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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. Let me begin by looking at two of the main drivers of capital markets this year: monetary and fiscal policies. I am quite confident that **monetary policies in developed countries will stay very expansionary**, with nominal central bank rates in the neighborhood of zero and a more-than-generous supply of central bank money. Except for deflationary Japan, real policy rates will thus remain negative. Inflation rates are mostly on the way down and will soon be below targets. Central banks cannot afford to tighten.

2. **Japan desperately tries to get out of its deflation trap** – Mr Abe, the new prime minister, intends to force the Bank of Japan to adopt a 2 per cent inflation target. This will result in massive purchases of domestic securities as well as of dollars and euros – the latter is de facto a competitive depreciation of the yen and may be the opening shot in an international currency war.

3. Meanwhile, **fiscal policies of rich countries will be fairly restrictive** and thus, given high unemployment and capacity reserves, pro-cyclical. They neutralize to a significant extent the positive effects of monetary policies on overall demand. In key countries such as the **US, Japan, the UK and Spain** budget deficits are expected to be still in the order of 6 to 9 per cent of GDP in 2013. This implies that government debt will continue to rise rapidly which in turn severely limits policy makers' room for manoeuver.

4. In **Italy and France** deficits will be lower (1.1 and 4.2 per cent of GDP), but debt is already at dangerous levels (122 and 93 per cent), threatening governments' credit rating and access to bond markets; so these two countries are also pursuing tight fiscal policies.

5. Among the large economies, **only Germany has an almost balanced budget**; in view of the considerable underutilization of capacities this implies that there is actually a structural budget surplus. Stimulating the economy to boost domestic demand, and in this way support struggling euro area countries and stabilize the euro, would be possible without too much risk to public finances. Frau Merkel will have nothing of it, in spite of the federal elections scheduled for September 22 this year.

US struggles to fix fiscal mess

6. **One major risk that threatened the world economy has more or less been removed, the risk that America would fall from a "fiscal cliff"**, the combination of tax increases and automatic spending cuts worth $600bn or 4 per cent of GDP. It could have triggered a new recession. The last-minute agreement between Congress and the White House was a reasonable compromise, with a slightly rather than a massively restrictive effect on US demand. The annual impact of the measures that are effective immediately - the payroll tax

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increase, higher Medicare taxes and the 2011 discretionary spending cuts - is about $200bn. In terms of near-term effects on employment and growth the outcome is better than expected.

7. The main risk to economic growth that has been avoided would have been the repeal of the **Bush tax cuts**: as it turned out, these **were made permanent for 99 per cent of US households, those whose income is below $450,000 a year**. For households above that limit, the marginal tax rate was raised from 35 to 39.6 per cent (fiscal year 2014). Further tax increases apply to dividends, capital gains and inheritances. Since the better-off save a large share of their income, the net effect of these tax hikes on final demand is probably modest. A strongly negative impact on workers' disposable income and on consumer demand can be expected from the increase of the payroll tax from 4.2 per cent to its old level of 6.2 per cent.

8. **Further difficult and potentially disruptive negotiations lie ahead**: one issue are the automatic spending cuts which will come into effect at the beginning of March, unless a new agreement is reached, another one is the federal government debt ceiling of $16.4bn that has been breached at the end of 2012. Because of these uncertainties and the restrictive effects of the various fiscal changes, it is likely that US real GDP growth will be in the order of 1 to 1½ per cent annualized in Q4, Q1 and Q2.

9. Medium term, the **fundamental problems** of large budget deficits (7 to 8 per cent of GDP in 2013), rising debt (109 per cent of GDP) and insufficient government revenues **have not been addressed**, though. US public finances are in bad shape and something like a time bomb.

10. With one major uncertainty gone, **stock markets in the US and globally reacted almost euphorically to the news while bond markets declined.** The latter was due to an increase of inflation expectations and the prospect that the US budget deficit would not come down as quickly as assumed before the agreements. The news has also given a boost to **commodity prices**, including oil and gold. For the **dollar exchange rate**, GDP growth that is somewhat faster than expected suggests an appreciation; but it also means that the trade deficit will not shrink as fast which is dollar negative – the two effects will probably cancel each other out.

11. **The US economy is likely to pick up speed in the summer,** in response to easy money policies, a bottoming out of the housing market, the fairly robust increase of world trade, the rebuilding of inventories and stronger corporate spending on equipment. The financial situation of business remains excellent. On average, real GDP will exceed its 2012 level by 1¾ percent, implying that spare capacities continue to increase. The inflation rate will fall to almost 1 per cent by year-end.

