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Wermuth's

Investment Outlook

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by Dieter Wermuth*

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1. Financial markets have yet to come to terms with a situation for which there is no precedent. In these uncertain times, **investors would like nothing better than buying safe assets**. These are usually extremely expensive by now, such as works of art, Swiss and Japanese government bonds, yen futures, or homes in fashionable places. Short-term German government debt, also considered to be super-safe, carries a negative nominal interest rate!

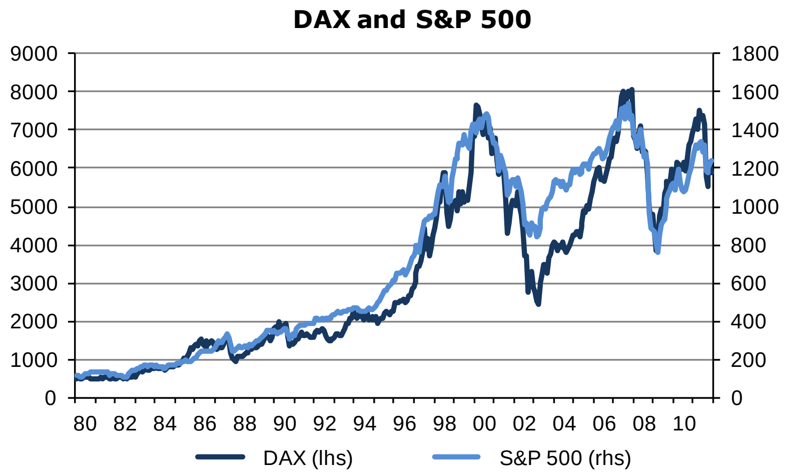
2. The notion of a safe asset itself is not carved in stone: gold, the euro or triple-A-rated French bonds have recently lost this status. Since the European sovereign and banking crises will not go away quickly, and might actually spread to the rest of the world, it is probable that safety considerations will continue to dominate investor strategies in 2012. **Safety plus a reliable cash flow is the combination that institutional investors need more than ever these days, and forget about growth opportunities.**

Markets dominated by flight to safety

3. The desperation is such that **US Treasuries or British gilts are in strong demand**, in spite of actual and expected government budget deficits in the order of almost 10 per cent of GDP, and in spite of those two countries' large structural current account deficits and aggressive money printing (bond purchases by their central banks). 10-year yields have fallen to record-lows of 1.9% and 2.0%. In real terms, after subtracting today's inflation rate, they are negative - investors do not mind being expropriated over time because, for them, the alternatives are even worse. Both countries' sovereign debt is denominated in domestic currency and their central banks are able to bail out their governments if necessary – Italy or Spain are not in such a situation and are now paying the price for having given up their own printing presses.

4. **US equities have recently been regarded as another "safe asset".** From a top-down perspective, fairly rich valuations and the prospect of a second year of below-trend GDP growth in 2012 (2.0% y/y) would argue against American stocks. But as it is, they have been last year's outperformers, together with British and South-East Asian stocks. Since US companies are sitting on piles of cash but hesitate to boost capital spending, given the uncertain outlook for final demand, most of them can afford to pay generous dividends. Defensive stocks in particular come with dividend yields that exceed the yield on government debt by a wide margin. Investors like that.

* 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.



sources: Deutsche Bundesbank, ECB

5. They may also like the fact that austerity measures will be avoided because neither Congress nor Mr Obama - who will run for a second term - want to be seen as scrooges in this election year. Even though the debt-to-GDP ratio will probably hit 100 per cent before the end of 2012 **US policy makers refuse to pursue euro area-like pro-cyclical strategies and rather prefer to postpone the day of reckoning to next year.** Funding the deficit and rolling over maturing debt is no problem at all (amounting to 24.3 per cent of GDP in 2012, or more than in Italy). There is no sense of urgency. The likelihood of a recession this year is thus quite small.

