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Wermuth's
Investment Outlook

March 2012

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Wermuth's Investment Outlook

by Dieter Wermuth[*]

March 14, 2012

1. **The euro crisis has not really been solved**, and long-term the situation for Greece remains as difficult as ever, **but for now, the worst has been averted** in that typical European Union muddling-through fashion: Greece will get the funds needed to roll over the debt maturing at the end of this month, and about €100bn of government debt held by the private sector will be forgiven. The country had to accept draconic conditions, requiring structural reforms that are overdue but will certainly push the country deeper into recession. Output is already 17 percent below its cyclical high.

2. As usual, this was a last-minute agreement. Investors should always heed the three guiding mottos famously popular in Cologne and other places in the Rhineland, when trying to predict the outcome of inter-government negotiations about the future of the European Union: "it is as it is; what will come will come; and everything is going to be alright". **The unification process is not for purists – but even though it appears incomprehensible and irrational from an outside perspective it seems unstoppable.** Even the Greeks want to keep the euro, and so do the Germans.

3. **The ECB, meanwhile, is also doing its utmost to stabilize the financial system**. By now it has lent about €1tr of central bank money for three years at the extremely favorable main refinancing rate of 1 per cent – in real terms it is actually negative. For the Bundesbank, this is heretical politics, but it is in the tradition of the Fed and the Bank of England: in a systemic crisis such as the present one, you, as the owner of the printing press, have to supply all the liquidity that is required to prevent important banks to go under. "Lend freely" in a systemic crisis, as Walter Bagehot has recommended in his 1873 classic "Lombard Street". After all, the interbank market is not working any longer. The write-downs on Greek bonds could easily have become the straw that broke the camel's back.

4. The Bundesbank is extremely worried about the new lending strategy of the ECB. While the **eurosystem will supply all the liquidity that banks need, even if there is no repeat of the 3-year offer, it has no power to force the borrowers to reduce their risks and to strengthen their balance sheets**. This is clearly one of the birth defects of the euro. As the lender of last resort the ECB must also be the regulator of last resort, or at least cooperate closely with a supervisory agency that is able to intervene directly in the banking sector on a euro area-wide basis. National solutions are not always adequate, given the size of some banks and the dangerous government debt levels in some countries. The European Banking Authority, based in London (!), is a toothless tiger. It seems that the euro crisis must escalate further before new regulatory policy options will be seriously considered.

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corporate profits are doing well

5. **In any case, with the European risk out of the way for a while, there is no reason not to be moderately optimistic about the global economic outlook**: at actual exchange rates, the world's real GDP is running at a sub-par but still healthy annualized rate of 2¼ per cent, and of 3 per cent on a purchasing power basis; inflation is once again on the way down - in spite of booming commodity markets -; monetary policies are either extremely expansionary, as in most OECD countries, or are being relaxed, as in China, Brazil, India and the rest of the emerging world.

6. Meanwhile, the share of labor in national income continues to shrink globally, due to an abundant supply of labor and the ongoing increase of the capital intensity of production. **Corporate profits outside the financial sector are therefore on the rise**, especially, of course, in the commodity sector, or at firms which benefit from the growth of emerging economies such as China. The liquidity situation of business is excellent due to cautious capital spending plans and the aggressive expansion of base money in the rich countries. In such an environment there will be no repeat of the deep 2008/2009 recessions.

7. Since the risk of a chain of uncontrolled government defaults is not so likely anymore, there is now **less reason to emphasize the safety aspect in investment decisions**. Some assets such as gold, oil, Swiss, Swedish and Japanese money market and fixed income products, German Bunds or US Treasuries of various maturities had been the beneficiaries of the recent flight to safety, but are rather expensive by now – their weights should be reduced.

moderate but steady expansion of global GDP

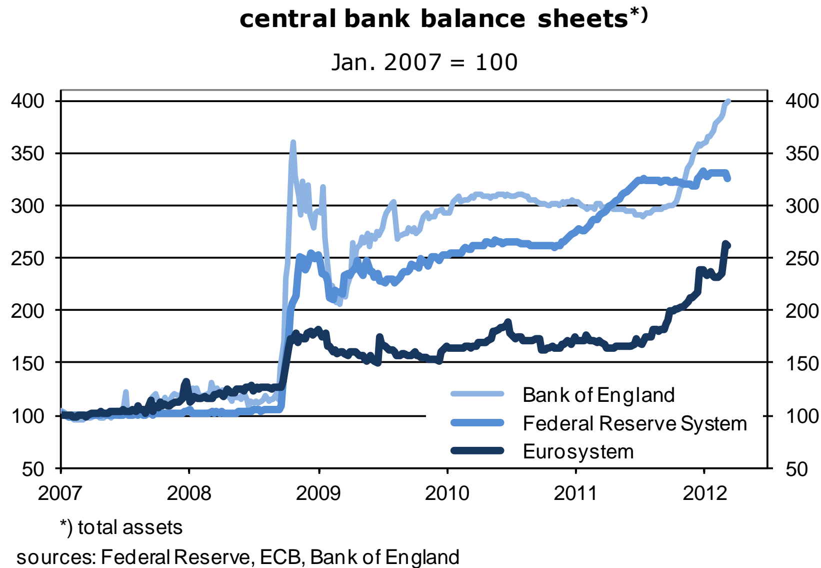
8. With regard to equities, this **does not necessarily mean that it is about time to go for growth stocks again. For several reasons, global output growth is and will remain lackluster.** One is the oil price boom which is beginning to take away big chunks of purchasing power in oil importing countries – which account for about 80 per cent of the world's GDP. As in the past, rising oil prices reflect a more optimistic outlook about the economic future, but beyond a certain level, they act as an increasingly powerful brake on the growth process that triggered the oil boom in the first place.

