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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth*

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1. **At first glance the global economic situation looks quite robust.** Nasty surprises may happen but are relatively unlikely, and investors can not do much wrong by betting that emerging markets will continue to expand briskly, that commodity prices are well supported by secular trends but have peaked for now, that output gaps in developed economies are not about to be closed any time soon, that globally wages will not rise faster than nominal GDP and that consumer price inflation is coming down again. The cost side of firms in commodity importing countries remains in good shape: moderate wage inflation and falling prices of commodity inputs combined with considerable productivity reserves suggest that profits continue to be supported from that side.

2. **I see four main risks: an escalation of conflicts in the Near East and in its wake strongly rising oil prices; an overheating in emerging economies, leading to a series of popping asset price bubbles there; the euro crisis; and a new recession in the US. If any one of these materializes, it would destabilize the world economy again and lead to stagnation and deflation.** To put this into perspective: it is well-known that the number of possible crises tends to be a lot larger than the number of actual ones. Like Paul Samuelson once noted: "Stock markets have correctly predicted eight of the last five recessions."

emerging economies drive global growth

3. Real GDP in developed economies seems to be increasing at an annualized rate of about 2% at this point, somewhat below trend. Emerging and developing markets are powering ahead at a rate of 5½% which is less than in 2010 and early this year but enough to keep the world economy on an even keel**. In general, global growth has lost some momentum now that the post-recession inventory rebuilding is over while, globally, both monetary and fiscal policies have run out of ammunition.**

4. Since rich countries have, for various reasons, not been able to fill the large output gap that was created in the course of the 2008/09 recession, their employment situation is generally quite poor. Therefore the bargaining power of workers, especially less-qualified workers, remains weak: wage **increases are mostly below the rate of inflation.** Employers hold an important trump card called "we may shift production to some low-wage country". This will not change as long as countries keep their borders open and the international division

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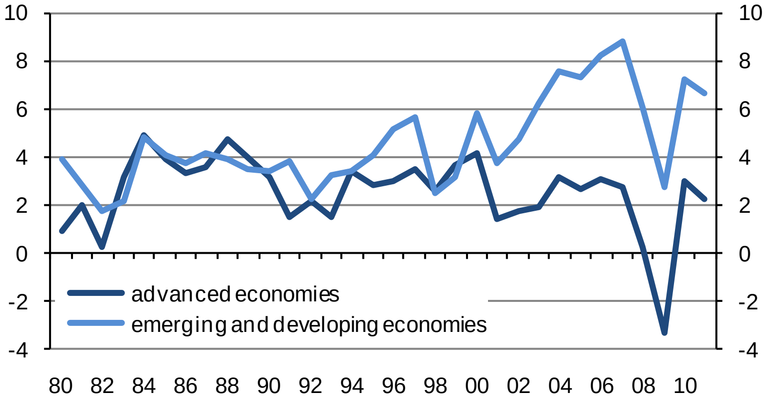
of labor intensifies as a result. In view of substantial productivity reserves it is likely that unit labor costs are either stagnating or falling – this is obviously good news for those who are afraid of rising inflation rates.

growth of global output*)