12. **Weak growth means that US employment will hardly increase faster than the labor force**: the unemployment rate will therefore stay in the range 7½ to 8 per cent, possibly throughout 2013. The Fed had earlier announced that it would pursue aggressive quantitative easing, ie money printing policies until 6½ have been reached. According to the minutes of the Dec 10-11 FOMC meeting, members are not so convinced any more: they have been discussing an earlier end of these policies, perhaps by the summer of this year already. This may have been one reason for the 31 basis point increase of 10-year US Treasury yields over the past month (to 1.90%).

13. In any case, at 134.02m in December, **the number of jobs (nonfarm payrolls) was still 2.9 per cent lower than in November 2007, the all-time high, more than five years ago.** For comparison: Germany's total employment in November has been 2.8 per cent higher (!) than the previous cyclical and all-time high of February 2009. The US economy does not create enough jobs yet and continues to depend on life support from the Fed. But this can only be a sort of band-aid – the real problems run deeper.

14. **US wage growth will remain subdued and hardly exceed consumer price inflation.** In December, average hourly earnings of employees in the private sector were only 2.1 per cent higher than one year ago (Nov. CPI: 1.8% y/y). The ongoing intensification of the international division of labor, a result of lower costs of transportation and information as well as generally low trade barriers, is creating something like a single global labor market where marginal workers in emerging economies increasingly determine marginal wages in the rich world, ie the wages of unskilled workers. Given the large international discrepancies in per capita incomes, the process has obviously some time to run - unless trade barriers go up again. **This means that the US income distribution before taxes and transfers continues to shift in favor of capital and skilled and protected jobs.**

euro area makes progress towards a banking union

15. This is, of course, not just an American phenomenon. **Downward pressure on real wages will persist in all industrial countries, especially in Western Europe where spare capacities are even larger than in the US. Unemployment in the euro area is heading toward 12 per cent.** From a financial investor's perspective this suggests that money will mostly be made by shifting funds into equities, especially of firms with a highly-qualified labor force that are doing well in the international market place (lightly regulated and dividend-paying domestic monopolies are an alternative). To be sure, quality bonds will remain well supported by low inflation expectations and near-zero money market rates, but the long period where they have outperformed most rich-country stock markets is coming to an end.

16. **As to Western Europe – what are the chances that the euro crisis can be overcome this year?** The crisis has forced almost all governments to pursue pro-cyclical fiscal policies. Given the comparatively large share of government spending in total demand – almost 50 per cent of GDP, compared to America's 40 per cent -, the effects of these policies on GDP growth have been significant, and they have, not surprisingly, depressed business expectations and thus capital spending and job creation.

17. **After shrinking by about one half per cent year-on-year in 2012, the euro area's GDP may well shrink again in 2013.** The ECB has just published its new staff projections, according to which the mid-point of the forecast range is -0.3 per cent y/y. Only three months ago the forecast had been +0.5 per cent. The gloom has deepened. All components of domestic demand are expected to decrease, from about 0.5 per cent for private and government consumption to 2.6 per cent for gross fixed capital formation. Foreign trade provides the only relief in an otherwise extremely bleak picture.

18. The forecast may be somewhat biased because the ECB has to justify its loose policies, especially to a skeptical German public. Other institutions are slightly more upbeat, but their forecasts have recently been close to zero as well. It means that the euro area is now entering its second year of recession. **Output gaps are not only wide, they are widening, and**

unemployment has reached dangerous levels. The income distribution is becoming ever more uneven in the process. Across the region, it is moving up quickly on the political agenda. Meanwhile, year-on-year consumer price inflation is generally expected to average between 1.6 and 1.9 per cent in 2013 and thus to be on target or somewhat below. Inflation is not an issue. In 2014 it will be lower still.

19. The night is always darkest just before dawn. Assets of crisis countries such as Italy, Spain, Portugal, Greece and Ireland could be the positive surprises of the year. I have the impression that the recession has finally begun to force the hand of policy makers. The public is fed up with the never-ending euro crisis and demands decisive action. **The process that leads to a genuine banking union has suddenly gained momentum.** There is now a fair chance that the loop where bank failures and bail-outs led to ever rising government deficits and borrowing costs – and to more pro-cyclical fiscal policies – will be cut. The idea that bank risk and sovereign risk must be addressed separately is now generally accepted.

