WEBLOG

Wermuth's
Investment Outlook

August 2011

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Wermuth's Investment Outlook

by Dieter Wermuth*

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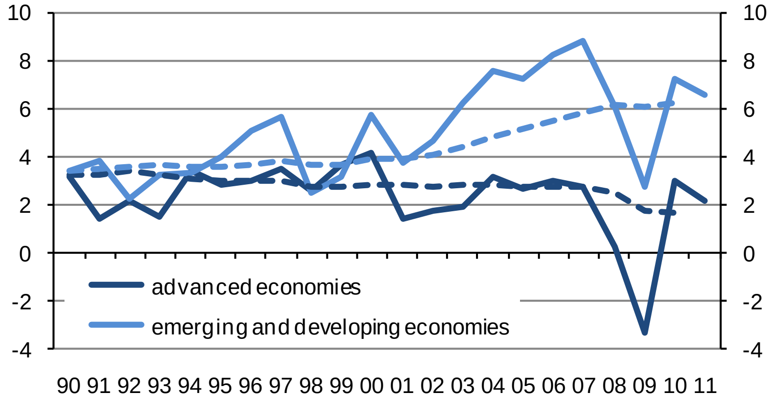
1. The global economy is less robust than it seemed just a few weeks ago. Output gaps have widened again, and will continue to do so if analysts' consensus view about the near-term growth trajectory turns out to be correct. **The new element is the "crisis of competence"**: policy makers in the US and the euro area are out of their wits. The impact of the proposed solutions to their budgetary problems is pro-cyclical while monetary policies have run out of ammunition. As a result, investors have become extremely risk averse, dumping equities and, to a lesser extent, commodities in favor of safe haven assets. All this suggests that **the Great Recession is not yet over and that inflation is on the retreat.**

2. **Forecasts of real GDP have recently been revised down dramatically**, following steep declines of sentiment indicators across all major countries. In the second half of this year, America's and euroland's annualized growth rates will be a mere 1 percent, or less, followed by a below-trend expansion in 2012. Among industrialized countries, only commodity-rich Australia and Canada have so far escaped the maelstrom. Japan is strongly rebounding from its catastrophic first half, but it is more than uncertain that the present momentum can be sustained – the yen has appreciated so much that there are now doubts about firms' competitiveness.

growth of global output*)

real GDP, % y/y



*) 2011: IMF forecast; dotted lines indicate 10-y moving averages

source: IMF

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3. Meanwhile**, the epicenter of the world economy is moving further toward emerging markets** where growth rates these days are almost four times higher than in the OECD area. The combination of low standards of living, a Schumpeterian business culture and sound financials, i.e. high saving rates, has created a vibrant growth environment. But **even in this benign part of the world economy, the slowdown of final demand in the West will leave its skid marks.** Domestic demand cannot compensate fully for the likely reduction of export growth. GDP forecasts for the countries in catching-up mode remain upbeat but less so than only a short while ago.

cautious US consumers

4. **The US, still the world's largest economy, is facing two major obstacles**. **One is the ongoing deleveraging process of private households**: a quarter of them are financially underwater in the sense that the market value of their homes is lower than their mortgage debt. Falling house prices have been a shock and continue to force people to save more, or consume less, than in more normal times. The affordability of real estate has improved a lot since 2006, when the housing cycle peaked, but mortgage providers are all trying to improve the quality of their balance sheets and are demanding much higher down-payments than during the boom years. With employment still about 4½ percent lower than in 2008 and unemployment at over 9 percent, at least another quarter of all US households are presently either unwilling or unable to buy a house. Renting has become a viable alternative.

5. Consumer confidence which had long been boosted by rising house prices is at very low levels and household spending, the former driver of US overall demand, and indeed global demand, will expand only moderately for the foreseeable future. Consumer credit has been only +1.7% y/y in June, the latest available data, and thus less than CPI inflation. **America is stuck in a liquidity trap**: the central bank has aggressively been printing money, but borrowing and spending do not pick up.

America pursues pro-cyclical fiscal policies

6. **America's other major problem is its budget.** With so much slack in the economy, the desirable strategy would be to stimulate demand via fiscal policies and accept that this will lead to widening budget deficits in the near term. Real GDP has not yet reached its pre-recession level of more than three years ago. Since its trend growth used to be almost 3 percent a year, the gap between potential and actual output is now in the order of 10 percent.