real GDP, % y/y



*) 2011: IMF forecast

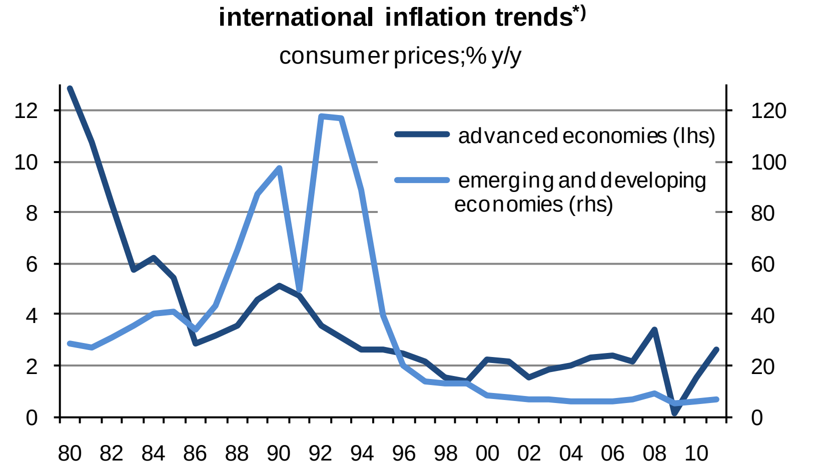
source: IMF

5. **The main reason for the sluggish recovery from the recession in some important countries such as the US, Japan, the UK or Spain is the attempt of households, but also of banks there to repair their balance sheets which have been damaged by the collapse of asset price bubbles, mainly in real estate**. For large parts of their economies, liabilities are now larger than the market value of debt-financed assets, and even very favorable lending conditions cannot convince people to borrow more money. Policy makers are pushing on a string. Note that these four countries alone account for a third of the world economy.

6. **The poorer part of the global economy is operating closer to, but by no means at full employment.** For these countries, the "recession" of 2008 and 2009 consisted of a reduction of the real GDP growth rate from 8% in the two previous years to an average of 4½%. They are mostly financially sound, and many of them are actually net capital exporters (the flip side of having current account surpluses), contrary to what textbooks lead one to expect. Their output structure reflects the rapid catching-up process, with an emphasis on the production of goods rather than services. **The growth process is thus energy and commodity-intensive. They have been responsible for the latest commodity price boom, as for the one before.**

inflation in retreat

7. By now, the cooling-off of global growth has caused a decline of commodity prices from their peak in March, as well as a decline of consumer price inflation. In emerging markets, the latter will be about 5% y/y in a year's time, from 6% now. **In spite of rapid economic growth and ample liquidity, there is still no evidence of a new global inflation mentality.** To be sure, on average commodity prices are still about 20% higher than one year ago (in euro terms) - commodity producers thus continue to be in good shape.

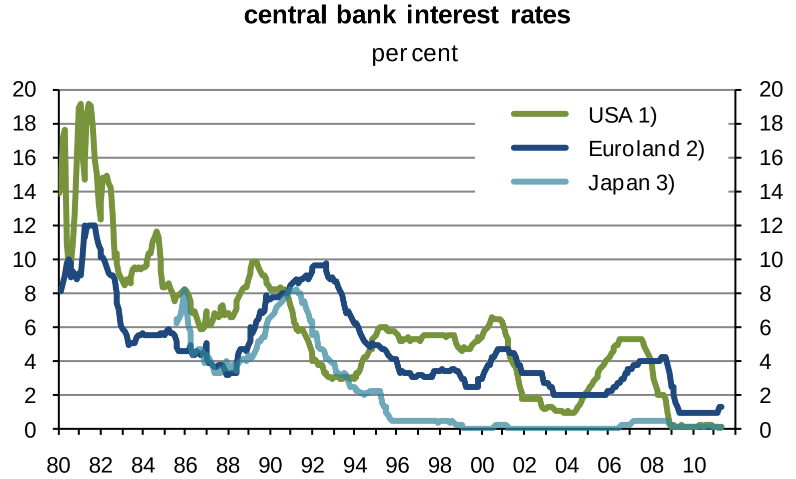


*) 2011: IMF forecast

source: IMF

8. Lower commodity prices translate into an increase of purchasing power and stronger final demand in importing countries. This is one reason why the present lull in global growth will only be temporary. **Annualized growth in developed economies will accelerate to about 3% in the second half of this year, a rebound from the weak first half, and then proceed at the trend rate of 2½%, provided there is no major accident. This will do little to reduce unemployment, though.**