9. **Another brake on global growth is restrictive fiscal policies by governments which try to reduce their budget deficits.** Some do this voluntarily, as the US, the UK or Japan, but others are under pressure from market participants who are only willing to invest in their debt if they are compensated by very high interest rates: Italy, Spain, Ireland, Portugal, Greece and Hungary are in this category. To avoid being crushed by an ever heavier debt service, these countries have almost no alternative but to tighten their belts. At actual exchange rates, the two groups of countries have a share of more than 40 per cent in global GDP. The impact on world growth is thus very strong.

extremely easy monetary policies in OECD countries will continue

10. To counter these effects and bring about a self-sustaining economic expansion, **monetary policy makers in rich countries have pulled out all the stops**: they flood their economies with central bank money, continue to reduce the quality requirements of collateral, lengthen the life of loans to the banking sector, buy government bonds in the open markets in order

to flatten the yield curve, and push policy rates close to zero. Yet in spite of all these efforts the results in terms of **bank lending growth are quite disappointing.**



11. The main reason is that **households** in countries where credit-driven real estate and stock market bubbles have popped are frequently financially under water and are forced to restore their creditworthiness - which means they hesitate to increase their debt, no matter how favorable the conditions.

12. **Banks, meanwhile, are cutting back on lending** because this is one of the main strategies to boost their capital ratios. Since the price-to-book ratios of the major European and American banks are in the order of 0.5 or less, rather than the usual 1.2 to 2, their access to the stock market is difficult if not impossible. Raising their equity base is usually not a viable option, and their main and only degree of freedom is lending policies. Under Basel III they have to boost their capital ratios by the summer of this year. This does not only have a massive restrictive effect on the economy as whole, it also reduces the long-term profitability of financial institutions: leverage is not permitted to the same extent as before the crisis.

13. As mentioned, **non-financial corporations are cash rich and rather cautious about their capital spending plans**; moreover, they increasingly tap capital markets rather than ask their banks for money. Finally **governments:** they try to cut back on borrowing in order to improve or stabilize their ratings and thus reduce the interest rates they have to pay.

14. In other words, **monetary policy in the OECD area is expansionary but not effective**. It is pushing on a string and cannot provide a compensation for the restrictive effects of fiscal policies because the main economic agents are all trying to repair their balance sheets. This is just another way of saying that their priority is saving rather than spending. This is normally a recipe for recession, if not for deflation and even depression.

why euro area and US growth rates differ this year

15. **Perhaps I am generalizing too much: there are significant differences between the US and the euro area.** The US administration has been more forceful and successful in

stabilizing the banking sector than European governments, thanks to the existence of national regulators and a national Treasury. The euro area has nothing comparable – a fiscal union is in the making but is still in its infancy.

16. Even though the US has a much larger fiscal deficit and a much larger current account deficit, **the fact that crisis resolution is so much easier and the economy fundamentally more stable has led to a large appreciation of the dollar against the euro and considerably lower government bond yields** – in the 10-year range, US Treasuries yields are 2.16 percent, compared to a GDP-weighted euro area average of 3.85 per cent. In real terms and across the whole yield curve, US interest rates are a lot lower than euro area interest rates.

17. **This helps to explain why the US economy will expand by about 2¼ per cent from last year while the euro area may shrink by half a per cent.** The other explanation, of course, is the difference in fiscal policies – the US administration is much less ambitious in this respect. It is under less pressure from markets to reduce the budget deficit.

emerging economies as the drivers of global growth

18. **What keeps the world economy on track at this point are emerging and developing economies.** In purchasing power terms – rather than using actual exchange rates to calculate their weights – they produce almost one half of the world's GDP. As a group, they are not plagued by the aftereffects of deflated asset price bubbles nor do they need to tighten fiscal policies. The oil producers among them, such as Russia, can actually afford rather profligate spending policies. Until quite recently, their main concern has been inflation, not growth.

19. **They are all in catching-up mode**, meaning they are in the process of closing the gap vis-à-vis the rich countries as fast as they can. One of their key strategies is to go for export-driven growth by maintaining undervalued exchange rates; the tools are capital controls and FX market interventions. Simultaneously, they liberalize their internal markets for goods, services, labor and capital but spend very little on social benefits and (usually) defense. In this way, they boost national savings and thus the growth rate of their capital stock.