6. **The surprising resilience of commodity prices can also best be explained by the flight to safety.** In normal times, the on-going downward revision of global economic growth rates and the widening of output gaps would have caused commodity markets to crash, given their sensitivity to changes in the outlook for the world economy. Not so now: investors irrationally think that they provide protection against the risks of both inflation and deflation. At the same time, the cost of carry is, and will remain, close to zero. The main central banks have made that quite clear. It is therefore not costly to hold on to commodities. They are, of course, also a hedge against the risk that the confrontation between the US and Iran may disrupt oil supply and drive up oil prices.

Why investors are scared

7. **What is behind this flight to safety? One factor is the impression that the financial crisis in the OECD countries will go on and on, as the one in Japan.** The crisis began in early August 2007 when investors found out to their surprise that a large portion of their financial assets was worth much less than they had thought. Their books were full of “toxic” securities which had to be written down - which in turn reduced equity buffers and forced them, especially in the case of banks, to ask for government help. The crisis is four years and five months old by now and thus on track to become the longest and most severe one in modern economic history, outside of Japan, of course. A solution is not in sight.

8. **Much of what is proposed by regulators and undertaken by banks and sovereigns is bound to cause harm to the real economy: near-term, most of it has pro-cyclical effects.** In their book “This time is different”, Carmen Reinhart and Kenneth Rogoff have reminded us, on the basis of vast empirical evidence, that it may take a decade before real per capita GDP reaches its pre-crisis level again - if the recession follows a major correction of asset

prices. The present one belongs in this category. This is a scary prospect for investors. Their priority is thus to reduce risk and to concentrate on assets which allow them to service their debt.

source: ECB

9. **In countries where asset price bubbles had popped, governments and households had been – and still are – overindebted and try to deleverage. This means they cut back on spending**, which in turn leads to an almost structural weakness of demand and therefore economic growth. Countries where asset prices had been less volatile, such as Germany, Sweden or Switzerland, are doing much better and respond in a predictable way to expansionary monetary policies. German employment, for instance, has been 1.9 per cent higher in Q4 ’11 than in Q1 ’09, the last cyclical high, whereas US employment has recently still been 4.1 per cent below its peak of November 2007.

10. **Banks have their feet on the brakes as well**. In the good years before the crisis, the period that is now called the Great Moderation, they had generously expanded their balance sheets, including asset backed securities, mortgages, Greek, Irish, Italian and Spanish government bonds as well as regular loans. There had been a rush to acquire high-yielding assets in an environment of falling interest rates, without much concern about their risk, and to leverage-up their balance sheets with cheap borrowed money. Central banks failed to anticipate where all this would lead to. They were sleeping on their watch, or, more friendly, underestimated the dangers that were building in an extended period of tranquility. **The impression that policy makers do not really know how to overcome this supposedly novel kind of crisis is one of the reasons for the flight to safety.**

11. When a large portion of banks’ assets turned sour, many of them, including large multinationals and leading investment banks, became almost insolvent and had to be bailed out by taxpayers. **They are now under pressure to repair their balance sheets which means they have to increase their core capital-to-risk-weighted-asset ratio, by either shedding assets or raising fresh capital. But price-to-book ratios are often only around 0.5, or less.** A few examples: Bank of America 0.28, Citi 0.47, Unicredit 0.19, Intesa 0.36, Société Générale 0.32, BNP Paribas 0.56, Deutsche Bank 0.53, Commerzbank 0.32, ING 0.46, Royal Bank of Scotland 0.31, Mitsubishi UFJ 0.58, and so on. In normal times, bank shares trade at one to two times their book value.

12. Bank shares are like hot potatoes these days, and it is de facto impossible for banks to access the stock market. **So they have to sell liquid assets and hold back on new loans. This is a supply-side reason why credit growth is less than nominal GDP growth in the OECD area these days.**

Slower global growth

13. So what is the **outlook for global fundamental indicators**? The OECD, the club of rich countries, has recently published its new economic projections. In this part of the world, real GDP will expand by 1.6 per cent next year, after 1.9 per cent in 2011. Since potential GDP is growing at a faster rate than that, the output gap will once again widen while unemployment will rise to an average 8.1 per cent, from 8.0 per cent in 2011.