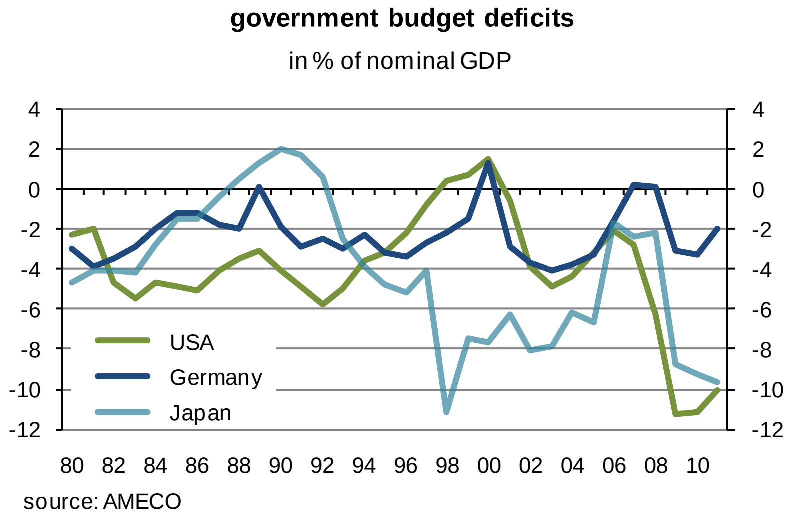
9. **Monetary policies remain very expansionary as virtually no one worries about inflation.** Nowhere are central bank rates near the medium-term growth rate of nominal GDP which is, for lack of anything better, a proxy for the short-term equilibrium policy rate. In the US, trend growth is about 4½% but the Fed funds rate is just 0.125%; in China, a nominal GDP growth trend in the order of 13% compares to a policy rate of 6.56%. Rates are gradually raised in most countries, both developed and emerging, but are, for now, not doing any harm to output growth. In the US, in Japan, the UK as well as in some emerging markets (Peru, Indonesia and the Philippines) they are actually on hold: sub-par growth is the main problem there, not inflation.



1) Fed funds rate; 2) before 1999: overnight rate in Frankfurt, followed by the ECB's Main refinancing rate; 3) call rates

sources: Federal Reserve, ECB, Bank of Japan

10. **Easy monetary policies are also a compensation for tighter fiscal policies.** The global recession, and the financial crisis that triggered it, have caused havoc in government accounts. Several countries' budget deficits and debt levels are so high by now that their good credit rating is at stake. Fiscal policies have mostly no room left for supporting overall demand, and are being tightened in spite of high unemployment. This includes the US, the UK, and most countries in the Latin belt of the euro area, including big ones such as France, Italy and Spain. It is well known that fiscal policies are much more effective than monetary policies when output gaps are as large as they are today.



11. **On balance, therefore, economic policies have lost their effectiveness in these countries. Luckily, "animal spirits" in the rest of the world are still strong and will probably pull the others along**.

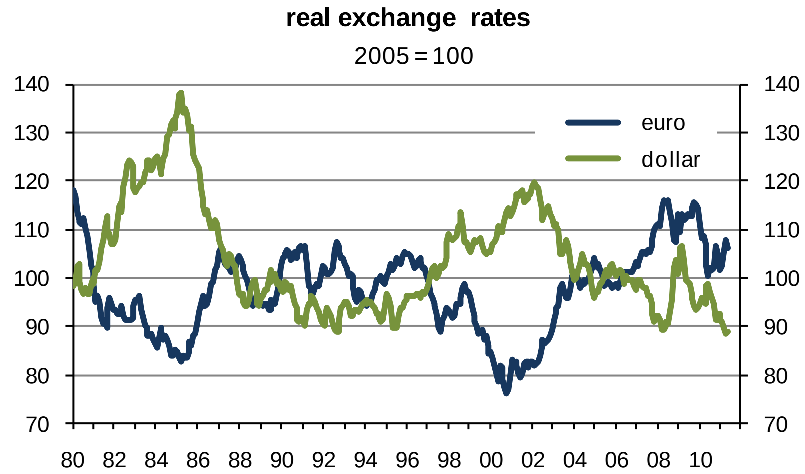
balances on current account determine FX moves

12. So what does the above analysis mean for the various markets? **To start with foreign exchange, the most fundamental driver remains the level and the expected changes in countries' balances on current account.** On this basis, the US dollar, sterling, the Canadian and Australian dollars, the Czech krona, the Polish zloty, the Turkish lira, the Indian rupiah, the Brazilian real and the South African rand should all be depreciating in trade-weighted terms. On the other side of the ledger are the yen, the renminbi, the Scandinavian currencies, the rouble, the Swiss franc, the HongKong and Singaporian dollars, the ringgit, the won – these are all appreciating – or would appreciate if central banks would let them.

