foreign assets. This is a key aspect: other than Greece, the country is not at the mercy of nervous foreign investors. Huge liabilities, but Japanese 10-year government bonds yield just 1.1%!

bonds of rich country borrowers are expensive – but still in safe territory

20. If I am right about the rather limited inflation risks in developed markets, then there is no reason to be afraid of a crash of Treasuries, Bunds, JGBs or Swedish, Dutch and Swiss government bonds. They had an extended rally during the two decades of the “Great Moderation” and have by now reached **levels which suggest to the skeptics that they must be in bubble territory**. Compared to actual and expected inflation, yields are very low. Gilt yields have fallen particularly steeply – to 3.38% for the 10-years -, in spite of an inflation rate of 4.5%: investors are impressed by the ambitious fiscal consolidation plans of the British government. Even in commodity-driven and potentially high-inflation economies such as Canada and Australia bond markets are surprisingly strong.

21. The message in all of this is that **future economic growth rates in those countries are expected to be much lower than before.** Real risk-free bond yields should move in step with the growth rate of real GDP or, more precisely, productivity. This is a sobering insight. Market participants tell us that living standards (real GDP per capita) in the OECD region will improve by just about 1% a year for a long time to come. A more positive reading could be that there is presently a global scarcity of safe assets – which explains why bond and gold prices have been moving in the same direction lately, rather than inversely as they usually do. Gold prices have presumably skyrocketed because of inflation fears, but if this is the case, why have bond prices which are negatively affected by rising inflation, gone up as well?

22. **One risk for bonds are rising central bank interest rates**. If we are at the beginning of a major tightening cycle this would at some point drive up bond yields. It is obvious that American, Japanese or British rates - which are near zero - can move in one direction only: up! The question is when. It needs a self-sustaining economic expansion to start the process. We are not there yet. The ECB is also not too eager to raise rates aggressively: I expect, as everybody else, two more hikes this year which will bring the main refinancing rate to 1.75%. This would still be below headline inflation.

the euro is wobbly but will not fall

23. **The crisis of the euro has also deflationary implications.** Greece is the country most at risk of defaulting at this point. The government cannot afford to pay the interest rates markets are demanding – 25.0% for two years and 16.0% for five years – and is thus asking for additional financial help from the other euro area countries and the IMF. A major haircut of principals down the road is already priced in. Investors are not convinced that Greece can achieve the dramatic turnaround of its finances that is required for a return to financial health, while the resistance in core countries against throwing good money after bad is on the rise.

24. This year, Greek government debt will reach 153% of GDP, most of it owed to foreigners. In the past five years, current account deficits, ie **net capital imports, have averaged no less than 12.3% of GDP** (IMF WEO, ibid, p. 199). Italy and Belgium have also debt ratios in excess of 100% of GDP, but as in the case of Japan, the proportion of foreign debt is relatively small; these countries can thus still borrow at low rates in international markets.

25. **An outright default is not an option for Greece at this point**. It would lead to an exclusion of the government from capital markets and force it to cut spending to a level compatible with revenues, ie by something like 10% of GDP. This reduction in final demand would mean a deep recession. It also would have very negative repercussions on the balance sheets of both Greek and foreign creditors, ie banks, pension funds and, not least, the ECB (which would have to be recapitalized unless all the losses would be absorbed by a "balancing item" – but this would turn the ECB into a zombie bank), and thus trigger the next major financial crisis of global dimensions.

26. **I had hoped that the present crisis would lead to more coordinated fiscal policies within the euro area**, with the deal being the mutual supervision of annual budgets in return for reliable as well as sizeable financial transfers from the core countries. Since they benefit from open borders and a somewhat undervalued exchange rate they could well be more generous. In any case, for the euro to survive, a fiscal and eventually a political union of the member states is needed, if not immediately. A window of opportunity has been opened by the crises in the peripheral countries.