14. US and Japanese growth is actually expected to accelerate – to 2 per cent year-on-year in both cases. **The euro area, on the other hand, is experiencing a mild recession this winter**; its economy will only start to expand in the second quarter again, but growth will remain anemic and sub-trend well into 2013. With France now on the radar screen of portfolio investors and speculators, the larger part of the currency union is forced to pursue pro-cyclical fiscal policies.

15. On an aggregated basis, the OECD analysts expect the **fiscal deficit of the euro area to shrink from 4.0 percent of GDP in 2011 to 2.9 per cent in 2012.** This is rather impressive and a sign that the euro zone fundamentals are quite sound, at least when compared to the US, Japan and Britain. The problem, of course, is that euroland is not a nation state and does not yet have a common fiscal policy - which means that investors are not sure that there is actually a lender of last resort.

16. They are **reducing their exposure to the euro and also continue to discriminate between good and poor credit**: in the 10-year range, they are content with a yield of just 1.9% on Germany's Bunds (or a negative yield on BuBills) but won't settle for less than 28.8% on Greek government bonds. They are pricing in a large haircut whose details have yet to be negotiated before the next large maturity in March. Other bonds are trading at less excessive but still punitively high yields: Portugal 12.2%, Ireland 8.0%, Italy 6.8%, Spain 5.2%.

Euro crisis will drag on

17. These numbers suggest **that in spite of the many emergency meetings of euro area leaders the financial crisis has by no means been resolved**. With a recession already underway in the euro area, sovereigns will not be able to pay such high interest rates. This is why they are scrambling to implement structural reforms on both the revenue and the expenditure side of their budgets. It is a race against time as huge debt roll-overs are looming this year. On top of all this, the banking sector may have further write-down and recapitalization needs which would drive up governments' debt ratios once again. Rescuing banks may not be possible for some sovereigns any more.

18. One thing is obvious**: in spite of all the talk the euro area is by no means close to a fiscal union yet.** Such a union would not necessarily require a euro area Ministry of Finance but certainly a mutualization of existing debt in some form or other, a common issuing agency for all 17 member states ("euro bonds"), backed by the ECB and supported by some kind of euro area Monetary Fund which evaluates budget policies and makes pay-outs to national

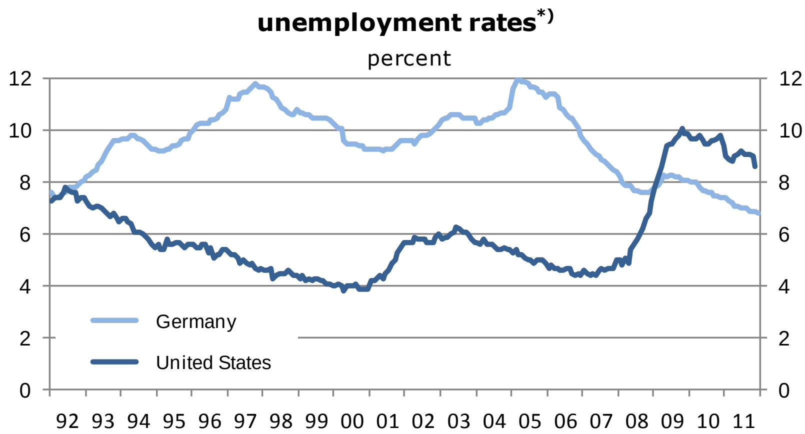
governments conditional on "good behavior", a much stronger bank supervisory role for the ECB (rather than the toothless London-based EBA), including the responsibility for bailing out and "nationalizing" banks which are too big to fail, and a concept for the enhancement of the already-existing transfer union.

19. **So far, the emphasis has been only on reforming and strengthening the Maastricht Treaty.** On the one hand, Germany, France, Holland, Austria and Finland hesitate to make meaningful financial commitments, while the potential borrowers, on the other hand, are mostly not willing to give up a significant part of their sovereignty. Without recognizing that such a deal is the conditio sine qua non for a fiscal union, the euro will remain under pressure. The best thing that can be said about Germany's foot dragging is that it forces profligate member states to put their house in order – once money would start flowing unconditionally the impetus to reform might wane. Perhaps.