7. Fiscal policy makers should pull out all stops to fill that gap and end the recession – but cannot, or are prevented by a fundamentally conservative Congress to do what is necessary. To emphasize saving rather than growth is a serious mistake. The US continues to follow closely Japan's post-bubble strategy and might thus be heading toward years of stagnation, very low inflation, if not deflation, and central bank rates close to zero.

8. Investors from within and outside the US would probably not mind more expansionary fiscal policies. Their trust in the country's ability to service its debt is still strong, judging by the record low yields of Treasury notes and bonds - 10-year Treasuries are at 2.19% -, the resilience of the dollar exchange rate and the fact that stock markets are falling less

than most foreign ones. As it is, **the US administration does the opposite: it tries to shrink the deficit, stubbornly at about 9 percent of GDP, by cutting expenditures and raising taxes, an approach that was unsuccessfully used by President Hoover in a similar situation more than 80 years ago. This kind of policy was a main trigger of the traumatic depression that followed.**

euro area policy makers still without a road map

9. **In the euro area, Greece, Ireland and Portugal had been close to default** not long ago, and for a while the two heavyweights Spain and Italy were at risk as well. Yields of their 10-year government bonds had risen to more than 6%, two and a half times higher than Germany's. Even the yield spread of French over German debt had widened dangerously a few weeks ago. The very survival of the euro seemed at stake.

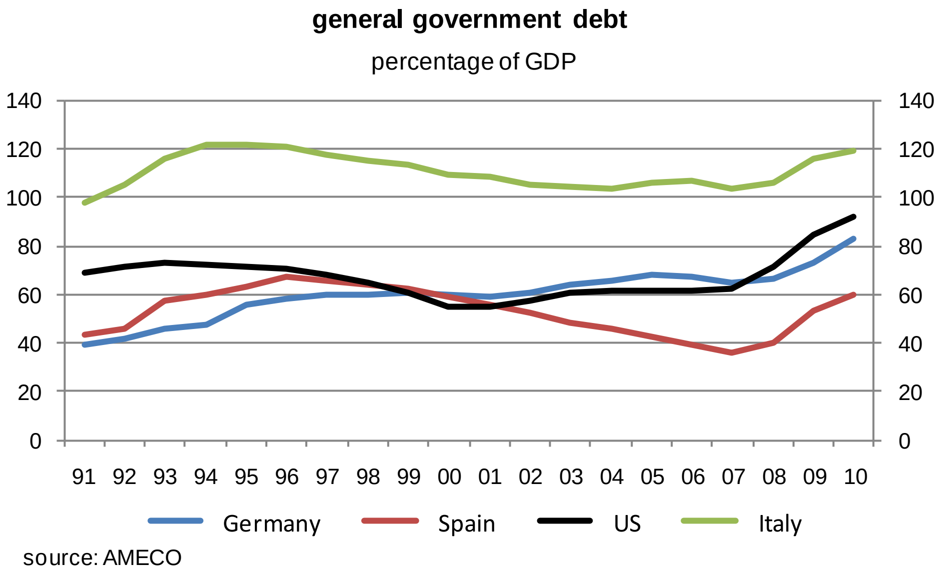
10. The message of the markets could not be clearer: **a currency union can only survive if it can reasonably be expected that it will lead to a fiscal and, in the end, a political union.** However, such a project is not yet wholeheartedly pursued by European politicians – after the failed French and Dutch referenda on the so-called Constitutional Treaty in 2005 they are scared of a populist backlash and thus prefer to muddle through, driven by events rather than try to convince the public of the merits of their rescue operations.

11. The ECB has successfully provided price stability, but as it turns out, this is by no means enough to stabilize the euro. There must also be a consensus about guaranteeing each other's debt and the transfer of national sovereignty in case a country needs help from the partners. The process leading to such an insight is still painfully slow.

a common currency requires new bank regulations

12. Even more important, but largely ignored in the public discussion so far, is an agreement about the regulation of banks and the procedure in future bank bailouts**. Loosely controlled banks have been at the heart of the financial crisis in the euro area.** Ireland and Spain, for instance, had very low debt to GDP ratios before 2007, but governments were then quickly overwhelmed by the size of bad assets (real estate and toxic US securities) in their banks' balance sheets and the associated costs of rescuing them.