20. The recipes have been very successful so far and have resulted in **average real GDP growth rates which, over the past 15 years, have been two to three times higher than those of the OECD area.** For them, the 2008/2009 "recession" had been just a brief slowdown of growth, not a decline of GDP. On the basis of sound financials such as low government debt, large foreign reserves and current account surpluses, growth has a strong underlying momentum. Under these conditions, economic policy making is still quite effective.

21. **In the first half of 2012 emerging economies are expected to expand at an annualized rate of 5¼ per cent**, compared to the likely 1 per cent growth rate of developed markets. They will continue to move ahead fast. Since domestic demand is increasingly the driver of their overall demand, they are not too much affected by the problems of the OECD countries. Growth will probably accelerate to 5¾ per cent annualized in the second half of the year.

commodity prices high but well supported

22. Since their output is considerably more energy and commodity-intensive than that of the rich countries – they produce things that can fall on your foot -, they **have become the swing factor for commodity prices.** We are witnessing something of a sea change: the OECD area has all of a sudden become a price taker. It will never again be the world's price setter in tradable commodities. After all, only 15 per cent of the globe's population lives in North America, Europe, Japan and Australia.

23. **Commodity prices are not only determined by expected changes in global output and its composition, but also by liquidity and interest rates. On both counts, they are well supported. The question is whether they have already increased so much that a correction has become likely.**

24. **Oil, for instance, has rebounded 236 per cent from its last low in late December 2008**, and is now above its long-term trend by at least one standard deviation. At this point, it is mostly driven by the fear of a war between Israel and Iran, less by economic fundamentals. Since a full-scale attack on Iran's nuclear facilities is extremely risky, and certainly not in the interest of the US, the sponsor of Israel, it is a low-probability event, as far as I can tell. Once market participants realize this, oil prices will adjust downwards.

25. Other candidates for significant corrections are copper and gold. But as to the other commodities, prices have already been coming down since last fall and are generally far below the levels reached in spring 2008. **Global growth is too weak to suggest a new boom in commodities.** On the other hand, I do not see that their prices will crash – there is simply too much liquidity around, and real policy rates in the US and the euro area are negative. It is cheap to hold commodity inventories.

inflation not a risk at this point

26. Going forward, **neither consumer nor commodity price inflation is a genuine problem**, for the simple reason that the rate of capacity utilization for the world economy as a whole remains low. The near-stagnation of global output three years ago has by no means been made up since, considering that the underlying growth trend of real potential GDP is in the order of 4 per cent. The output gap, the difference between potential and actual GDP, remains large.

27. In my understanding, this rate of **growth of potential GDP is determined by the product of labor force and productivity growth**. Especially the latter continues to increase strongly, mainly because the emerging economies tend to leapfrog development stages by installing state-of-the-art capital goods and processes. Think telecommunication, transportation systems or robotics in manufacturing (this is one reason why German exports are so successful in this part of the world).

28. In such an environment, **most workers do not have much bargaining power** – the exceptions are jobs which either require special skills or are protected from foreign competition by language, geography, regulation and various other barriers to entry, as in much of euro area services.

29. Aside from these cases, there is a clear **trend toward a single global labor market**. This trend will persist as long as international trade volumes continue to expand 1.8 times or so faster than the world's output, i.e. as long as the international division of labor intensifies in leaps and bounds. Labor costs, the main drivers of inflation on the input side, will thus pose no threat to inflation for years to come. This allows central banks, especially those in the OECD area, to keep the money taps wide open – and real interest rates in negative territory.

some bonds are overpriced

30. **Bond yields of high-grade government bonds are at or close to their all-time lows**. They are driven by moderate inflation expectations, plenty of liquidity, low policy rates and safety considerations. As to 10-year maturities, Swiss government bonds yield 0.77 per cent, Japanese governments 1.00, Bunds 1.90, Swedish governments 1.92, US Treasuries 2.19 and UK gilts 2.27 per cent. Debt-to-GDP ratios vary widely within this group of blue chip borrowers and can thus at best be of secondary importance in explaining why yields are so low. Investors do not much care as long as they are convinced that fundamentals are robust and that debt service will not become a problem.

31. Still, I would not allocate too much money to this asset class. They are a hedge against deflation (which, admittedly, remains a risk, in spite of all the money printing). **I am presently impressed by the structural reforms in Italy**, to a lesser extent also by Spain's efforts to reduce its budget deficit in a recessionary environment; 10-year yields are 4.87 and 5.11 per cent. Greece is for the courageous (17.86 per cent).

32. **An attractive alternative to high-yield government bonds are stocks which pay generous dividends**, such as telecoms, logistics, utilities, insurers and various old-economy names from other sectors, especially if they have an unassailable market position. Many institutional investors are desperately looking for a steady income stream that allows them to meet their long-term obligations.

33. **To sum up, I think the following are the main themes for investors:**

- global growth is moderate
- emerging economies continue to expand significantly faster than rich countries
- the latter are held back by deleveraging and pro-cyclical fiscal policies
- output gaps remain large, implying a low risk of accelerating inflation
- monetary policy in industrialized countries will stay extremely expansionary
- commodity prices are high but fundamentally well-supported
- the financial sector is on a secular downtrend
- high-grade government bonds are expensive
- which argues for riskier government bonds and dividend stocks

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