13. The balance on current account is regarded by market participants as an indicator of an economy's health and resilience in turbulent times. But there are other drivers which determine where a currency is heading. One is **central bank interventions.**

14. **The People's Bank of China seems to aim for a 5% per year appreciation of the renminbi against the dollar.** If the appreciation were larger, it could undermine international competitiveness, reduce GDP growth and thus cause destabilizing social unrest. The news that real GDP increased by 9.5% y/y in the second quarter, significantly faster than expected by analysts, is probably taken as evidence by China's government that

the policy mix can not be too bad. Moreover, it seems that in spite of the huge accumulation of dollar and euro reserves, and a resulting expansion of monetary aggregates in the order of 15% y/y, inflation is seen to be no more than a transitory problem (June CPI was 6.4% y/y, a high for 2011). Monetarists probably like that: money supply expands almost in step with nominal GDP, **inflation is therefore indeed not a serious issue.**



source: Bank for International Settlements

15. **Japan's yen is kept from appreciating** – even though the country's current account surplus will reach 2.4% of GDP this year! - by interest rates close to zero which make the currency a natural source of funding in international carry trades. **The central bank's main worry is deflation** – it is therefore a safe bet that rates will be left where they are for years to come. Another reasonable bet is that the Ministry of Finance (MoF) will start intervening when the yen becomes too strong. Deflation is extremely hard to get rid of if the real exchange rate were left to market forces pushing it higher. Over time, the Japanese will probably try to target the yen/renminbi cross rate rather than the dollar: China has already become the main trading partner.

16. **Given the financial problems in Greece, Ireland, Portugal, Spain and now Italy the strength of the euro is something of a mystery**. The main explanation is that the US is also in trouble and may be following the Japanese route into stagnation and deflation. 10-year Treasury yields of 2.89% - when headline inflation is 3.6% y/y - suggest that both expected real GDP growth and inflation are very low. According to the 10-year inflation-linked Treasury note, the annual real yield is just 0.56%. Are markets telling us that this will be the average growth rate of US real GDP for the coming ten years?

17. **Seen from the other side, euroland does not look as sclerotic any more. Investments in euro assets are just as, if not more profitable than in US assets**. Private capital inflows support the euro exchange rate. On a per hour or per worker basis, the euro area output expands just as fast as America's. The labor market is actually performing significantly better. Since the last cyclical high of Q2 2008, the loss of jobs has been 1.9% while US employment is still 4.5% below its previous high (of December 2006) and about 9% below trend. The US must create 1% more jobs every year simply to keep the unemployment rate constant. Incidentally, the corresponding trend rate for euro area employment is, surprise, surprise, 1.1% - if the US is a job machine, the euro area is an even stronger one.

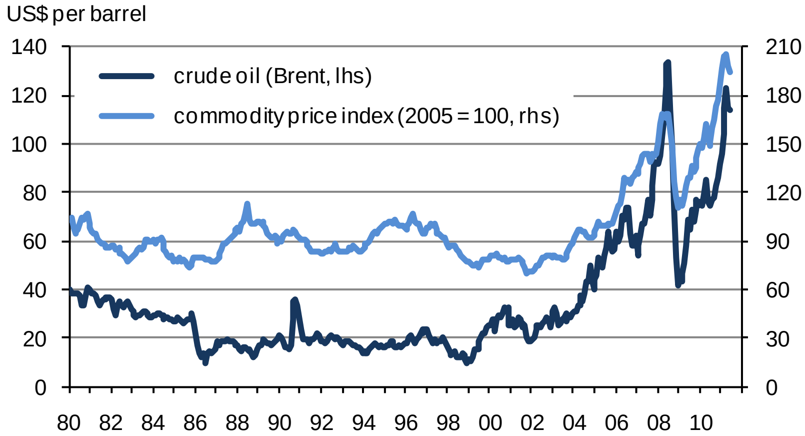
18. **There are three other arguments that may explain the present euro strength**: 1. the 2011 current account deficit of the euro area will be 0.4% of GDP, compared to America's expected deficit of 3.3%; 2. euroland's aggregated budget balance will be 4.3% of GDP which is a lot less than the 9.1% deficit of the US; 3. the ECB has driven the main refinancing rate to 1.5% and has indicated that another increase will follow this year while the Fed will keep the funds rate at 0.125% for the foreseeable future.