13. **Fiscal policies may meet the Maastricht criteria, but when banks whose balance sheets are a multiple of a country's GDP are at risk of going bust and thus need to be bailed out, debt levels can quickly shoot through the roof and become unsustainable.** In Germany, a country that is usually regarded as a role model of fiscal probity, the bailout of the financial sector since 2008 has increased government debt by no less than €335bn, or 13.4 percent of GDP – this has been the main reason why the debt to GDP ratio will reach 84 percent this year, far above the 60 percent limit of the Maastricht Treaty. The Greek ratio will hit 153 percent this year, Italy's 121 percent, and Ireland's 114 percent. At 68 percent, Spain looks relatively healthy in this regard. Bank regulators were sleeping on their watch during the boom years that preceded the financial crisis.



14. **Investors have no clue what will happen if the European banking crisis escalates once again.** The growth outlook has deteriorated so much that a new round of asset write-downs is not any longer just a far-fetched possibility. Regulators have gently pushed banks to increase reserves, move away from short-term funding and avoid risky assets. Their initial time horizon has been about ten years, so progress has been slow and the banking sector is probably not yet prepared to weather another shock in the near term. The ECB, by raising rates by 50 basis points so far and thus reducing interest margins, has not been helpful either as far as strengthening banks' equity base is concerned.

15. **A reform of the banking sector must be an essential part of the new infrastructure of the currency union.** There must be agreements about central institutions in charge of regulating the banks and organizing future bailouts, the sharing of the costs of rescue operations, about the acceptable size of banks, about the kind of business they can or cannot do, including foreign banks operating on the territory of the euro area. Trading for the own account must be strictly limited, and over-the-counter derivatives must be prohibited.

16. **Banks remain loose cannons** that can any time cause havoc and put at risk the very existence of the euro. Solutions are not yet in sight, as the awareness of the potential danger is still underdeveloped.

17. Even so, I remain convinced that solutions will be found – because they must be found. Events will force policy makers to do what is necessary, as long as there is the will to keep the euro. This is still the case, just.

pro-cyclical fiscal policies in the euro area as well

18. **For the time being, the emphasis of policy making in the euro area is on reducing government budget deficits.** Fairly ambitious austerity programs have been introduced by all countries. Following Germany's lead, so-called golden rules are being incorporated in countries' constitutions: "structural" general government deficits must not exceed half a percent or so of GDP. This is far more ambitious than the earlier non-binding definition

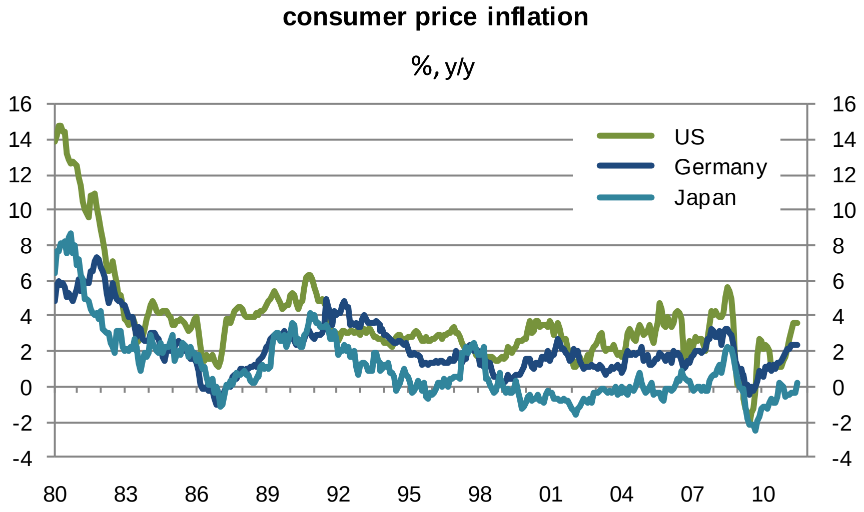
of a golden budget rule – that the deficit should not exceed a government's capital expenditures.

19. On the other hand, even constitutional requirements are not really binding in an emergency, not to mention that no one really knows what a structural deficit is: this requires the calculation of the output gap. There is no generally accepted definition of that. Market participants have thus not really been impressed by these attempts. They see them as no more than another declaration of good will, just as the Maastricht rules.