20. **A new banking supervisory authority attached to the ECB, but with a separate staff and an independent steering committee, is now being established and should be fully operational by year-end 2013.** It is called the Single Supervisory Mechanism (SSM). About 80 per cent of the area's bank assets will be under its control, but it will probably have a say over the rest as well; this has yet to be worked out.

21. **This is a big step forward. I am convinced that others must and will follow, especially in the case of new banking crises. The longer the recession lasts the likelier this gets.** Should the SSM one day declare that a systemically important bank must be recapitalized, because it cannot survive on its own, the question has to be answered where the funds should come from. This is particularly relevant if the bank's headquarters are in a country that is already highly indebted and must pay interest rates that exceed, perhaps by a large margin, the growth rate of its nominal GDP. This applies to all crisis countries. Put differently, it does not make sense to have a central or supra-national supervisory authority while relying on national governments to bear the costs of its decisions.

22. Once the European Parliament has approved the December 13 compromise about the SSM – which is likely - **the discussion will focus on creating and organizing a single bank resolution authority that is charged with the direct recapitalization and winding-down of weak banks, and what the role of the ESM, the European Stability Mechanism should be.** Discussions will be very difficult because potentially large sums of money are involved, as well as a further transfer of national sovereignty to a common institution. Not much will be agreed before the German election next fall. But policy makers are asked to submit a "Recovery and Resolution Directive" and a "Deposit Guarantee Scheme Directive" by next June.

23. In the meantime**, the ECB "will do whatever it takes" to provide liquidity and stabilize the euro. This, of course, raises a moral hazard issue:** if countries come to rely too much on the unlimited financial fire power of the ECB, they may let up in their efforts to reform their economies and to bring down budget deficits. Germans in particular are afraid of a mutualization of government and bank debt through the back door. In its recent Financial Stability Review the ECB has expressed such worries as well. So far, the numbers do not suggest that deficit reduction is not a top priority any longer. In all peripheral countries that are, or may be, candidates for financial support from the ESM or some other common source,

deficits are on the way down, in spite of dire economic conditions. They all try to solve their debt problems on their own, including Greece.

24. I am obviously painting a rather upbeat picture here. I also have a home bias. The main idea is that **giving up the euro is extremely expensive, certainly more expensive than the cost of supporting struggling banks and sovereigns**. At the same time, muddling through is becoming less and less of an alternative. The house is burning.

25. If I am right, **euro area bond spreads will narrow some more**. In spite of the risk of a second bailout, even Greek bonds have some upside potential left (10.97% for the 10-years), but less risky Portuguese (6.16%), Spanish (5.05%) and Italian (4.30%) bonds will also perform well. German bonds are the losers in this process. On average, euro area bond yields continue to be on the way down: inflation rates are falling, the recession will drag on for a while, and government budget deficits are shrinking.

26. A similar **adjustment of relative prices can be expected on euro area stock markets**. Spanish, Italian and probably French stocks should outperform German stocks (which had gained no less than 29% last year). Banks may well be the stars of the season as the likelihood increases that no systemically important bank will be allowed to go under. Moreover, the Basel committee has just recommended to reduce, compared to initial plans, the liquidity coverage ratios which force them to hold cash and easy-to-sell assets to withstand a 30-days funds outflow. This will boost their profitability. Price-to-book ratios are frequently at 0.5 or below, and price-to-earnings ratios are reasonable.

Japan tries to reflate

27. The euro area banking union will be one **game changer this year, another one will probably be the reflation of the Japanese economy.** The yen is in a free fall: at the strongest point last summer, 94 yen bought one euro, today the price has increased to 114.1! So far, neither the Europeans, nor the Americans, nor the Chinese have objected strongly against this competitive devaluation. It will probably continue.

28. Meanwhile, 10-year bond yields have risen from 0.68% to 0.82% over the past month and could rise much more if the new government and the Bank of Japan succeed in bringing back inflation. Note that gross general government debt is approaching 250 per cent of GDP this year, that the budget deficit will be about 9 per cent of GDP, and that the current account surplus has been shrinking fast, from almost 5 per cent of GDP in 2007 to about 1 per cent this year**. A Japanese bond market crash has unsuccessfully been predicted several times in the past. It could finally happen.**

29. This would then be **the time to shift into Japanese exporters** who are becoming very competitive internationally. The Nikkei stock market index trades at 10,599 and thus only at a little more than a quarter of the level it had reached at the end of 1989. At the receiving end of the reflation efforts will probably be the banks and the insurers with large holdings of Japanese government debt.

emerging economies continue to grow fast

30. **Emerging economies continue to steam ahead and remain the growth engine of the world economy.** Most of them are in good shape financially: contrary to common sense and economic theory they are net exporters of capital to the rich countries. They can therefore afford to pursue expansionary policies. J.P.Morgan predicts that their combined GDP will increase by 5.1 per cent year-on-year in 2013 (after 4.6 per cent in 2012), compared to a meager 1.0 per cent for the developed markets (using actual exchange rates).