19. **I also have the impression that market participants continue to believe that the euro will not fail, and that at the end of the day a durable solution will be found, call it a transfer union, a fiscal union, a euro area debt agency, or even a political union.**

commodity prices have peaked

20. As mentioned above, **commodity markets** are well supported by the moderately brisk expansion of the world economy and the shift in emphasis from services to the production of goods. Previous highs of spring 2008 have not been reached again after two and a half years of recovery (since early 2009). Gold reaches new highs almost daily, as the news flow creates an apocalyptic mood among a lot of investors. The prices of copper and some soft commodities such as corn or coffee are also at record levels. I suspect that we are witnessing bubbles rather than new secular price trends there. By definition almost, commodities, being unsophisticated mass products, are extremely volatile – what goes up must come down.

commodity prices*)



*) food and industrial commodities ex-oil

source: IMF

21. **In general, though, the markets for raw materials are not particularly overstretched.** Prices are high but there is no indication that they are excessive. This includes oil and gas.

22. Note that commodity prices go up during a recovery from a global recession by more than world nominal GDP, but as this continues, this increase progressively turns into a brake for growth in commodity importing countries. High commodity prices do not cause inflation, they just reflect strong GDP growth. **The higher they rise, the stronger will be their eventual deflationary impact on the commodity importing countries and the world economy as a whole.** They will always come down if there has been an exuberance (such as in the spring of 2008). My guess is that commodity prices will be on a moderate downtrend for a year or two.

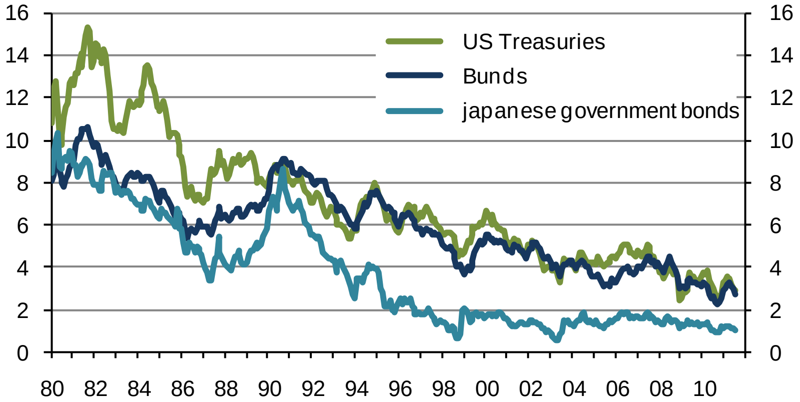
bonds: either very strong or very weak

23. **Turning to the bond markets, the outlook is unusually mixed:** very good for countries which are perceived to be solid and creditworthy such as Switzerland, the northern countries of the euro area and the Scandinavian countries which have not adopted the euro, Russia, the Czech Republic, Japan, Taiwan, Singapore, Hong Kong, Brazil, Canada, but also the US and the UK, and bad for highly indebted and/or slow-growing countries without credible austerity programs such as Greece, Ireland, Portugal, Spain, Italy, Venezuela, Mexico, Pakistan, India, Indonesia and the Philippines.

24. **Investors have become risk averse during the financial crisis and discriminate strongly against weak issuers**. One group of countries can raise long-term funds below the current rate of inflation while the others have to pay large, often even suicidal risk premia. I have the impression that the less a country uses anti-cyclical fiscal strategies over the years, the more trustworthy it is, the more likely will it be regarded as a safe haven - which means it can borrow cheaply.

yield of government bonds*)

per cent



*) 10 years; July 2011: estimate

source: IMF

25. This analysis does not fit the US situation. **Why are Treasury yields so low in spite of huge current account and budget deficits, and a weak currency?** One popular explanation is that no other bond market is as liquid: within seconds even very large positions can be unloaded without much moving the price. This is not convincing: the Swiss bond market is quite small compared to America's and yet yields in the 10-year range are no less than 144 basis points lower. Differences in liquidity are obviously only of second-order importance.

26. One answer is that **the dollar is the main reserve currency**: all countries which manage their currencies, such as China, India, Russia or the OPEC, instinctively do it via dollar purchases. Once they have accumulated a big stock of dollar assets (mostly T-bills and notes) they cannot afford to dump them – they must keep buying in order to avoid losses from mark-downs. The US has thus a considerable institutional advantage (called seigniorage). The demand for US Treasury bills (short-term government paper) has been so strong lately that their nominal interest rates became negative at times.