20. In any case, governments are presently quite serious about reducing their budget deficits, even in Germany where stimulating growth and thus helping the countries that are forced to tighten their belts would make most sense. **In the euro area as a whole, real government consumption has begun to fall and thus contributes significantly to the slowdown of final demand this year and next. Incidentally, real spending by the US government will also decline at rates between 1 and 2 percent year-on-year this year and next. Pro-cyclicality is back in fashion. Budget deficits don't disappear this way.**

global inflation on the way down

21. With the two largest economies, the US and euroland, weakening, and the UK and most of central and eastern Europe weak as well (the Czech Republic and Poland are notable exceptions), it is a **foregone conclusion that global consumer price inflation will decrease.** The peak of the present inflation cycle has been in the second quarter of this year, and it is downhill since. Within one year, both America's and the euro area's inflation rate will be in the order of 1¼% y/y and thus well below central banks' targets. Japan remains stuck in deflation.



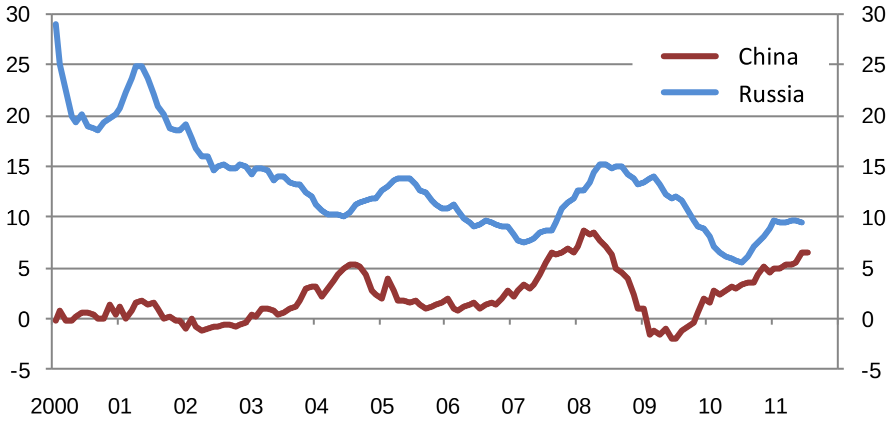
sources: Federal Reserve, Bundesbank, Ministry of Internal Affairs and Communication

22. As usual, **prices rise faster in emerging markets** – because rapid productivity growth permits rapid wage increases across their economies, without hurting international price competitiveness. **But inflation has peaked in that part of the world as well**. Between the second quarter this year and the second quarter 2012, China's CPI will decline from 5.7% y/y to 4½%, Russia's from 9.6% to 6½%, India's from 9.1% to 7½%, and so on.

The slight widening of output gaps and the decline of commodity prices work in the same direction.

Chinese and Russian consumer prices

% y/y



source: IMF

oil prices are gradually falling

23. **The question is whether commodity prices will continue to fall.** Between the spring of 2009 and April this year they had briskly recovered from the preceding crash (that followed the earlier bubble) without, however, reaching the exaggerated levels of early 2008. April marked the turning point. Oil prices, for instance, had advanced from $35 at the end of 2008 to $126.6 in April 2011, and then declined gradually to about $110. They remain 50% higher than a year ago. In terms of standard deviations from long-term trends, most commodities are still expensive, including food and most metals. They continue to drain purchasing power in countries which are net importers (accounting for more than three quarters of global GDP), if by less than before last April.

oil price

Brent; US$ per barrel

source: IMF

24. **Where are oil prices going from here? In the near term, a further decline is quite likely, but it is also likely that oil will never be really cheap again**, even if the Near

East and North Africa begin to produce at capacity. According to OPEC, this year's oil supply will be 86.8 million barrels per day (mb/d). Demand is expected to increase by an average of 0.9% a year between now and 2030, to 105.5 mb/d, and supply will follow suit.

25. This means, incidentally, that the cartel does not forecast a peak of oil production ("peak oil"), followed by a decline. But getting the stuff out of the ground is obviously getting more and more expensive which puts a rising floor under its price.