27. The main actors in the play are not yet thinking this way: Greece would have to accept a major loss of sovereignty and a large-scale privatization of state assets such as highways, utilities, railroads or the telephone company, while Germany and the other so-called core countries would agree to well-defined financial transfers along intra-German lines. **Ironically, the euro area is already both a transfer union** – think agricultural and regional policies – **as well as a political union** – think competition policies, common external tariffs and the European Court of Justice, among others. Nothing more than a further step in this direction is required. The public does not like these ideas at the moment, given an average

unemployment rate of 10%, while politicians don't have the stature to lead from the front. They are afraid of a xenophobic backlash. Dominique Strauss-Kahn's demise has been an additional blow for europhiles like myself.

28. From today's perspective, **the most likely outcome of the crisis in Greece will be a gradual reduction of the government deficit by about 3% to 4% of GDP a year, a rising so-called primary surplus (budget deficit excluding interest expense), a more determined effort to privatize assets worth about €50bn or 21% of GDP and, perhaps in 2013, an extension of debt maturities - while financial help from the rest of the euro area would continue to be provided. The hit for most lenders would be manageable in such a scenario.**

29. **Extending maturities reduces the present value of the cash flow from the bonds and would thus de facto be a default. But it would be a mild one**, and Greece would still be required to raise taxes, cut spending, improve tax collection and privatize in a major way. By reducing domestic absorption (demand) the balance on current account would then approach equilibrium, a key point. In principle, capital-poor countries can have large current account deficits, but these must be reflected in a sizeable increase in the national investment ratio and not just replace domestic savings. The euro cannot survive if capital flows do not end up in profitable investments.

euro will continue to appreciate

30. **Other countries, especially Portugal, Ireland and Spain would undertake similar reforms**. In the end, this would mean a more solid institutional set-up for the euro. For the time being, as long as a convincing and comprehensive solution is not on the horizon, the euro will probably remain relatively weak - which is nice from a short-term point of view: reforms are easier that way. On the other hand, a crash of the currency is quite unlikely because the problems of the US and Japan are as severe as those of the euro area. Just as an aside, the likely aggregated government budget deficit of the euro area countries will be in the order of 4% of GDP this year and will thus be substantially smaller than the deficits of the US, Japan or the UK. Germany is actually heading toward a balanced budget.

31. If my euro script works out, **investors may want to add some of the periphery's government bonds to their portfolios.** Even if the haircuts are in the end larger than assumed by the market, they will still, in all likelihood, gain on the currency. Greek, Irish, Portuguese and Spanish debt will remain denominated in euro.

32. Why do I expect an appreciation of the euro? It will certainly not be across the board: Switzerland, Sweden, Norway, China and to some extent even Russia have all better fundamentals than the euro area and therefore stronger currencies. But **compared to the United States and the UK, the euro has some advantages and could strengthen further:** (1) the ECB has started to raise rates while the Fed and the Bank of England are on hold; (2) euro area policy rates are higher; (3) the currency union's balance on current account deficit will be just 0.3% this year, compared to 3½% in the US and 2% in the UK; (4) as I just pointed out, the aggregated government budget deficit of the euro area will be 4% of GDP whereas America's and Britain's deficits are expected to be in the range of 9 to 10%; (5) euro area real bond yields are higher, just as (6) equity risk premia (see below) – points (5) and (6) make the euro an attractive destination for portfolio investors.

33. To be sure, there are also **some points which argue against a stronger euro**: (1) the unresolved problems of the periphery; (2) a bilateral purchasing power exchange rate of about $1.20 - the euro is considerably overvalued by that yardstick; (3) the devaluation of the dollar / appreciation of the euro will lead to a smaller trade deficit in the US and a larger one in euroland; (4) in times of crisis, the dollar is more of a safe haven than the euro, mostly because the US has a central Treasury while the euro area has not.

34. **From a global perspective, a weaker dollar would be quite beneficial.** Assuming that the depreciation wipes out the US current account deficit or even generates some surplus, several problems which afflict the global economy would be resolved at one stroke: US unemployment probably comes down a lot as exports and capital spending pick up (Ben Bernanke's favorite scenario); emerging markets stop to intervene and accumulate dollar assets – which reduces domestic liquidity and prevents asset bubbles in countries like China; their current account surpluses shrink, as they should, given these countries' low per capita incomes; and the US consumer stops being the world's consumer of last resort – this role is taken over by emerging economies' demand for capital goods which in turn boosts the world's growth potential.