20. **For investors, the bottom line is that the euro crisis is not yet over.** That the euro is still relatively resilient is mainly owed to the fact that the situation in the US, in Japan and in the UK is in several ways just as bad. Meanwhile, pressures to come to a comprehensive and durable solution will increase further as a mountain of maturing debt has to be refinanced in coming months. The population in all euro member states is firmly for keeping the euro and seems willing to accept the consequences. Politicians don't quite see it that way yet.

Germany has a good euro crisis so far

21. **As an aside, Germany benefits a lot from the weak euro and those low interest rates.** I cannot remember that real rates along the whole maturity spectrum have ever been so far in negative territory as today. The Ifo Business Climate Index has recovered two months in a row, to 107.2 in December, which is significantly above the 20-year average of 100.7. The labor market continues to improve as well: the December unemployment rate dropped to 6.8% (down steadily from a peak of 12.1% in March 2005). Using the ILO definition, the unemployment rate was just 5.5%. In such a benign environment, wages have finally begun to rise faster than the price index, if by only about one percentage point – more is certainly possible. Real wage growth will accelerate further from here on as the rate of inflation continues to decline, to about 1% at the end of the year.



*) seasonally adjusted
source: National Labor Offices

22. **In the ten quarters since the cyclical trough in Q1 2009, Germany's real GDP has expanded at an average annual rate of 3.1%. In the wake of this good performance, the government's budget deficit has fallen to something like 1 per cent of GDP.** All this provides a strong buffer against the expected slowdown of external demand and the likely near-term escalation of the euro crisis. Inside the euro area, Germany is the main safe haven.

Emerging economies can maintain their momentum

23. **Emerging and developing countries which account for 85 percent of the world's population and, meanwhile, 48 per cent of global GDP at purchasing power parities (less at actual exchange rates), have begun to feel the impact of the economic slowdown in the advanced economies.** Growth forecasts for the group continue to be scaled down and are now 5.7 percent for 2011 and only 4½% for 2012. The annual average growth rate of real GDP had been 7.0 per cent between 2003 and 2010! Even so, this part of the world remains very dynamic and supports global demand. But output gaps are widening there as well because the switch from exports to domestic markets is not a frictionless process.

24. **All this argues for a decline of inflation rates around the globe**. The OECD predicts that the average consumer price inflation rate will fall from 2.5 per cent this year to 1.9 in 2012, and even less the following year. Japan will remain stuck in deflation. In spite of their excellent performance in 2011, high grade bond markets remain solid investment opportunities. In the poorer part of the world, inflation will retreat from about 6 percent in 2011 to less than 5 percent in 2012.

25. Everywhere, **central banks have therefore become relaxed about inflation** and are thus either on hold or try to stimulate borrowing and spending. A major exception is Hungary's which uses higher interest rates to halt the forint's slide against euro and Swiss franc - the country is heavily indebted in these two low-interest rate currencies.

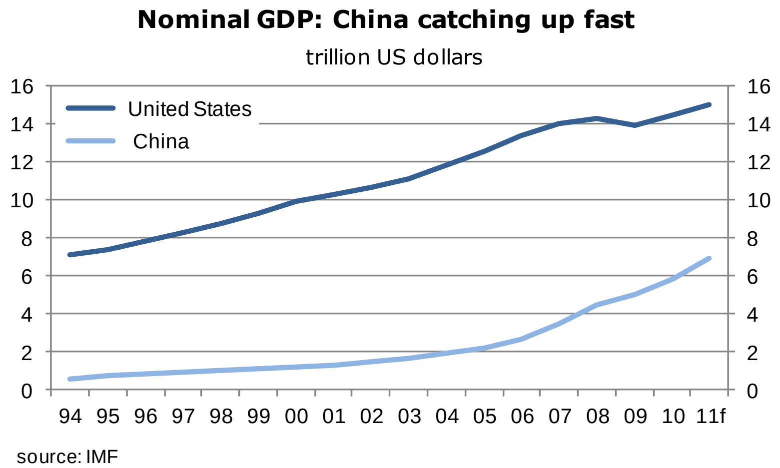
26. **Expansionary monetary policies in advanced countries are not very effective any longer**, not so much because interest rates are so low already, but mostly because households, banks and governments cannot be stimulated to borrow – and spend – more when their main desire is to reduce debt burdens and to improve their credit worthiness. Corporations, as mentioned earlier, are mostly cash rich and not under pressure to take out loans. As long as they are skeptical about the economic outlook they rather wait. **The US, the euro area, Japan, the UK and most of the rest are stuck in so-called liquidity traps.**