26. **The expected growth rate of oil output of 0.9% annually compares with a trend growth rate of global real GDP of more than 4%** - which means that the oil intensity of economic growth is rapidly declining. This is good news for environmentalists, but also for all net importers of oil. In the OECD area oil demand has actually been falling since 2005, especially in Western Europe, and all the additional demand has been, and will be, generated by non-OECD countries. OPEC forecasts that by 2030, OECD countries will account for only 41% of global oil demand. At this point, it is still more than half.

27. On a per capita basis, North American oil consumption is more than ten times higher than in emerging Asia outside of OPEC. Consumption patterns will converge over time, just as living standards, but no one is able to predict where the equilibrium price will be. If each of the 7 billion people living on this planet were to consume as much oil as the Americans, oil production would have to rise to about 460 mb/d, a 5.3-fold increase from today. Prices would explode in such a nightmare scenario. It will not happen.

28. In real life, **oil demand will expand only moderately because the global financial crisis may drag on for a long time.** Moreover, energy efficiency is improving in leaps and bounds, and substitutes such as gas, coal, nuclear and renewables will play a larger role. On the supply side, high oil prices will lead to more exploration and a rising output from seismologically challenging fields. High oil prices also act as a brake on oil demand. Bottom line: the oil price is presently on a solid downtrend, but the next lower turning point of the cycle will be higher than last time, i.e. higher than $35. Admittedly, this is a rather evasive and not particularly surprising forecast.

policy rates mostly on hold

29. In the present environment, one easy bet is about central bank interest rates. Chairman Bernanke has already assured markets **that the Fed funds rate will remain where it is, at 0 to 0.25%, until mid-2013. The ECB, meanwhile, is reconsidering its plans to raise the main refinancing rate beyond 1.5%** - the euro area economy is getting weaker, inflation is coming down now, and the sovereign debt crisis of the countries in the periphery remains as unresolved as ever. The rescue package, agreed among euro area governments on July 21, has yet to be ratified by national parliaments, which is by no means a certain outcome.

30. Furthermore, the package is also not comprehensive and large enough to resolve the crisis once and for all. It does not make sense to support Italian, Spanish and other shaky government bond markets and at the same time raise interest rates. Since fiscal policies are getting more restrictive, monetary policies must remain expansionary. No**, the next**

increase of the ECB's policy rates is a long time off. As things develop, I would not be surprised if the next step would actually be a rate cut.

31. **The list of other countries which will leave rates unchanged for at least one more year has become very long.** It includes, in the OECD area, Japan, the UK, Switzerland and Sweden. To varying degrees, these four countries are the destination of safe haven capital inflows which have driven up exchange rates; their central banks have begun to worry about international price competitiveness and growth.

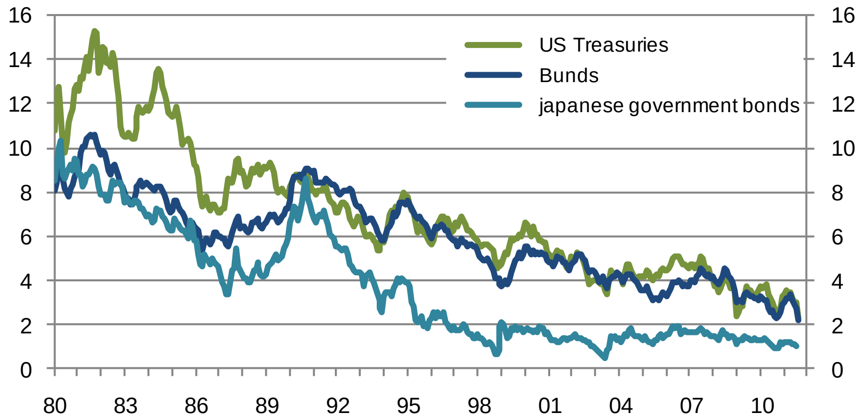
32. **Central bank policies in most emerging markets are on hold as well, among them China, Brazil, Russia and Indonesia**. Very few will tighten this year: India, Korea, Thailand and, in the OECD, Canada and Australia where inflation, on the back of the mini-commodity boom, has reached 3½%. But overall, inflation is simply not a near-term issue any longer.