35. **The yen could also be one of the stronger currencies this year**. Japan's growth will probably be quite brisk in coming quarters. To clean up after a major natural disaster means a lot of work for everybody. There is no lack of funds, interest rates are low along the whole curve, and the labor force is underemployed. It resembles a post-war situation. Apart from that, Japan is the neighbor of the world's most dynamic economies and has, like Germany, the products that are needed there. I am not sure whether the Japanese government will allow the yen to strengthen substantially, but it could well decide not to put up too much resistance. With domestic demand likely to take off in coming months there is less need to protect the country's international price competitiveness by maintaining a cheap currency. Note that the yen is at least 25% weaker against the dollar than it had already been at one point in the past (April 1995), calculated on the basis of 16 years of inflation differentials between the two countries.

36. I would also guess that the major **correction of commodity prices** which I forecast at this point **will weaken commodity currencies** such as the rand, the Canadian and Australian dollars, and the rouble – they have all be exceptionally strong over the past two years of rising commodity prices. This does not mean that they will fall through the floor, but I do expect some normalization.

on standard valuation measures, equities are rather cheap

37. Finally some remarks about stock markets: in general, investors are quite cautious because they **fail to see where the strong new driver may come from** that would take stock prices to the next level. The inventory build-up is largely completed, the biggest post-crisis productivity gains lie behind us, it is not easy to pass on higher input (commodity) costs, and risk aversion is widespread.

38. This is actually an **opportunity for contrarians**. The fundamental situation is still sound, not least because the world economy expands at a solid rate. Profits are rising faster than wages so far because the marginal worker in China or India determines how fast wages can grow in the rest of the world: not very fast, at least as long as borders stay open. Risks are not higher than usual, it seems to me.

39. First of all, valuations are modest in a historical perspective. Take, for some major stock indices, their **price-to-earnings ratios on the basis of this year's estimated earnings, followed by their price-to-book ratios**: S&P500 13.4 & 2.3, Euro Stoxx50 9.8 & 1.3, FTSE 100 10.4 & 1.9, DAX 11.0 & 1.5, Nikkei 16.6 & 1.3, Shanghai Composite 13.2 & 2.5, Russia's RTSI$ 6.0 & 1.21.

40. There are no signs of new bubbles here. **Risk premia**, which I define as the difference between the so-called earnings yield (the inverse of the p/e ratio) and the real yield of riskless long-term bonds reflect this. They **are unusually high**. As you would expect, they are highest in Russia (18.4pp), followed several streets away by the UK (10.7pp), the euro area (9.9pp), China (8.7pp), Germany (8.4pp) and the US (7.6pp). I am not sure how meaningful the calculations for Russia and China are, due to the lack of truly liquid bond markets, but the minimum I would say that especially for Russia a very considerable risk margin has been priced in. It can be attributed to the generally poor corporate governance in that country.

41. But **even the more mature markets appear to be extremely cheap**, considering that risk premia are usually in the order of 4 or 5 and are now between 7 ½ pp and 10 ½ pp. The reason, of course, is not just high earnings yields but extremely low real bond yields. Equities are cheap relative to bonds.

42. It does not mean that the recent stock market correction cannot continue – "sell in May and go away!" - it does mean, however, that **investors are probably overestimating risks**. Note that, very unusual, dividend yields in some markets exceed nominal government bond yields: in the euro area 4.2% vs. 3.1%, in Germany 3.4% vs. 3.1%, in Japan 1.9% vs. 1.1%. These differences provide thick safety cushions for investors. In the UK the two ratios are on par, while dividend yields are significantly below bond yields in Russia (2.1% vs. 7.8%), China (1.4% vs. 4.3%) and, less so, in the US (1.9% vs. 3.1%). Investors like to see steady and adequate cash flows. It makes them trust the management.