27. The euro area does not come near in this respect, given the heterogeneous nature of its bond markets. Moreover, while the US government can always service its debt – because it owns a printing press – even Germany is no longer in control of the money creating process: 16 other European governments have veto rights. The US can manipulate its exchange rate, Germany can not. **The euro will only be on par with the dollar, and get the same benefits in terms of low real interest rates, if the currency union turns into a full-blown fiscal union.**

28. Since the deleveraging, i.e. debt reduction process is still **underway in the US, the domestic demand for goods and services is bound to remain weak.** This could theoretically be compensated by an export offensive – the world economy is expanding quite briskly, after all – but this would require a considerably weaker dollar, i.e. a change in relative international prices. So far, the reserve currency status of the dollar prevents this. The Chinese must stop buying the greenback.

29. On balance, the inflation outlook for the US is thus quite benign. Core consumer price inflation is just 1.5% y/y and will come down from now on. It is a leading indicator for headline inflation. So **Treasury yields will probably fall some more. Only a large dollar depreciation can prevent this.**

yields on gilts will fall some more

30. **Some of these arguments also apply to British gilts (government bonds).** The country has experienced a big asset bust. Among major industrialized countries Britain has, as a percentage of GDP, the highest levels of debt. Getting out of the debt trap is the order of the day which will inevitably keep private sector demand in check. Moreover, fiscal policies have been tightened in a very pro-cyclical and credible way which is an additional negative for demand and output. Even so, the budget balance will still be 9% of GDP this year which means tight policies will continue. It has helped in this environment that sterling has depreciated by almost one third against the euro over the past couple of years.

31. But unemployment is unusually and stubbornly high (7.7% in May), employment is still 2.2% below the peak of June 2008, average weekly earnings are just 2.3% y/y and thus significantly below the rate of inflation (4.2% y/y in June, core 2.8% y/y). In view of these numbers the expected 1.5% y/y increase of real GDP this year is surprisingly good.

32. **Overall, though, it is an ideal environment for bond investors. They do not doubt that the belt-tightening will have the desired results** – the assumption is probably that the world economy holds up well, especially Europe’s. This explains why 10-year gilt yields have fallen 50 basis points over the past half year, to just 3.1%. In real terms (using today’s inflation rates) this a lot lower than the yield on Bunds. The British government gets rewarded for owning a central bank that can put national interests first.

33. **Gilt yields will fall as long as the financial crisis on the continent continues**, They will rise steeply in case a sustainable solution to the euro area’s debt problems is found. The same holds, incidentally, for Swiss and Scandinavian bond yields.

euro area bond market in crisis mode

34. **So what will happen to euro area bond markets?** Right now, short-termism prevails, or what they call in Brussels "kicking the can down the road". Policy makers of the 17 countries that use the euro have not yet arrived at a point where they can agree to take the quantum jump toward a long-term solution.

35. It is clear that **neither Greece, nor Ireland or Portugal** will be able to go to the market in the next two or three years – long-term interest rates of significantly more than 10% are not affordable when growth is anemic or negative, without a chance to inflate debts away or depreciating the currency.

36. **Spain and Italy** have now arrived on the radar screen of investors as well – the yield on their 10-year bonds is more than twice as high as Germany's. The governments of both countries are scrambling to reduce budget deficits and accept that growth will be less than 1% this year and next. While people in these two countries protest only mildly against the austerity measures - because these feel they are overdue, and because they want to keep the euro – investors are less impressed and continue to sell and go short the bonds of these countries. **In the near-term, yields will therefore rise further.**

37. **The next candidates on the list are Belgium and France**. The yield spread between French and German 10-year governments is now 70 basis points - 15 to 20 basis points used to be normal. France runs a current account deficit of more than 2.5% of GDP and lacks in competitiveness. Things are thus getting serious in the euro area. They will probably escalate further in the near-term. **Bond spreads between the "good and the bad" will widen more.**