record-low bond yields

33. This is also reflected in **the steep decline of bond yields. Good quality borrowers in several OECD countries can raise long-term funds at rates which are lower than at any time over the past two centuries.** The Japanese and Swiss governments have to pay no more than 1% for 10-year debt these days while the US Treasury and the German and Swedish debt agencies can access their markets at around 2%. Investors wonder whether they should start to sell or go short these bonds. Looks like a bubble, doesn't it?

yield of government bonds*)

%, y/y



*) 10 years; August 2011: estimate

source: IMF

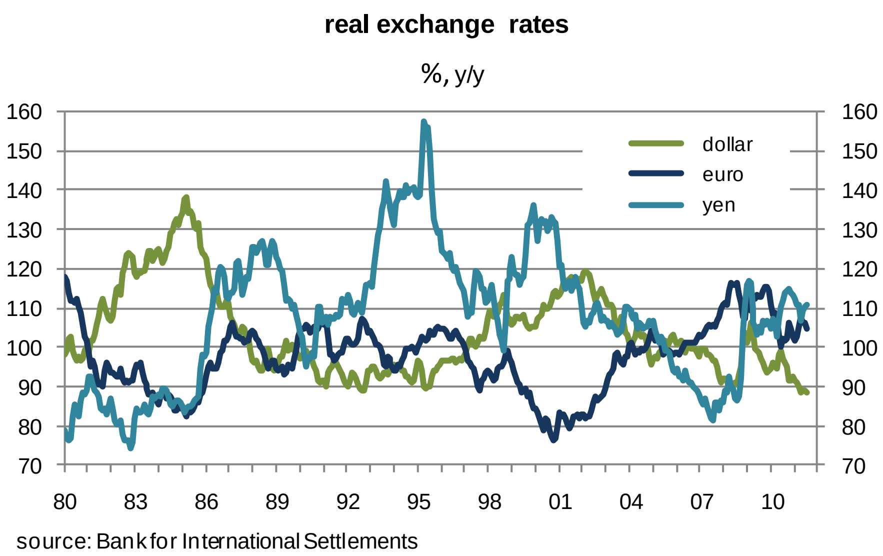
34. **Long-term bond yields are determined by several factors**. These are, aside from default risks, inflation expectations (future policy rates), exchange rate expectations, and the trend growth rate of real GDP per capita. For a "normal" country this translates into 2% (the inflation target of US and euro area central banks), an unchanged real exchange rate, plus perhaps 1½% for growth (productivity), plus another half percentage point as a compensation for the elevated volatility at the long end of the yield curve. This adds up to 4%.

35. For investors to settle for 1 or 2% means they are prepared to pay a hefty premium for the fact that these borrowers are financially relatively sound and will thus be able to service their debt. As long as central banks do not tighten, as long as the euro crisis is not credibly resolved and as long as inflation remains on a downtrend, it would be **too early to dump the bonds of these preferred borrowers.**

36. Italian and Spanish 10-year bonds yield around 5%. Buying them at these relatively attractive levels is de facto a bet on the survival of the euro, continued ECB purchases and successful austerity programs and privatizations. It is a bet worth considering. Greek, Portuguese and Irish bonds are strictly for investors who can take risks, though – they yield 16.7%, 10.6% and 8.4% these days.

euro continues to move sideways against dollar

37. **Exchange rates have been mostly on one-way streets this year.** The Swiss franc in particular has had an unprecedented run. In spite of the concerns expressed by Swiss central bankers and the threat of tying the franc to the euro, the appreciation could well go on: unemployment is just 3% and the current account surplus remains in the order of 10 percent of GDP. Equally the yen: unemployment is very low as well and the trade surplus is about 4 percent of GDP. The appreciation has been fairly modest so far: to reach the heady level of April 1995 in real terms against the dollar, the yen would have to revalue to about 50, from 76.6 today. Both Swiss and Japanese short-term interest rates will occasionally have to be negative in nominal terms to ward off speculative inflows.