27. **Easy money comes at a cost though. It slows the adjustment process in the banking sector - which actually needs shrinking**. There are too many banks. Resources should go into sectors which have a future, and not be used to support an unproductive old-economy activity like banking. While the day of reckoning will come in any case for the sector, it may be a very long time off, as we know from Japan. The walking dead, the zombie banks, do not know how to die any longer, or are not allowed to! Subsidizing the banks (mostly their managers and shareholders) means taking money away from the rest of the economy, not least from the state and the non-financial business sector. Overall GDP growth is thus less than it could be, and savers have a hard time building reserves for old age. Real returns on savings can only be high if the underlying growth rate of output and productivity is high.

28. In other words, **I am not very optimistic about the economies of the rich countries**. **But the emerging world continues to go strong** and should be able to overcome the frictional problems of switching from external to domestic demand. There is, in general, no lack of savings and foreign reserves, real interest rates are low, exchange rates are competitive and budget deficits are manageable. Combined with an average GDP (at current exchange rates) that is just 12 per cent of the OECD average this translates into a huge market potential. Productivity will increase rapidly, often leapfrogging several stages of economic development as modern – and easily available – technology is combined with a low-cost and usually highly motivated labor force.

China keeps racing ahead

29. **China in particular, with its population of 1.4 trillion, continues to race ahead**. It is on track, as I have shown earlier, to become the largest economy by the end of this decade. In terms of steel production, energy consumption, car sales, mobile phones, spending on fixed investment, exports, manufacturing output, electricity generation and even of patents granted it is already there. So far economic management is skilled and likely to master the three main challenges: the overheated real estate sector (with relatively little leverage, though), the overinvestment and overborrowing of local authorities, and the transition from export to domestic demand-led growth as the world economy slows.



30. **Since China's inflation is on the way down – CPI was 4.2% y/y in November after a peak of 6½% last summer – the emphasis of policy makers is on growth again** and thus on monetary easing (via first lowering reserve requirement ratios rather than policy rates). The aim is to stabilize real GDP growth in the range of 8 to 9 per cent. For manufacturing output, this implies an annual growth rate of about 15 per cent. China is the main reason why the prices of energy and other commodities will continue to fall this year but will not crash.

31. **At current exchange rates, global real GDP this year will probably exceed its 2011 average by about 2 per cent**, thanks mostly to the fairly brisk growth in emerging economies (China 8.2%, Russia 3.4%, India 7.6%, Brazil 3.1%). Output gaps are therefore rising, and inflation will fall to somewhere between 2 and 2½% y/y by the end of the year.

To conclude, let me summarize what all this means for asset allocation:

- bond markets are well supported by falling inflation rates and expansionary monetary policies
- but capital gains of high grade bonds will be much less than in 2011
- near-term risks are rising, mostly because of the unresolved euro crisis – stay clear of bonds of countries facing haircuts
- corporate finances are mostly sound – defensive stocks with high pay-out ratios are recommendable
- these are a good alternative to low-yielding bonds and cash
- corporate credits are another attractive investment vehicle
- risk appetite will rise after the end of the euro crisis – which argues for emerging market stocks in the second half of 2012
- commodity prices will gradually decline throughout the year
- the oil price is a function of developments in the Persian Gulf (and could thus stay high)
- the yen will continue to appreciate against the dollar, and the dollar against euro and Swiss franc
- commodity currencies will trend down, but could rebound in H2
- dollar peggers in South America and Asia will be strong (at least until mid-year)