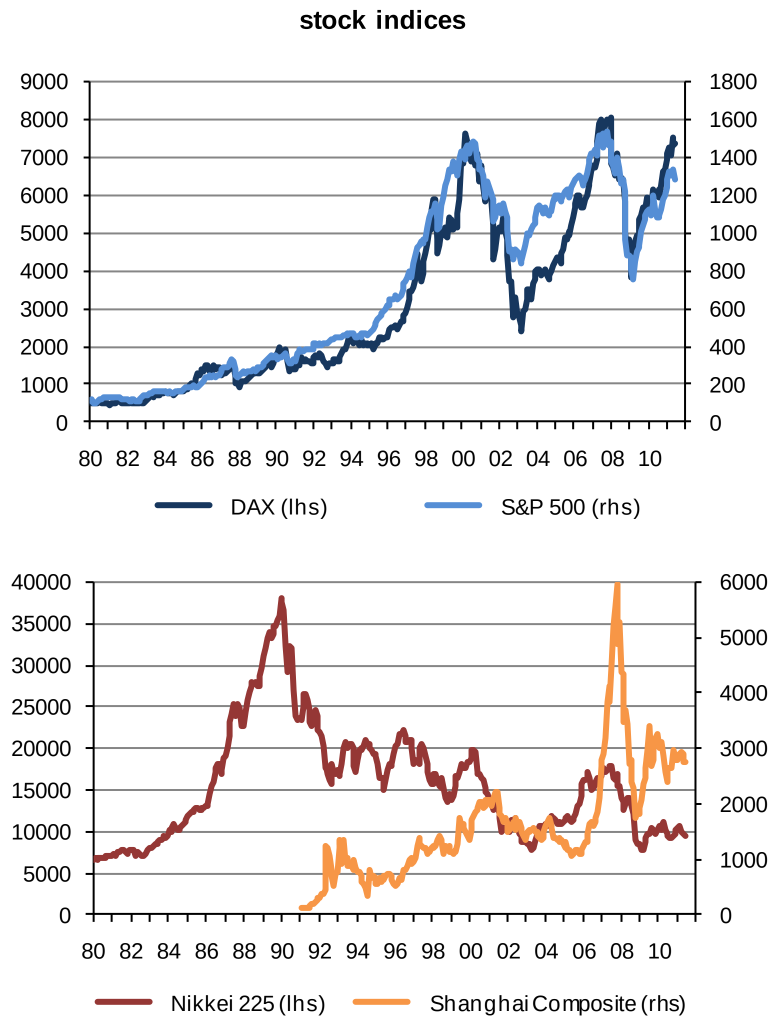
38. **How does a genuine and durable solution look like?** Everybody who knows about the history of currency unions, or who has a basic economic understanding, is aware that the project is doomed unless crowned by a political union. The center of such a union may be weak, like in Switzerland, but it must have the **possibility to issue bonds**, guaranteed by the community as a whole, at yields comparable to those of Bunds or below (because the market would be more liquid) and organize the transfer of funds to the weaker members of the union. The aim must be to bring down the yield on Greek or Irish 10-year bonds to 2.% or so. This would allow these countries to reduce the effective burden of debt by growing fast.

39. **In return for such largesse, all member countries must submit their fiscal policies to a common and truly enforceable set of rules.** The approach goes way beyond just hardening the Maastricht rules. If the crisis continues and becomes deep enough, such a solution will appear as the only way out, assuming that giving up the euro will be regarded as the worst possible solution, even in Germany. As everybody has known from the outset, the euro is a political project called the peaceful and voluntary unification of the continent. We are getting there.

40. **In the meantime, as long as the preferred solution is not yet in sight, it makes sense to continue switching from "periphery" bonds into German, Dutch, Austrian, Finnish and even Swedish, Danish and Swiss bonds.**

stock markets still supported by robust corporate earnings

41. To **forecast stock market developments** consists of several tasks: to determine whether stocks are presently cheap or expensive, how earnings per share will change, and what are the likely effects of various assumptions about the future? **Compared to government bonds of countries without credit problems, most liquid equities look cheap on the basis of present-year earnings.**



sources: Deutsche Bundesbank, ECB, Handelsblatt

42. Take, for instance, **America's S&P500 index**. Its average price-to-earnings ratio is 13.27 and the earnings yield, its inverse, is 7.54%. On the other hand, 10-year Treasuries yield 2.92%; adjusted for expected inflation of 2.5% this translates into a real yield of 0.4%. Deducting this from the earnings yield of 7.54% results in a risk premium of no less than 7.1. This is far above "normal" levels of 4 to 5. Result: US stocks are a "buy".