31. **The catching-up process can actually run for many years to come because average per-capita incomes are still only at 18 per cent of OECD levels**. Investors should bet on companies which are doing well in this part of the world – such as scores of German, American, Japanese and Korean exporters – or, if they can control the risks, put their money directly into emerging stock markets. The combination of cheap, plentiful and often skilled labor with modern technology produces extraordinary growth rates.

32. For a while, **the future of the Chinese economy has been a big worry. No more**. Real GDP growth which had "declined" to around 7 per cent annualized at the middle of last year, is generally expected to be in the order of 8 per cent in 2013 while nominal GDP will be up by about 11 per cent year-on-year and reach €6,250bn (US: €12,300bn, euro area: €9,600bn). In absolute euro terms, China's 2013 addition to nominal GDP is larger than the GDP increase of the US and the euro area combined. Industrial production is running at 10.1 per cent year-on-year. China's demand is by far the most important determinant of commodity prices – and has been a major reason why German exports are doing so well.

33. **The Chinese leadership is trying to wean the economy from its reliance on exports.** The exchange rate has been kept stable for more than one year now in order to protect the country's international price competitiveness, but exports are struggling nevertheless, especially those to the US and Europe where tight fiscal policies are retarding growth.

34. **China's real policy rates are deeply negative, and total credit growth is in the order of 20 per cent.** Both the savings and investment ratios are in excess of 40 per cent, which is a very solid base for further strong long-term growth. Given that consumer price inflation is presently only 2.0 per cent year-on-year, annual retail sales growth of 14.9 per cent and fixed asset investments of plus 20.7 per cent in November are signs that the transition is working: the domestic economy is successfully picking up the slack left by sluggish foreign trade. The **main risk** at this point seems to be the ongoing reduction of the duration of corporate and local government borrowing, and the rise in shadow banking. Lenders are getting risk averse, it seems.

35. **As to the rest of the emerging world, the picture is generally less rosy.** The weakness of demand in rich countries is leaving its skid marks, and the switch from export to domestic demand is generally not as easy as in China. **Especially central and eastern European countries are suffering** from the euro area recession next door. Excluding Russia (real GDP y/y: +3.0 per cent) and booming Turkey (+3.9), the region will expand by somewhat less than 2 per cent. Even Poland, the most resilient country of the group so far, seems to be slowing to a disappointing rate of only 1.5 per cent.

36. **The main Asian countries outside of Japan and China continue to expand briskly**: India 5.6 per cent, Indonesia 4.5 per cent, Korea 3.0 per cent. Catching-up processes are mostly based on sound fundamentals and can last for a long time. For the same reason, Latin American countries are also doing quite well: Mexico 3.4 per cent, Brazil 3.6 per cent.

commodity prices well supported

37. Since global growth continues at about the same rate as in 2012 there is **no reason for commodity prices to move dramatically up or down from present levels.** The Goldman Sachs Commodity Index has fluctuated in a range from 560 to 760 for two years now, well below the 890 mark it had hit in July 2008. It is now at 647.

38. **The world economy's structure of growth is tilted much more toward commodity-intensive industrial production than in earlier decades when rich service-oriented countries dominated the scene.** Catching-up means that people are mostly demanding goods that they can touch before they buy services (although some of these can also be energy and commodity intensive). So this will be an enduring feature, supporting the prices of oil, iron ore, copper and so on, as well as of food that benefits from rising household wealth in emerging and developing markets where 85 per cent of the world population lives.

39. **Summing up, I would draw the following conclusions:**

- buy equities which benefit from strong growth in Asia and Latin America
- avoid equities that are driven by consumer demand in rich countries
- buy euro area banks (a risky trade)
- underweight cash (near-zero interest rates!) and high-quality bonds
- overweight sovereign bonds from the euro area periphery
- sell yen against euro and dollar
- the euro could surprise on the upside against the dollar, following further progress toward a banking union
- corporate bonds in OECD countries are well supported by firms' sound financials
- oil will be on a slight down trajectory (cheap LNG as an attractive alternative)
- gold will also trend down (no significant inflation risk, euro survives)