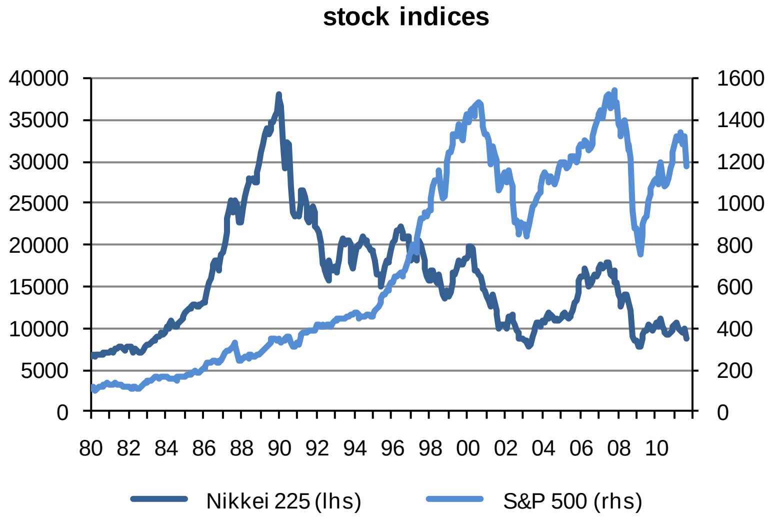


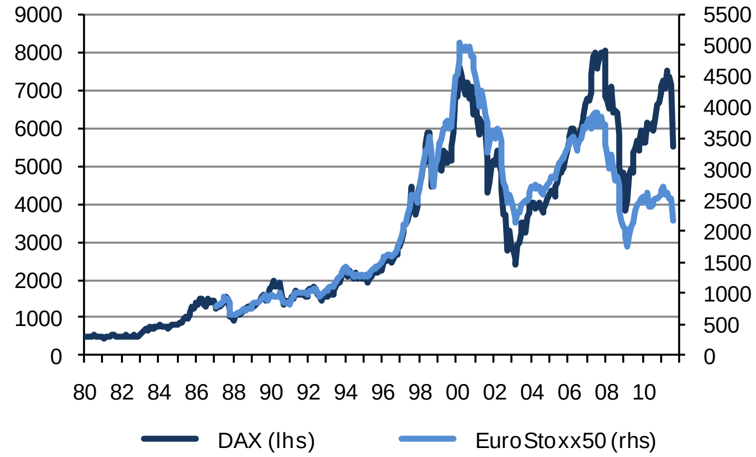
38. **At first glance, the euro should appreciate further against the dollar**: the aggregated government budget deficit of euro area countries is “only” about 6 percent of GDP, versus 9 percent in the US, the current account deficit is less than 1 percent of GDP, compared to America’s 4 percent, short-term interest rates are much higher, and the balance sheet of the Eurosystem has been expanded by less than that of the Federal Reserve system – money printing has been more cautious than in the US. Globally, there is much more dollar than euro liquidity.

39. **The key factor that prevents a significant appreciation of the euro is America's superior ability to service its debt** – which is almost exclusively dollar-denominated. The US Treasury can rely on the Fed to provide the necessary funds while the Italian, Spanish or indeed the German governments have no such leverage. European governments can declare default, America's government cannot (even if Congress tries hard)**. On balance, the euro has little upside against the dollar as long as Europe's sovereign debt crisis keeps simmering.**

stocks are cheap

40. Finally some remarks about **stock markets**. Policy makers in OECD countries are determined to reduce government deficits at a time of high unemployment and very low capacity utilization. Rather than stimulating growth they intend to slow it. With consumer and government demand weakening, investors can be forgiven to speculate about **a coming decline of corporate profits.**





sources: Deutsche Bundesbank, ECB, Handelsblatt

41. In the US or the euro area, **the financial situation of the business sector outside of finance is quite sound**, and will improve further as commodity prices are gradually coming down. Wages have been under pressure from emerging market competition and

have not really recovered yet. All the productivity gains realized over the past two years of recovery have thus gone to the owners of capital and the managers they employ.

42. Stock markets have on average lost some 15 percent this month while bond markets have been extremely strong. It is obvious that equities are now relatively cheap. Such a lot of bad news has been priced in that even forward-looking price-to-earnings ratios are at historically low levels. Taking into account that real riskless bond yields are close to zero or even negative, depending on the market, means that equity risk premia are extremely high at this point.

43. **This looks like a very good time to buy stocks**. There are many companies which enjoy near-monopoly market power that pay dividends that are two or three times higher than government bond yields. Think utilities, food companies, or chemicals. Cyclical stocks should mostly be avoided as long as the world economy keeps cooling off. Before going overboard, though, I want to warn readers that things look a little less attractive if one attaches some probability to a Japanese-like scenario in the OECD area. Just a warning.