43. Now just accept **Robert Shiller's argument** that corporate earnings must be adjusted for cyclical factors: in a recovery earnings always rise faster than stock prices – they are more volatile than these. On this basis, the US p/e ratio is about 23 at this point which is significantly above the historical average; stocks are therefore expensive and a "sell".

44. As to **expected earnings**, the main determinant of stock prices: they are losing momentum because the US economy is now already in its third year of recovery. Moreover, for the reasons explained earlier – tighter fiscal policies, deleveraging, difficulty to further ease monetary policies, poor labor market conditions – growth is much slower than in “normal” business cycles. So the earnings outlook is rather modest. Sell US stocks?

45. In **Germany**, the p/e ratio of the DAX index is 10.83, and the earnings yield therefore fairly high at 9.2%. Deduct from this the real 10-year Bund yield of 2.75% - 1.9% (expected inflation) = 0.85%: this gives us a risk premium of 8.35. Therefore: buy the DAX! Even better: its average dividend yield is a remarkable 3.4%, well above bond yields.

46. **France’s CAC40 is even cheaper**, with a risk premium of 8.7 and an average didend yield of 4.16%. The French economy is operating further below potential than Germany’s and has thus correspondingly larger productivity reserves. Investors who believe that **Spain and Italy** will make it through the present crisis should have a second look at their markets: p/e ratios are 9.7 and 9.1, and indices have underperformed this year.

47. The **outlook for earnings in the euro area is much less homogeneous than usual**. Since the epicenter of global growth has shifted to the East Asian manufacturers in full catch-up mode, suppliers of capital goods and sophisticated consumer goods are doing better than others. Another distinguishing factor is fiscal policies: Germany is about to loosen the reins, France must tighten them to maintain its credit rating – the budget deficit will almost be 6% of GDP this year while Germany’s is approaching 1%. In other words, **the French stock market is cheaper on the basis of this year’s earnings and dividend yield, but less attractive from a forward-looking perspective**.

48. **In spite of the new commodity boom, Russia’s stock market remains very cheap**, with a current-year p/e ratio of just 5.73, a risk premium of 17.2 (!) and a price-to-book ratio of 1.26 (S&P500: 2.21, DAX: 1.45; CAC40: 1.23). Investor sentiment is very negative and can hardly get worse. Given that Russia is the world’s major producer of energy and metals and that the demand for these is well supported in the medium-term, some diversification into its stock market would make sense.

main risk: a new oil price boom

49. This brings me to some **concluding remarks about risks** which I have not analyzed in detail above. **The oil price** is one. Should it rise in the wake of an escalation of the uprisings in the Near East, involving Saudi Arabia and Iran, a steep increase beyond the $145 level reached in 2008 is conceivable. This would immediately push the world economy into the next recession, cause a new round of rescue operations for banks – and cause stock market crashes all over the place. It would be a time to buy safe haven bonds, even if their yields approach 1%.

50. **Another 800-pound gorilla in the room is the investment boom in China**, in particular with regard to the financial viability of private sector real estate projects and the spending and borrowing of local and regional governments for infrastructure. The assumption is that Chinese bank balance sheets are full of non-performing loans, perhaps in the order of 10% of assets.

51. It helps that **the residential mortgage market is still rather underdeveloped** – when the bubble explodes the amount of knock-on effects will be relatively small because households are not forced to repay their debt. Their extremely high savings rates suggest that deleveraging will not be a major macroeconomic problem.

52. As to the profligate lower-level government entities, if they are forced to declare bankruptcy, the solution will most certainly consist of **debt-rollovers at subsidized conditions** and the assumption of debt by the central government.

53. I fail to see problems in China which can not be overcome, given the robust financial health of the country. Interest rates, for instance, might be lowered quite a bit in an emergency. Perhaps I am naïve. But China is still very poor, and its capital stock is relatively small. Overinvestment in certain sectors is a possibility, but not across the board.